SOUND BUSINESS OR DEVELOPMENT INSTRUMENT

Gert van Maanen

MICROCREDIT

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SGO Uitgeverij - Hoevelaken

Oikocredit and ICCO in microfinance

Oikocredit is one of the world's largest private capital providers for microfinance. In a number of cases microfinance organisations are supported in cooperation with ICCO, the largest Protestant development agency in the Netherlands. This cooperation makes it possible to enable microfinance organisations to reach out towards clients in difficult areas, to maintain a strong developmental agenda and to reach sustainability in the course of time.

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Preface

It is with great pleasure that we introduce this publication about microfinance written by our friend Gert van Maanen, former Managing Director of Oikocredit and former vice-chairman of ICCO.

Microfinance is a relatively new term, but as a concept it is well established. Oikocredit has supported microenterprises and financial intermediaries for the past 29 years, partly in alliance with ICCO. During his many years at Oikocredit Gert van Maanen has followed the developments within the global microfinance industry from the front line. He has witnessed the tremendous growth that microfinance has experienced in various parts of the world; he has been inspired by the impact a small credit can have on the lives of the marginalised; and he has been and is very concerned when their only source of credit is greedy moneylenders.

Why is microfinance getting so much attention these days? Is it because it is a great business based on social responsibility? If one agrees with the Nobel prize winner Milton Friedman, it is not. 30 years ago Friedman said: "There is one and only one social responsibility of business: to use its resources and engage in activities designed to increase its profits". Since that time much has changed. And people, organisations and businesses increasingly realise that business has many responsibilities in addition to the creation of shareholder value. The reason microfinance gets so much attention is that it works. It works to reduce poverty by providing millions of marginalised people with opportunities to find the means to survive, and by providing them with hope for the future.

In this publication Gert van Maanen describes what he refers to as the two different schools of thought in microfinance. One is primarily development-oriented and the other is more commercially-oriented. Both schools have their advocates. Is one better than the other? Do we have to chose between them, or can the two schools be combined and strengthen one another to achieve better results - to the benefit of all stakeholders? Amongst other questions he raises are: On what terms should marginalised people be given banking services? Should the terms be subsidised or cost-related? Who should subsidise? Should the microfinance institutions aim at sustainability and, if so, how much time should they be given to reach that level? Gert van Maanen discusses these issues in his own colourful and inspiring way. His views are his own, developed over many years both in and outside his life with Oikocredit, and they show a strong commitment to microfinance as an essentially effective instrument to empower the marginalised.

Whatever views one may have on microfinance, we warmly recommend all those interested in the sector to read this document. It is an important contribution to the discussion on the role and impact of microfinance. The reader gets a good insight into the two schools of thought, and into the challenges the microfinance industry currently faces on a global level. It is a good basis for discussions, seminars and workshops on microfinance, and it provides many thoughts and ideas for the future development of the sector.

Amersfoort / Utrecht, the Netherlands, September 2004

Tor G. Gull
Managing Director, Oikocredit

Jack van Ham
General Director, ICCO

Introduction

Introduction

Since the first Microcredit Summit in Washington in February 1997, microcredit has blossomed and captured the attention of the development world and beyond. That attention is fully justified because microcredit has proven to be one of the most effective instruments in reaching the very poor. Especially the poor in the informal sector, who - in the absence of formal structures - are difficult to reach through other development instruments.

In underdeveloped countries it is within this informal sector that up to 70% of the population, and close to 100% of the poor, try to survive. It is the people in this sector whose daily life is hardly touched by the economic paragraphs in official development aid programmes. These paragraphs primarily focus on the development of the formal sector: businesses, banks, export companies etc. At best they devote additional attention to the SME sector (Small and Medium size Enterprises), which operates at the lower level of the formal sector. Economic initiatives below that level are in most cases beyond the scope of policy makers. They look at poverty as a macro problem of underdevelopment and come up with macroeconomic approaches - such as internationalisation, liberalisation and privatisation - which focus on the formal economy. Sometimes they recognise in general terms the existence of an informal economy, but usually find it too informal to give it a formal place on their agenda.

That was the case with the Structural Adjustment Programmes of the IMF and World Bank in the last decades of the 20th century. It also applies to most of the Poverty Reduction Strategy Papers (PRSPs), which set the tune today.[1] In spite of their stronger focus on the poor, they devote surprisingly little attention to the challenge of how to enable income generation in the informal sector, although that is the day-to-day context in which the target group of the PRSPs, the poor, have to survive. Even the Millennium Development Goals, the all-encompassing approach decided upon in 2000 by the United Nations' Millennium Assembly, fail to mention the informal sector, leaving aside the need for instruments to foster income generation in this sector.[2] Of course, poverty reduction is impossible without education and proper health services, but at the end of the day poverty reduction is about better prospects for the generation of income.

> After his retirement as professor of gynaecology at Madras University, Prof. Wilson started to run the medical clinic for the students and staff of Karunya Educational Trust. He added a maternity ward for the poor in the neighbourhood. He showed me five incubators for premature babies, because - as he told me - most of the newborn babies of the poor are premature or underweight. *"We keep them here for some six weeks,"* he said. *"Then they are strong enough to be handed back to their parents, but in fact we hand them back to a situation of near starvation. Unless we can enable their parents to earn income. So we started five income-generating projects. Without that, our life-saving work for these babies hardly makes any sense…"*

Worldwide poverty is of course a macroproblem, but it manifests itself at a microlevel in the lives of millions of individual people and their households. Poverty reduction requires more than macroeconomic designs. It requires that instruments are put in place to enable the poor in the informal sector to earn a *living* in the exact meaning of that word, and to do so in a sustainable manner and in a less strenuous and unpredictable setting. It requires instruments that are tailored to the needs of people for whom there is no chance whatsoever of being employed in the formal sector, with a regular income, job security etc. In this area the microcredit organisations have proven their relevance, as allies of the individual poor, focused on their specific needs and potential.

Oikocredit currently finances some 160 of these allies of the poor - Microfinance Institutions (MFIs) in Latin America, Africa, Asia and Central Europe - with a total outstanding loan portfolio of 55 million euros.

Oikocredit is an ecumenical development cooperative society founded at the initiative of the World Council of Churches in 1975 as alternative investment instrument for churches, designed to operate closer to the values of the Sermon on the Mount than to Wall Street.

It is financed with share capital of more than 500 churches worldwide, some 23,000 local congregations and individuals, 32 project partners that fulfilled their obligations for more than 5 years and - through a separate Share Foundation for non-church investors - some 50 banks, development organisations, trade unions etc. such as ING Bank, Rabobank, Triodos, ASN Bank, Novib, Grameen Bank, CNV, FNV etc.

The total share capital stands at present at 192 million euros and has a yearly increase of about 15 million euros. More than half of this share capital is made available to more than 380 projects in the South and in Eastern Europe. The remainder, including funds that are allocated but not yet disbursed, is invested in secure bonds to supplement the income and reduce the risk.

Since 1989 Oikocredit has paid 2% dividend to its shareholders, with the exception of 1998 and 1999 when the dividend was only 1% as result of the Asian currency crisis.

Oikocredit's Headoffice (the International Office) is in Amersfoort, the Netherlands. It has 11 Regional Offices and 8 Country Offices in the South and the East, staffed with local professionals, no expatriates. The Board consists of 15 members, of which 9 from the South. The majority of the membership, and therefore the voting rights, is in the South.

For more information on Oikocredit, see www.oikocredit.org.

With a further 56 million euros, Oikocredit finances 220 other income-generating projects such as coffee processing plants, weaving cooperatives, rural cooperatives, fishing boats etc. This makes Oikocredit the largest equity-financed funding agency for unbankables.[3] So far, only two of the MFIs in its portfolio have failed, primarily as a result of the Asian currency crisis. The others are growing in size and effectiveness, offering more than three million poor families *"a lifeline out of the poverty trap"*.[4]

This publication deals with the lessons Oikocredit has learned in the course of almost 30 years financing MFIs, with special focus on the debate in microfinance circles concerning the issue of sustainability versus outreach. At the end it makes some recommendations to set the tune for 2005, the year the United Nations have designated as Microcredit Year. That should be the year for a major leap forward.

I am grateful to all experts from the microcredit world that shared their experience and views with me. Muhammad Yunus from Bangladesh, who opened my banking eyes to the relevance and potential of microcredit as an effective instrument in serving the poor. Partners in the field, such as FIE and ANED (Bolivia) and SHARE (India), the SACCOs in Kenya, the cooperative banks in Uruguay, Banco de Desarrollo and Propesa (Chile), and the BPRs in Indonesia etc. My former colleagues in Oikocredit, above all my predecessor Douglas Brunson (USA), who identified MFIs as relevant partners in reaching the poor; Stanley Mills (Uruguay), the "godfather" of the Oikocredit operations in Latin America; the Regional Managers who fostered and nurtured the relationship with MFIs, such as Leonel Roland (Uruguay), Lavinia Camacho (Chile), Teresita Murillo (Costa Rica), Lourdes Ledesma and her predecessor Sally Bulatao (the Phillipines), Kathure Mwenda (Kenya), Muriel Holdbrook Smith (Ghana) and Mariam Dao (Côte d'Ivoire). This publication was not written for them. Each and everyone of them could have written their own one, with more in-depth experience.[5] I hope that this publication will stimulate them to do so.

It was also not written for Erik Heinen or Ben Simmes (the Netherlands), Mina Ramirez and Delle Tiongson (the Phillipines), Pete Ondeng (Kenya) or Zanele Mbeki and Peter Roussos (South Africa), Bambang Ismawan (Indonesia), Vorakit Kantakalung (Thailand), Udaia Kumar (India) or Pilar Ramirez (Bolivia), Xavier Reille (CGAP), Deepa Narayan (World Bank), Damian von Stauffenberg (Microrate), Maria Nowak (Adie), Muhungi Kanyoro (ECLOF), Phyllis Kibui (WWB, and now the Oikocredit President), Lars-Olof Hellgren (Swedish Development Fund), Ken van der Weele (Opportunity International), Michael Chu or Enrique Ferrero of Acción International, Sam Daley Harris (Microcredit Summit), Cor Wattel (ICCO), Henk Moll (Wageningen University), Charles Ruys (Rabobank), Johan de Waard (DGIS), or Grzegorz Galusek of the Microfinance Centre in Warsaw. I benefited greatly from their experience, skills and down to earth commitment; and from the lessons they learned and then shared with me.

For whom is this story then? For people who know less, but start to take on responsibilities in the field. Either as a board member or staff member of MFIs in the South,[6] or as a board member or staff member of donor organisations or funding agencies in the North. It is also written for my former colleagues from the banking world, to show them that there are vital and viable banking activities beyond regular banking, and that it is much more rewarding to enable poor people to earn a living than to make rich people richer. Finally it is written for all those policy makers who are defining the context in which poverty is going to be reduced. Of course, except where I quote others, the conclusions and the opinions are mine. Including the ones that might be wrong or could be better.[7]

Voorburg, the Netherlands, September 2004

Gert van Maanen

1 *See: Pro Poor Growth, An Analysis of Poverty Reduction Strategies, AIV (Advisory Council on International Affairs), Ministry of Foreign Affairs, The Hague, 2003*

2 *See for an extensive outline of the Millennium Development Goals: Human Development Report 2003, UNDP, Oxford University Press 2003. See for a positive critical analysis of strengths and weaknesses of the MDG approach the inaugural address of Prof. Dr. Jan Pronk, Collateral Damage or Calculating Default, The Hague, Institute of Social Studies, Public Lecture Series 2003, no. 3.*

3 *A CGAP study of January 2004 finds that of the 1.15 billion dollar invested in microcredit, 1,025 is from public funds and only 125 million from private funds. Oikocredit signs for 40% of this amount.*

4 *Most of these MFIs have more funding sources. Consequently, their outreach is not the result of Oikocredit's support only. If the average outstanding loan is 100 dollars, Oikocredit's 55 million counts for 550,000 families.*

5 *So far only Leonel Roland did so, in "A Ship in the Mountains", Montevideo, 2001. An impressive account of 'walking a second and a third mile' with the very poor in Bolivia.*

6 *In this publication I use the word South for all developing countries or societies, whether in Latin America, Asia, Africa or in Central Europe and the former Soviet Union. Before the fall of the Berlin Wall, the last two used to be called the Second World. Since the demise of the Sovjet empire the expression lost its meaning, when millions of people experienced the disintegration of their societies and the deterioration of their living conditions. The Third World became part of the Second World. The North is used for the OECD countries.*

7 *Comments will be highly appreciated. They can be mailed to gvmaanen@oikocredit.org.*

Banking the unbankables

Banking the unbankables

Microcredit, or microfinance, is about banking the unbankables, bringing credit, savings and other essential financial services within the reach of tens - or rather hundreds - of millions of people who are too poor to be served by regular banks, in most cases because they are unable to offer sufficient collateral. For banks that is a valid reason to refuse credit.[8] Quite often they do that also because the loan amounts are too small and therefore too expensive to handle. In general, banks are for people with money, not for people without. Banks are not for slum dwellers and for people who can't read or write. They must look elsewhere for allies.

> In the field, MFI practitioners make no sharp distinction between microcredit and microfinance. Originally the concept of *microcredit* was used for very small loans to poor individuals, to finance 'income-generating investments' such as a cow, a rickshaw, a small stove to make tortillas or trading stock for street or market vendors. When MFIs started to add other financial services such as savings (and later insurance), the concept of *microfinance* was introduced to make it clear that the product range was broader than just credit. *Microfinance* is also used for larger loans for small businesses, such as tools and equipment for a repair shop, trading stock for small shops or a second hand combi-car. There is, however, no sharp line dividing the two. MFIs are free to use the label they want. From a management point of view the distinction is relevant, because in the case of larger loans and a wider range of financial services, the staff of the MFI needs to have more banking skills than in the case of microcredit only.

Credit for unbankables is not a new concept. The first name that comes to mind is that of Friedrich Wilhelm Raiffeisen, the son of a German church minister who became mayor of the small German city of Weyerbusch. He was triggered by the fate of small farmers during the famine of 1846/1847. They badly needed credit to climb out of their poverty and had no access to normal banks, but only to moneylenders who charged usurious rates. He convinced these farmers to take their future into their own hands, to form small cooperatives, to pool their savings and to convert them into loans. One is inclined to say *"as simple as that"*, but it was not that simple. Raiffeisen saw that the famine had wiped out these farmers' savings, and that their credit needs were much larger than their short-run savings capacity. Consequently he convinced richer people in the area to add their savings to those of the poor, while nonetheless not taking control. The cooperative principle of *"one member, one vote"* kept the control in the hands of the poor majority.

It took Raiffeisen twenty years before the first cooperative credit union could start operating. The success of this initiative laid the basis for hundreds and later thousands of credit cooperatives owned by the poor themselves. First in Germany. From there it spread all over Western Europe[9], Eastern Europe[10] and even Japan. German immigrants took the concept overseas to the USA, Canada and Latin America, where the name of Raiffeisen is still remembered with awe and respect…[11]

A century later, after World War II, the picture was different: the credit unions in Eastern Europe had gone under, whereas most of the Raiffeisen bodies in Western Europe had united into larger cooperative banks that became the largest financers of agricultural development. However, because they had become successful regular banks, their original focus on 'unbankables' gradually diminished, if only because they had proven that farmers that united in cooperatives were creditworthy and therefore bankable.[12]

Outside Europe, it was - and still is - the credit unions that continued to serve their members according to the original concept.[13] However, with an average membership of a few hundred, they were relatively small and inclined to confine themselves to the inner circle of their members. Few of them had outside funding, and their capacity to give credit to their members was limited to the savings capacity of their other members. This meant that the Raiffeisen drive to serve unbankables with credit had come to a standstill.

New initiatives were few except those arising in the third world, where poor people have developed their own ways and means of supporting one another. In most cases these initiatives involve rotating credit schemes, where members of small groups pay a small amount every week (or sometimes every day), and each of them in turn receives the entire amount. To buy what is needed or to invest in income-generating activities. These rotating schemes are called Tontines and Susus in Francophone Africa, Stokvels in South Africa and Rosca's in Anglophone countries such as Kenya, India and Bangladesh.

Such Roscas (Rotating Savings and Credit Associations) became the answer of the poor to help themselves in a society in which they had no other allies. Roscas enabled the poor to get once a year, or once every few months, the entire amount the members brought together in small contributions in one week. They took many different forms: in most cases every member gets the weekly amount in turn; in some cases the group decides from time to time whose turn it is; or that choice is made by lottery; or the members bid for the amount by offering an amount to be deducted and to be distributed to the other members. Membership of a Rosca enabled people to buy items their own weekly family budget would not allow for.

> Stuart Rutherford gives an extraordinary example of the creative way the Rickshaw Roscas in Dhaka (Bangladesh) work[14]: *"Poor men are driven from villages by poverty and come to Dhaka where the only work they can get is to hire a rickshaw for, say, 25 taka a day and hope to earn 100 taka a day. Groups of them get together and agree to contribute 25 taka a day to a kitty, which is held by a trusted outsider. When there is enough in the kitty to buy one new rickshaw, this vehicle is bought and distributed by lottery to one of the members. The process continues until everyone has his own rickshaw. They have learned how to adjust the number of members, the daily contribution and the intervals between rounds to best suit their cash flow and the price of a rickshaw. One of their finest innovations is that once a member has won his rickshaw, his contribution doubles to 50 taka. There is natural justice in this, because he doesn't need to pay to hire one and is therefore*

not worse off. It is seen as a fair way to compensate late winners for their long wait. But the device has two other effects. It shortens the length of the Rosca cycle because by the time half of the members have won their rickshaws enough extra money is coming in each day to reduce the waiting time for the others by one third. And it gives winners an incentive to pay up and finish the cycle quickly, so as to hasten the day they can enjoy the full income for each day's work".

Nonetheless, when the world started to put development on the international agenda after World War II, there remained a lot of empty space between the economic strategies of the major development bodies, such as the World Bank, and the initiatives of the poor themselves. Donor organisations concentrated on other aspects, such as health, education and community development, but - except in the case of rural finance - very rarely on income generation. It was not until the 1970s that a number of initiatives were taken that focussed on the needs of unbankables to earn income.

- In 1973, four committed Americans established the South Shore Bank in Chicago (now called the Shorebank) with a clear focus of becoming an ally of the poor in that city. Within a few years the Shorebank became an example of community banking with total disbursements since the start of 600 million dollars. The success of the Shorebank in serving the poor with a different banking concept motivated them to move to developing countries as well.

- In 1975, the World Council of Churches decided to launch the Ecumenical Development Cooperative Society EDCS, now Oikocredit, as a worldwide cooperative of churches and church-related institutions to invest in the income generating initiatives of the poor themselves.

- In 1976, Muhammad Yunus started the first Grameen outlet in Bangladesh. Highly systematic and innovative, it became the benchmark for hundreds of MFIs worldwide. Today Grameen serves over 2.4 million poor people in Bangladesh not only with credit, but also with a range of other financial services.

- In 1979, a group of ten women who had attended the UN Women's Conference in Mexico City launched Women's World Banking as an international network to promote women's participation in the economy. Today WWB has 26 affiliates around the world with close to 600,000 clients. WWB provides them with training and best practices.

- Preceding these four promoters of credit for the poor, Acción International was founded as early as 1961 and has since achieved substantial growth. Acción is currently the leading back-up institution for microcredit in Latin America.

In the 1980s and 1990s, these five institutions were joined by many others, such as FINCA, the "inventor" of village banks, Opportunity International, Catholic Relief Services, HIVOS, GTZ, Oxfam and others. All these organisations have put the provision of financial services to unbankables high on their agenda, and have supported MFIs designed to provide credit to the poor.

In the same period a number of MFIs rose to the occasion and impressed both the donor and the financial world with their results. Three countries in the South took the lead: Bangladesh (with Grameen, BRAC and ASA), Indonesia (with the Unit Desa Scheme of the Bank Rakjat Indonesia, the Bank Kredit Desa and the many BPRs (Bank Perkreditan Rakjat - Peoples Credit Bank)[15], and Bolivia (with Bancosol, FIE and Sartawi). In most of these cases, these MFIs were the result of authentic Southern initiatives, designed and perfected by visionary people in the South. They were not based on blueprints made by experts in the North, as so often is the case with development initiatives that are overseas-financed.

Experts from the North entered the scene at a later stage. An increased awareness that microcredit was a relevant instrument in addressing the needs of the poor led to the first Microcredit Summit in Washington in 1997. At that time more than 600 MFIs participated in the summit. Since then the number of participating MFIs grew to more than 2,000 in 2003, serving together more than 50 million clients.[16]

These figures prove that microcredit is not a temporary brainwave of a few prophets which - like a comet - attracts a lot of attention before being replaced by another concept and fading away. Microcredit has established itself firmly on the development map as an innovative and effective instrument. It is here to stay, to grow and to improve.

The Grameen approach

There is no doubt that microcredit in its present form got a tremendous boost from the Grameen approach in Bangladesh that was "invented" and designed by Prof. Muhammad Yunus. This is not the place to describe the Grameen concept in detail, but it does have some basic characteristics that differ from the way normal banks operate.[17]

(a) Yunus realised that 'the poor' are not poor in all aspects of life. It is true that they lack money, but they are not poor at all in survival skills, in the love for their children, parents or animals, or in their existential commitment to keeping them alive. Moreover, they have skills richer people don't have:

- They listen and observe attentively because they cannot read; all the information they need to survive comes to them via their ears and eyes.

- They know how to survive under circumstances where other people would die;

- They know how to recycle waste into marketable goods;

- They know what solidarity is, not as an ethical concept but as a survival concept. Because *"if I don't share part of my rice with you today, why would you share part of your chicken with me tomorrow?"*

(b) They have no tangible assets that could serve as security for bank loans. But they do have pride and don't want to be shamed. Yunus turned this pride into a bankable asset by introducing the group-lending concept: five women per group, who guarantee the repayment of the loans given to all the group members. As long as one of them is in default, none of the others will get a new loan. Consequently, it becomes in their joint interest that no one defaults.

Regular banks work with a Damocles sword concept: *"If you don't repay we'll take your collateral…"* Grameen works with a 'carrots and sticks' concept. The carrot is that in the case of faithful repayment by all group members new loans can be obtained. The stick is that in case of non-payment the carrots for all group members are suspended.

(c) Before a loan is given to the first two group members, the groups start with a compulsory saving scheme of one taka per member per week.[18] Not to provide Grameen with extra capital, but as a kind of psychological test that these future borrowers - in spite of their poverty - have the mental strength to put money aside. Moreover, they pay 5% of the loan into this collective saving fund. This collective saving is owned by the group and serves as buffer in case of individual default. They can also decide to lend from this fund to one of the group members at an interest rate set by themselves.

(d) The weekly repayments take place in group sessions, when six groups meet with a staff member of the local Grameen branch. Halfway through the meeting, six group chairpersons come forward to repay what their group is due. Defaults are therefore visible to all. Their pride leads to the existential wish to prevent the shame of default. This has resulted in an extraordinary high average repayment rate of 98%. Which proves the point: that these people, in spite of their poverty, are bankable. In fact they have a better repayment record than many "bankables" in Bangladesh.

One may ask whether this form of peer pressure is not too much. The answer is: thanks to this peer pressure the system works and serves at present more than 2.4 million people (95% women).

(e) The loans have to be invested in a specified income-generating asset. Once a loan is approved and disbursed, no further approval or disbursement of loans to other group members will take place before it has been verified that this asset has been bought.

This implies that if the borrower's husband takes the money and wants to use it for other purposes, he will be under heavy pressure from four other women and their husbands to return the money to his wife, or else… In poor rural communities this peer pressure works.

(f) By introducing the group concept and banking on pride, Grameen solved two vital banking problems in one stroke:

- The selection of group members is done by the members themselves, who have a better view of the trustworthiness and discipline of their peers than any bank manager could have;

- The collection task is transferred to the group themselves. They do in a solidarity context what otherwise bank managers have to do in a hostile context.

(g) Grameen also filled two empty slots in these women's lives:

- By bringing them together in groups that sign for each other and support each other, Grameen contributed substantially to the internal cementation of the society. The song *"You never walk alone"* became a reality in the lives of many women. In their view this peer support has much more meaning than the peer pressure.

- During the weekly group sessions much more is done than the collection of loans: they start learning to write their name and in that way to reach the identity that is required to sign the loan contract. Furthermore they are trained in literacy, hygiene, child care, animal care, marketing, voter education and other life skills.

(h) Grameen Bank is focusing on the real poor, the bottom 20% of society. Contrary to normal banks they don't check whether people are rich enough to qualify for a loan, but whether they are poor enough… They do that through a so-called *'negative asset test'*. One of the criteria is that applicants are not admitted if they own more than 0.5 acre of land, just enough to have a small house or shack and one cow.

The proof of the pudding is in the eating. The mere fact that 2.4 million borrowers (more than 90% of them women) have an outstanding loan portfolio of 13 billion taka (= 225 million US dollars) with a repayment rate of 98%, taken together with thousands of individual case histories, prove the point that the Yunus concept is effective.[19] Impact studies have shown that half of these 2.4 million borrowers have crossed the poverty line in the course of their Grameen membership.

Moreover, this innovative approach has proven to be extraordinary relevant in a context where women are often in a much more vulnerable position than men on at least three counts: by being a woman, by being a wife and by being a mother, without any option to shelve any of the obligations that follow from these facts of life. This programme enables them to straighten their back and to replace their subordination with recognition by their husband and children, by their peers, by Grameen and by their village.

Could it be more effective?

Of course, it would be unwise to assume that what Muhammad Yunus has started is the end of the development of microcredit. That has been proven by hundreds of institutions that followed in Grameen's footsteps, with other and more refined instruments,

in and outside Bangladesh. Also Grameen itself is in an ongoing process of adaptation and evolution.
One of the examples is SHARE in India[20], which introduced the rule that members that have repaid two productive loans (of 5,000 and 6,000 rupees[21]) qualify for a third loan of 8,000 rupees plus a non-productive loan of 10,000 rupees to upgrade their houses. Provided of course that no-one of the other group members is in default. The carrot of the housing loan brings the husbands around as firm supporters of the scheme and of the required discipline.

Moreover, SHARE has taken out an insurance scheme that covers default in the case of death and disability, and therefore protects the other group members against *force majeure* striking one of them.

> In 2000 I visited one of the branch offices of SHARE near Hyderabad to get a personal impression of the way they operate. Seven staff members in their early twenties explained to me how they worked. When I asked them to show me an individual file to see how they handled the 'negative asset test', they picked at random the file of a family of four (mother, father, two daughters of 11 and 13). Their assets were carefully written down: one table, four chairs, some pots, no beds, no radio, no bicycle, no x, no y, no z, ending with the conclusion: *qualifies!* Then I looked at their income: father 3,500 rupees, mother 2,500 rupees, together 6,000 rupees. At that time about 150 US dollars. Then I saw: not per week or per month, but per *year*. It flashed through my mind: the World Bank and UNDP talk about one dollar a day as absolute poverty line. For these four people there was only *ten dollar cents per day*. How on earth had these two parents been able to keep these two daughters alive? And I remembered Yunus: *"Under circumstances where my children and I probably would have died…"*
>
> I asked the staff: *"How do you justify to give these people a loan of 5,000 rupees? How can they ever repay that amount? Are you sure that you don't push them down below the level where they can survive?"* *"No,"* they said, *"no problem, she is paying on time and their family income has grown."* *"What kind of income-generating investment has she financed with these 5,000 rupees?"* I asked. The staff opened another file and said: *"A cow. Please look at this monthly report: the cow gives milk that is sold for some 30 rupees a day. That is some 10,000 rupees per year. She repays us 5,000 + 1,000 interest and has 4,000 extra to feed her children."* *"But why does she repay those 6,000 rupees,"* I asked, *"instead of buying more food for her children and herself?"* Amazement all over the place. *"Because,"* they said, *"she wants a second loan. If you can keep one cow alive, you can keep two cows alive, or even three. Next year she does not need to repay the first loan, so her income will rise to 16,000. By taking out a second loan and buying a second cow, her income will rise to 20,000 and in the third year to 26,000. No, she will never default. And if she or if the cow dies, the remaining amount is insured."*
>
> *"How much money do you manage in this branch?"* I asked. *"12 million rupees, that is 300,000 dollars"* they replied. Seven people in their twenties, I thought. Which bank would entrust 300,000 US dollars to such a group? *"And your repay-*

> *ment rate?"* I asked. *"100%,"* they said, *"and we did not need to claim under the insurance."* Other question: *"Please tell me what was the major mishap that occurred last year? A mishap that rocked the boat of the system or of your trust?" "Mishap?"* they asked. *"We wouldn't know of any mishap, except that our computer broke down. So for the time being we take notes again. But in our lending operations…? No, sir, why would there be a mishap?"*
>
> Last question: *"Are you sure that not one of your borrowers is going to a loan shark to get the money to repay you?" "We cannot be 100% sure, but we don't believe there are many. Because most of them know from own experience or that of others, that loan sharks prevent you from growing, and what we see with our own eyes is growth."*

So much for effectiveness. Of course, one could investigate one or two layers deeper. With evaluation teams and impact studies. No doubt, they will find that not all clients can cope and that not all clients are satisfied. Even with these loans their life is strenuous and difficult. But that does not take away that microcredit schemes, such as SHARE, are far more effective than any banker, policy maker or development expert could have believed fifteen years ago.

It is these case histories that have opened the eyes and the minds of policy makers to give fully-fledged support to microcredit as an effective instrument for the self-development of people who are believed too poor to be part of the formal economy.

Some experts believe that microcredit cannot reach the very poor at the bottom of society. They need food, skills training and employment generation rather than debt.[22] The example provided by SHARE contradicts that belief: very poor people can benefit from microcredit programmes, provided they have the existential wish and drive to climb out of the poverty trap. Against all odds. Some are too tired and too demotivated to do so and have lost all belief in their own capabilities. However, more than books and seminars and speeches, it is the example of successful neighbours that sparks the hope that it is within their reach as well. As from that moment on they can be assisted by dedicated MFIs.

Credit is not a new concept

As mentioned before: credit is not a new concept among the poor. For example, the millions who are not linked to Credit Unions, Roscas or Tontines, often borrow money from relatives or friends, and sometimes substantial amounts, to pay for proper funerals or proper weddings in accordance with local traditions. Sometimes they have no option but to go to moneylenders or loan sharks. Once in the hand of real loan sharks it is extraordinary difficult to get out of their grip: they siphon off the borrower's earnings and keep them at survival level.

There is a difference between a "normal" moneylender and a loan shark.

A *normal moneylender* runs a kind of regular lending business and charges his clients a uniform interest. In most cases, the interest is deducted from the principal amount at the outset. Borrowers sign for 1,000, receive 850, and repay 1,000 in ten weeks (= 35% interest paid in ten weeks, which equals 180% on a yearly basis).[23]

In Northern eyes such an interest rate seems horrendous. In the eyes of many poor it is acceptable, especially those who are engaged in street or market vending. Each week during these ten weeks they buy goods to a value of 850, which they then sell for 1,200. After paying the moneylender 100, they take 250 home. Of course, this 250 is not guaranteed and depends on their capacity to sell for 1,200, but that is the risk they take.

If they would be able to borrow from an MFI at a yearly rate of 20%, they would take home some 340, or could afford to sell for 1,100 and still take home 240.

A *loan shark* looks at the earning capacity of individual clients and sets the rate at such a level that these earnings are to a great extent siphoned off. In 1997 I asked one of these loan sharks, who charged an interest rate of 25% per day from a market-vendor, why he was not satisfied with 15%? *"Why should I?"* he replied, *"Look, she is willing to pay that 25%." "Okay,"* I said, *"but why aren't you charging her then 30% or 35%?" "No,"* he laughed, *"that would make no sense, because in that case she would stop working."*

Other loan sharks go even further. They set the loan and the interest rate at such a level, that the borrower is bound to default. At best he can pay the interest, but never settle the principal amount completely, which keeps him and his family hooked for years. With all kinds of strings attached, such as the obligation to sell his produce to the loan shark below market price, up to bonded labour for himself, his wife and his children.

It sounds pathetic: children, bonded labour. Until you see it with your own eyes. In 1998 in Tamil Nadu, where Ravichandran, then Regional Manager for Oikocredit India, showed me a housing project for poor people. In the fields, some 50 meter from the site of the project, was a small open-air school under a tent. Fifty children and two teachers, shouting from the top of their lungs 3x3 = 9, 4x3 = 12! 250 meters away I found five children, aged 5 to 11, chipping stones in a quarry under the blazing heat of the sun. I returned to the school and asked the teachers *"Can't you include these children in your class?" "No,"* they replied, *"we tried, but these children are under contract. Signed by their father. When the children and the father are at work, the loan shark goes to the mother and gives her a new sari. That evening he adds a new amount to their debt."* Where is the MFI, I thought, that will refinance this debt and set these children free?

Of course, one could argue that the real solution for the poor is to boost the growth of the Credit Unions, Roscas and any similar initiatives of the poor themselves. The difference with microcredit is, however, that the *lending capacity* of such schemes is lim-

ited by the collective *saving capacity* of their members. Microcredit schemes bring in money from outside, which enables them not only to look at the saving capacity of their clients, but also at their *earning capacity*. Like regular banks do all over the world.

There is a permanent debate going on in development circles as to whether development of the poor should start by inducing/enabling them to pool their savings. This is based on the premise that a saving facility is one of the first essential services needed by the poor. Not because they have much to save, but because they need a safe place to put their savings, safer than hiding them under their pillow. In India, for example, there are trusted people that offer such savings services. Instead of paying their clients interest, they charge a fee for that service, a fee that the poor are willing to pay.[24] Thus a saving *and* credit scheme solves two of the poor's needs in one stroke: they will no longer have to pay for saving services, and the money is put to use in their own group.

Nevertheless, it is a meagre message to go to the poor and advise them that the solution for their plight is in their own hands, provided they are prepared to save. Whereas those who are better off - in the North and the South - are not judged on their past savings but on their future earnings. The focus of MFIs on the earning capacity of their clients does not reduce the importance of savings, but recognises that economic growth is based on earnings.

Credit is not the same as debt

In that sense it is important to realise that credit is not the same as debt (except in bookkeeping terms). Debt is a burden, sometimes even a millstone around the borrower's neck. Credit, provided it is well structured, is a stepping-stone to a sustainable higher income level. Worldwide, credit is seen as essential oxygen for economic growth. There is no successful business without a credit line and a credit history.

Most house owners in the North have financed their house with a mortgage. As long as they are able to service that loan without a problem, they don't feel burdened by debt at all. On the contrary, they are able to live where they live because the bank has given them credit.

Take that mother in Nicaragua who could borrow 60 US dollars to buy a stove on which she baked eight tortillas a day. One stove, three tables, 12 chairs and she had an open air restaurant. She repaid a few dollars per week and did not feel burdened by debt. She praised the day she could start. Within one year she bought a second stove and put her daughter 'in business' at the next street corner. Earning her own living. Credit as oxygen.

Debt is credit that has turned sour. Making credit available to the poor implies full attention to prevent stepping-stones from becoming millstones. That requires very careful and prudent management, especially because one is dealing with people below the poverty line. For these people failure is a disaster that crushes both self-respect and hope.

Credit to the poor is also more than simply credit. As impact studies have demonstrated, credit - provided it is well structured - leads not only to a higher income level, but also to improved nutrition, clothing and housing. Membership in a proper MFI programme leads to the empowerment of women, horizontal solidarity, lower child mortality, a lower birth rate, more emphasis on education and health care for children, plus greater participation in social and political activities. In short: credit is a door opener that brings a whole spectrum of development within reach. Step by step.

Why credit? Why not grants?

Of course one could ask the question: *"Why assist these very poor people with loans and credit that could turn into debt? Why ask them to repay? Why charge them interest? That mother in India, why don't we simply give her 100 US dollars and wish her well?"*

Some valid reasons:

(a) This mother is not the only one. There are millions of mothers in the same situation. Giving hundreds or thousand of them 100 US dollars brings some temporary relief but will not lead to structural improvement. Nor will it solve the problems of the others. To address poverty in a sustainable manner requires a structural approach that enables poor people to earn an income.

(b) Economic activities, activities that yield more income than expenditure, don't need to be financed with grants, but can be financed with loans, like all business ventures. However, it remains important that the repayment conditions are such that a real increase in the family income is not postponed until the credit has been repaid. *"Working for the bank"* is not an incentive. There must be early benefits for the borrowers.[25]

(c) The major problem for poor people is not their ability to repay a well-structured loan, but rather getting access to credit. No parents with two children and one cow can ever earn enough from that single cow to buy a second one. But - as outlined previously - if they can keep one cow alive, they could keep two alive, or even three. Provided someone looks at their potential earning capacity and gives them a loan.

(d) Why charge interest? If an MFI wants to treat its "unbankable" clients as if they are bankable, interest is a fact of (economic) life. Also in the eyes of these clients. Secondly: in most cases the interest amount is only a minor part of the total cost. Activities that earn enough income to repay a loan but not a normal interest, are not economically sound. Finally: if MFIs would position themselves as agencies that give loans for free, they would be flooded by bankables pretending to be poor. Which would derail their mission and endanger their future.

(e) Loans that can be repaid strengthen self-respect and dignity, much more than handouts and grants. *"Look, this we have achieved ourselves! We even repaid you…*

with interest!" Success, self-respect and dignity are basic ingredients in overcoming the conviction that they and their children are born losers, born to fail. That conviction is like a virus that kills the hope that their children will *ever* have a better life. In fact, what MFIs finance is not a cow, a rickshaw or a toolbox, but hope. The driving force for millions of poor people. Against all odds.

(f) The relationship between the MFI and the client is - unlike that in grant relationships - truly reciprocal and based on mutual dependency. People and projects that depend on grants must plead their case time and again and are forced to act like chameleons to convince the donor to repeat the grant. Grants are also addictive and tend to keep projects grant-dependent. They also put pressure on donors to keep coming up with new grants if they don't want projects to break down. While loans lead to people and projects straightening their back and bearing responsibility for their own future.

(g) Finally, in the case of loans it is the lender who depends on the borrower to get his money back. He is the one who has to nourish the relationship if he does not want the borrower to let him down. In the relationship between "those who have" and "those who need" that is an unusual but very important paradigm shift.

In Oikocredit we observed that the high level of repayment is not so much based on the loyalty of the partners to a Europe-based organisation, but on the loyalty they feel they owe to the Regional Managers who arranged for the loan and made it possible. In Ivory Coast, for example, the Cocoprovi cooperative of market women suffered heavily from internal disputes that lasted for more than a year. During that year Oikocredit was paid, because both parties agreed that the Regional Manager Mariam Dao Gabala should not be let down.

8 *It is not correct to blame banks for such a policy. Banks finance loans with savings and deposits from other clients. It is their duty to prevent that these funds get lost.*

9 *In England it was not the Raiffeisen concept, but the Rochdale movement that set the tune for the development of a strong cooperative movement. The "Equitable Pioneers Society" was started as early as 1844 by 28 poor weavers in Rochdale as a production/consumers cooperative. Their example was followed by hundreds of production and consumers cooperatives.*

10 *Sarah Forster mentions in her report The State of Microfinance in Central and Eastern Europe and the New Independent States, (MFC/CGAP 2003) that only in the Ukraine there were close to 3,300 credit unions (none of them survived the 1919 revolution), whereas in Poland there were some 1,300 at the end of World War II.*

11 *In Uruguay the Cooperative Movement yearly gives the Raiffeisen Award to people/institutions that have boosted the development of cooperative financing. In 1998 Oikocredit received this award in recognition of 20 years of dedicated support.*

12 *Most Raiffeisen banks have, however, started foundations that promote their original mission, such as the Raiffeisen Stiftung in Germany and the Rabobank Foundation in the Netherlands.*

13 *The World Council of Credit Unions has at present more than 40,000 memberorganisations in 79 countries, serving 118 million clients/members. They still work on a solidarity non-profit basis. The profit they make is converted into lower interest rates on loans and higher interest rates on savings.*

14 *Stuart Rutherford, The Poor and Their Money, Oxford University Press/DFID, 2000. A very enlightening study on how ROSCAs and other savings and credit schemes among the poor themselves work.*

15 *In Indonesia instruments to serve the poor with credit were already in place during Dutch colonial rule. Started around 1900, in 1928 there was already a network of some 90 people's banks with a total outstanding portfolio of 68 million guilders and 825,000 indigenous clients with an average loan of 80 Dutch guilders. These banks were supervised by a Centrale Kas, established in 1912. For even smaller credits there were some 6,000 village banks serving 1.1 million people with average loans of NLG 40 as well as the same number of rice banks, where people borrowed and repaid in rice. The repayment rate was as high as 99.6%. The interest rate was around 12%, which contrasted sharply with the rate charged by moneylenders. Under these schemes group guarantees were already introduced as substitute for collateral. Based on the track record of these people's banks, the Indonesian Government was keen to foster the development of credit as instrument to serve the poor. See: A.D.A. de Kat Angelino, Staatkundig Beleid en Bestuurszorg In Nederlands Indië, Martinus Nijhoff, the Hague 1930; Dr. J.C.W. Cramer, Het Volkskredietwezen in Nederlandsch Indie, Diss. 1929; Marguerite S. Robinson, The Microfinance Revolution, Volume 2, Lessons from Indonesia, page 173-175.*

16 *Exact figures are difficult to establish as long as there is no uniform definition of "unbankables" and MFIs. Are unbankables all those who are served by MFIs, or only those who live below the poverty line? Are MFIs only those that concentrate on the very poor, or also institutions that serve them as part of a larger programme? There is no disagreement, however, that 50 million is a conservative estimate. The Microcredit Summit reports more than 60 million of which 40 million were very poor when they obtained the first credit.*

17 *For more information on Grameen: www.grameen-info.org; Muhammad Yunus and Alin Jolis, Banker for the Poor, University Press Ltd. Dhaka, 1997; David Gibbons, The Grameen Reader, Grameen Bank 1992; Helen Todd, Women at the Center, Westview Press, 1996; Susan Holcombe, Managing to Empower, University Press Ltd. Dhaka, 1995; David Bornstein, The Price of a Dream, Simon and Schuster, 1996.*

18 *One US dollar is appr. 60 takas.*

19 *Jonathan Murdoch (Journal of Economic Literature, Dec. 1999) observes that under international accounting standards the repayment rate of Grameen is probably lower than 98%. One of the reasons being that Grameen - at least at that time - took provisions for losses later than other MFIs. Since then Grameen has introduced another provision policy.*

20 See the chapter on SHARE written by David Gibbons in Helen Todd, Cloning Grameen Bank, IT publications, 1996. See also www.sharemicrofin.com.

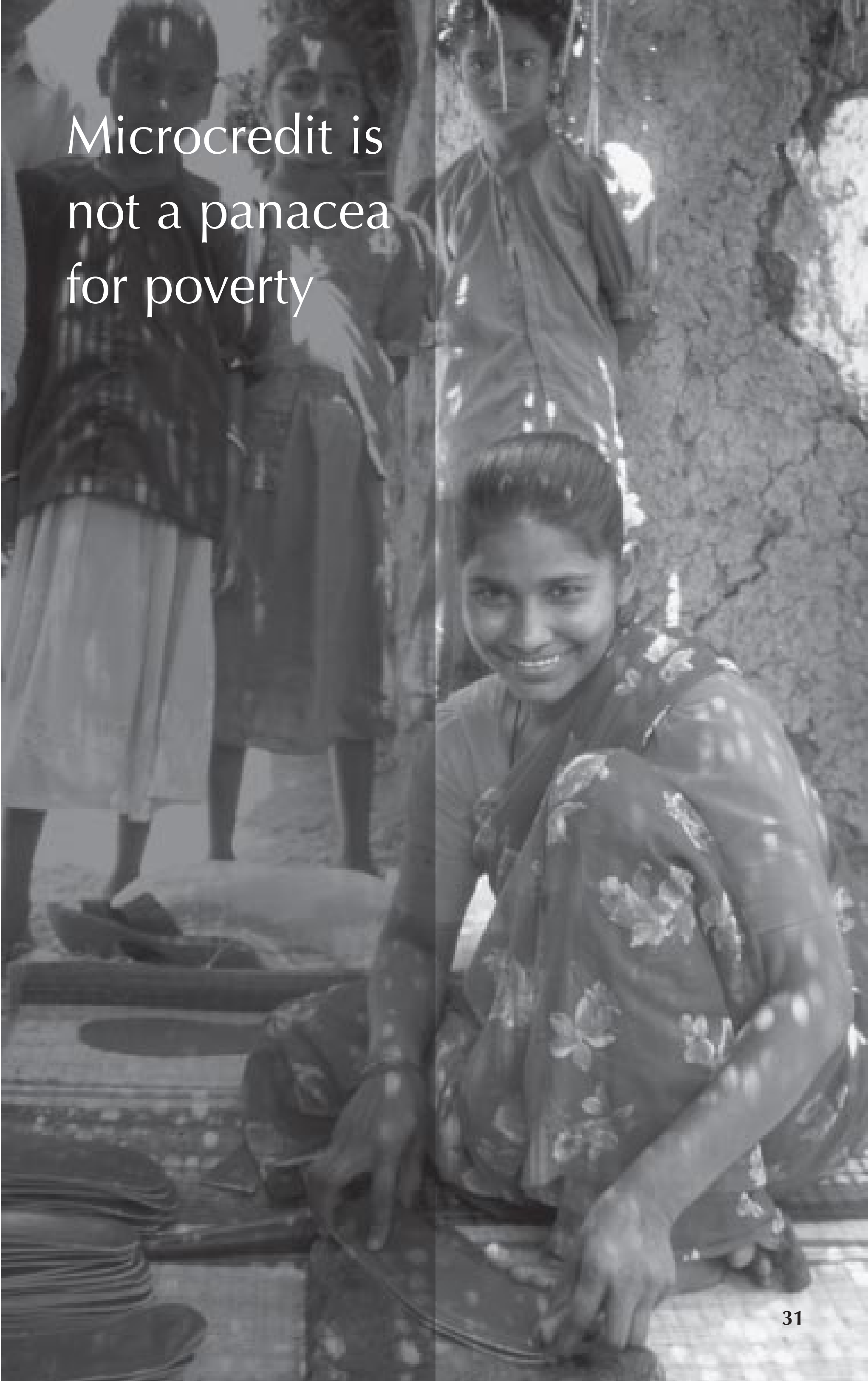
21 One US dollar is at present appr. 46 rupees.

22 See Marguerita Robinson of the Harvard Institute of International Development in her excellent study The Microfinance Revolution, World Bank/Open Society, 2001, page 20.

23 See: Stuart Rutherford, The Poor and their Money, op. cit. page 18. In the Philippines the rates are even higher. The moneylenders (and their clients) are used to a 5/4 system. Clients get 400 in the morning and have to return 500 in the evening, an interest of 20% per day.

24 Stuart Rutherford, The Poor and Their Money, op. cit., chapter 1.

25 That is why Oikocredit, in setting the repayment period for - for example - agricultural loans, looks carefully at the expected income increase as from the first and the second year. Because it is that increase that motivates the partner not to let the project slip out of their hands. Loans that could be repaid in four years, without such an increase, are given for five or six years to enable such an increase.



Microcredit is not a panacea for poverty

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Poverty

The most usual yardstick in defining "the poor" in international development circles is "people who survive in one way or another on less than one dollar a day". That yardstick has the advantage that comparisons can be made between countries, and that progress can be measured. It enables experts to report on progress: a worldwide reduction from 1.3 billion people in 1990 to 1.17 billion in 1999, primarily because of the economic development in China.[26]

However, what does the word "progress" mean if the positive results in China camouflage an increase of 50 million poor people in 25 other countries? What does progress mean in the one dollar a day group against a background of 2.5 to 3 billion people surviving on less than two dollars a day?

The disadvantage of this yardstick is that it is too simplistic. First of all, because it creates the impression that one dollar a day is an acceptable level and therefore a relevant development target. It isn't. Moreover, it camouflages that the wide majority of these 1.17 billion earn less than one dollar, and sometimes - as was the case of the SHARE mother - not more than 10 cents per day per family member. It also creates the impression that people living on more than one dollar a day are really better off and therefore don't need attention.

Jan Pronk, former Minister for Development Cooperation in the Netherlands, challenges this sacred one dollar a day concept and asks: *"Why are experts and politicians satisfied with such a yardstick without asking themselves the obvious question: what kind of life can you live on one dollar a day anywhere, in Africa, Asia, in the cities of Latin America, or even in China?"*[27]. The answer he gives is that a policy that would focus on reducing the *two* dollars a day group would imply far-reaching changes in the distribution of world income and entitlements, and therefore a much higher level of development aid. A consequence the richer countries are not prepared to face.

> In 2000, the message the European Union brought to Monterrey, the worldwide summit to underwrite the financial consequences of the Millennium Development Goals, was: *"We will increase the average level of development aid by member countries from 0.32% to 0.38% but not before 2006."* An increase of 0.06%, but not before 2006! Please note that Europe did not promise a minimum level of all member countries, but referred to the average level. In doing that Europe accepted that x member countries would dedicate less than the indicated 0.38%.
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> Gone are the days that the commitment was set at 0.7% (1972), leaving aside the solemn 1% promise made in 1962.[28]

Poverty as it manifests itself worldwide is more than having no money, no regular income and no access to credit. It affects all aspects of life and is the result of many circumstances beyond the control of the poor.

James Wolfensohn, President of the World Bank, describes poverty as *"A pronounced deprivation in well-being."*[29]

The OESO/DAC groups the various circumstances and root causes into five dimensions of poverty that are closely interrelated: [30]

1. The human dimension:
   - no access to health, education, clean water, food etc.
2. The economic dimension:
   - no access to means of production, regular employment, relevant economic support structures, credit etc.
3. The political-legal dimension:
   - no access to political decision making, legal protection etc.
4. The social-cultural dimension:
   - no respect for human dignity, no social acceptance, no access to relevant networks, no allies among the powerful etc.
5. The security dimension:
   - no protection against violence, insecurity, economic set-backs etc.

Jan Pronk, while agreeing with the relevance of such a breakdown, adds a description of the day-to-day reality of being poor:

"Poverty cannot be captured in terms of money and income alone. If poverty is seen as a lack of opportunity to acquire lasting control of resources in order to strengthen one's capacity to acquire the basic necessities of life - water, energy, food, a safe place to eat, rest, sleep, wash, have sex and go to school, basic health services and medicine in case of illness, a job enabling all this or the income to acquire it, access to economic markets and social networks, knowledge to survive in this world, information and education to acquire more knowledge and to gain the necessary insights to cope with disasters, threats, violence and challenges and, when that is beyond the capacity of the individual, some protection - *all that requires more than money, more than an income. It requires assets or entitlements, the value of which cannot be easily estimated in financial terms. In other words: rights that ensure access to all these things. Rights that certainly cannot be acquired for 1 US dollar a day."*[31]

Deepa Narayan and her team listened to the poor themselves and produced an impressive survey of their own observations, anger and energy in Voices of the Poor[32]. These eye-witness accounts help to get the discussion about poverty reduction back to the base line: the day-to-day experiences of the poor themselves, their capacities and the constraints they experience. These accounts also help to remind us of the persistent warning of one of Oikocredits' past Presidents, Dr. Mina Ramirez, Director of the Asian Social Institute in Manila, not to define the poor only in terms of what they *don't* have:

"Such an approach reduces the poor below the level they deserve, as if they are poor in all aspects of life. The next step is to reduce them to 'target group', whose future is going to be defined by others."

The manifold aspects of poverty lead to the obvious conclusion that the fight against it needs an *"integrated approach that covers all dimensions"*.

> The term "integrated approach", however, can easily become an academic or political mantra. Of course it is required, but it sounds better than it often is. It often results in officially installed coordinating bodies that shower do's and don'ts over the initiatives they are expected to coordinate and support. Resulting in co-ordinators who are more important than those being coordinated. The workers in the fields who want to make real progress don't feel strengthened by a continuous flow of meetings, minutes and monitors. There is an old adagium: *"If you want to make progress, focus! And let others focus on other aspects."* And there is another old adagium: *"Let thousand flowers bloom."* Before you cut their stems and try to group them in integrated bouquets.

Microcredit focuses only on one aspect: access to credit. That focus is of vital importance but is as such not sufficient to solve all the other deficiencies.

Moreover, poverty has two older sisters living in the same house and keeping her down and out. The eldest is called sister Exclusion. The second has specialised in passing the buck, or rather pushing the buck down. Her nickname is "Sister Downloading".

Exclusion

Whereas poverty is of all ages and to a large extent the result of circumstances beyond anyone's direct control, exclusion is the result of human action, the way society organises itself. Exclusion is the way in which those who are better off protect their interests.

For the great-grandparents of the current poor, life was not easy and quite often an uphill struggle in a society that did not care about their plight. But many of the current poor face a steep wall rather than a hill. Erected by a society that defends itself against them and pushes them down. Looking at this deliberate behaviour, the words of Archbishop Desmond Tutu come to mind, when he described the attitude of white authorities towards the black majority in apartheid South Africa: *"Okay, some die, but what you worry? There are millions of them! Like flies."* Tutu added.
Hernando de Soto gives a detailed description of all the energy that goes into keeping the poor in the informal sector down, and preventing them to get access to the formal sector and its support structures. With many dozens of rules, regulations, permits and authorities on all levels. If all the money, manpower and energy spent to keep the poor out were to be combined with all the money, days and energy the poor have to spend to find bypasses, it would result in a substantial funding base for structural improvement, instead of structural exclusion.[33]

The current poor, even if served with microcredit, do not find a rose garden. They have to cope in a society that is not only indifferent, but at times intentionally derailing their efforts. Their interests don't count in the minds of the powerful, if they are recognised at all.

"Downloading"

Whereas the first sister prevents participation, the second sister is the one that 'downloads' the negative effects of a stagnating economy on to the shoulders of the poor. Not in the form of trickle down, but in opening the floodgates to let the lowest layers of society absorb the bulk of the negative effects.

Take the example of Indonesia during the Asian currency crisis, when in less than 18 months the number of poor living below the poverty line increased from 22.5 to 49.5 million. Not because they had anything to do with the root causes of the crisis. It was the rich that had collected the proceeds of yesterday's loans and the poor that paid the price.[34] Or take the example of Argentina, where the upper middle class rushed to bring their dollar savings outside the country (an amount equalling the national debt) while more than 50% of the population nose-dived under the poverty line. No microcredit scheme is strong enough to protect its clients against such economic behaviour.

> It should be noted, however, that in Indonesia the major microcredit bodies, the Unit Desa scheme of the Bank Rakyat Indonesia, and the Bank Kredit Desa, managed to maintain repayment rates over 95%. One of the major reasons being that they were recognised by their clients as vital instruments in enabling them to cope.[35] An extra reason, beyond doubt, was that both schemes only give collateral-based loans and are primarily financed with savings. Their clients would stand to lose both if they did not meet their obligations. Be it at the expense of school fees and other basic needs.
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> Likewise, in 1998, Grameen managed to assist its clients in surviving the devastating effects of the floods by introducing special schemes that did *not* burden them beyond their capacity. That was the result of a deliberate drive not to let them down, in spite of their inability to meet their immediate commitments.

Downloading is not unique to the third world. It happens worldwide in times of economic crisis, when the burden is passed on to the immigrants, the vulnerable, the "others". It is in fact part of the worldwide economic system where the rich have better ways and means to avoid economic set-backs than the poor. And where - above all - the rich find the system on their side, both in the North and the South.

It are these three factors together - poverty, exclusion and downloading - that define the context in which poor people must find the energy to take their economic future into their own hands. Against all odds. While microcredit offers them an entry into the (informal) economy, it does not pave the way or remove other obstacles.

26 See Global Economic Progress and the Developing Countries 2002, World Bank 2003.

27 Jan Pronk, op. cit. page 12.

28 In May 2004 - motivated by Iraq and the war on terrorism - the OECD countries decided that security was a vital pre-condition for development, reason why programmes focussing at security could also be financed with ODA (Official Development Assistance) funds. The effect of that decision was that the funds that used to be earmarked for development can now be used to cover other political commitments.

29 James Wolfensohn in the preface of the World Development Report 2000/2001, Attacking Poverty, Washington, 2001.

30 The DAC Guidelines for Poverty Reduction, page 39, Paris, 2001.

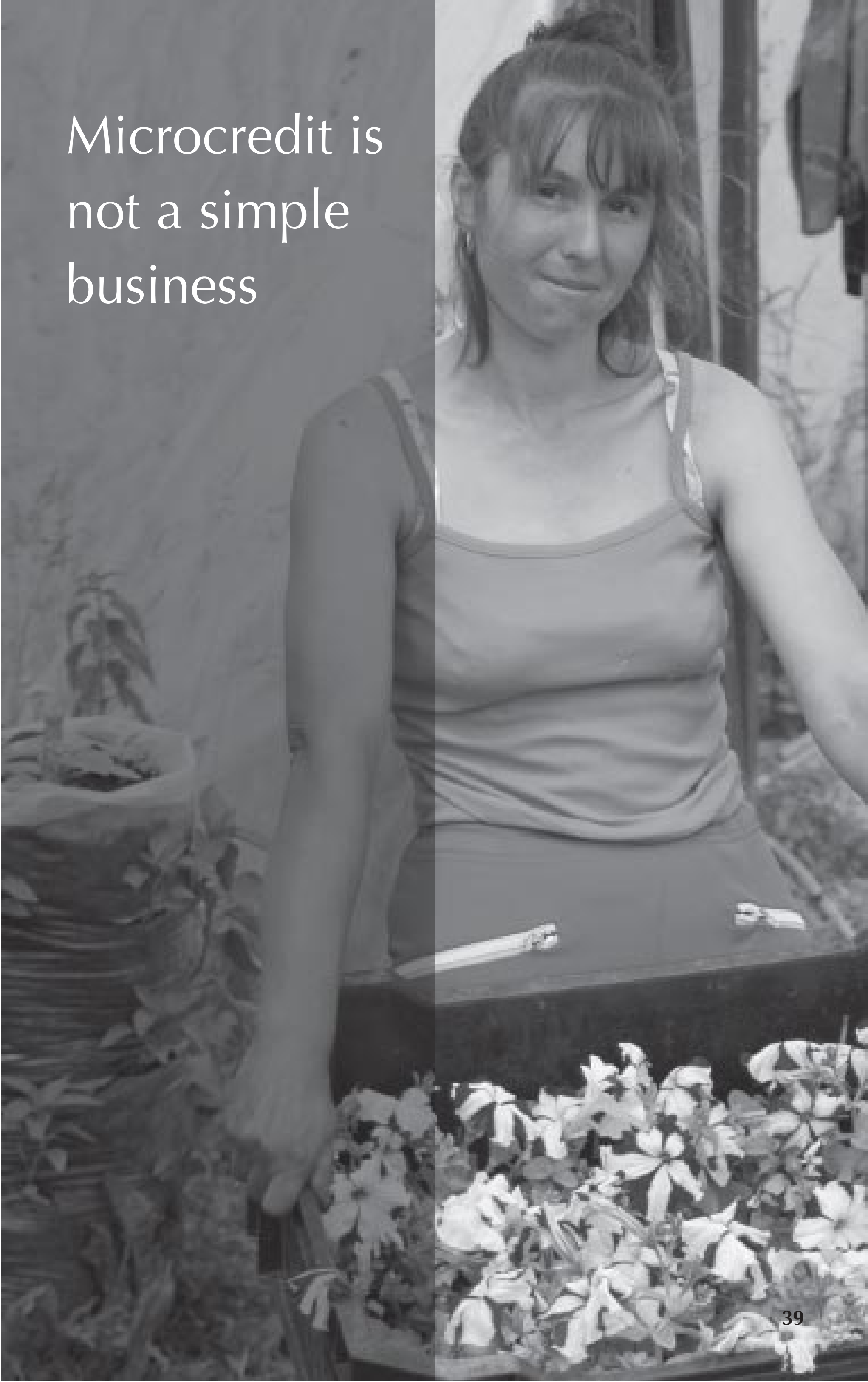
31 Jan Pronk, op. cit. page 10.

32 See Deepa Narayan e.a. in three volumes: Voices of the Poor, Crying out for Change, Can Anyone Hear Us? World Bank, 2000. A synopsis of 20,000 interviews with poor people in 23 countries.

33 See Hernando de Soto, The Other Path, Harper Collins, 1989, followed after 10 years by The Mystery of Capital, Basic Books, 2000. In this second book de Soto concentrates on the fact that most poor have no legal title to the land they live on (even if it is "no-mans land") , which prevents them to borrow against the security of that land. If that legal gap would be filled by the local authorities, the financial position of these families would improve considerably.

34 When in the beginning of 1998 President Suharto asked the IMF 40 billion US dollars to assist the Indonesian economy to overcome the currency crisis, his personal wealth was estimated at 40 billion US dollars. Nevertheless, no-one had the courage to say "Sir, why don't we make a deal: we 50% and you 50%?"

35 See for an in-depth analysis why the microcredit schemes survived and did much better than regular banks: Marguerite Robinson, The Microfinance Revolution, Volume 2, Lessons from Indonesia, chapter 15.



Microcredit is not a simple business

Microcredit is not a simple business

It is clear from the above that microcredit is not a simple business. First of all, because its clients are not normal banking clients. Quite a number of them cannot read or write. None of them have sufficient bankable assets. Most of them are not familiar with elementary financial planning. And the context in which they have to survive is not helpful. The MFI that gives them a loan is in their eyes a distant body with a lot of rules and regulations that they have to follow. The MFI may call itself *"a partner, that wants to help"*, but what is the difference with a normal bank? They too want to be repaid, or else…

At the same time, MFIs as financial institutions must work with great precision and discipline in order to keep the microcredit scheme on track. Repayment obligations that are not taken seriously don't lead to credibility and undermine the sustainability of the MFIs. While an MFI that is feared by its clients also lacks a future. MFIs have to work in such a way that they lose neither the support of their borrowers nor the trust of their funders. Which often entails a balancing act.

The Ten Commandments for microcredit

Apart from all the financial requirements, this leads to the following organisational Ten Commandments for MFIs:

1. On Board level knowledge of the context the poor live in, plus a firm commitment to serve them and to respond to their needs;
2. The skills to do that properly;
3. A highly motivated and well-trained management and staff;
4. Proper product development in microcredit and savings;
5. Adequate criteria and processes for loan acceptance;
6. Proper internal organisation with separation of functions;

   No account manager should approve the loan applications he himself has submitted; no disbursement should take place without another staff member having verified that all requirements for disbursement have been met.

7. Adequate monitoring and procedures for debt collection;
8. Adequate information systems with early warnings on default;
9. A high level of internal discipline;

   Rules are rules and must be observed. Deviation from these rules only with approval from above.

10. Firm grassroots' (client) support.

In the case of Moses' Ten Commandments there is no death penalty for not observing some of them. In the case of microcredit *all* Ten Commandments must be observed, or else the microcredit scheme will collapse. In addition, one should realise that observance of all Ten Commandments is not a guarantee for success. While neglecting one of them is a predictable cause of failure.

The last (but not least) of the Ten Commandments is grassroots' support. It is not difficult to hand out money and to require the beneficiaries to call it a loan. It is difficult to install in a community the awareness that it is in everyone's interest that the loans are repaid. Without such awareness and support, collection becomes a painstaking task in a hostile environment.

> One of the major risks of the present "Microwave" climate is that funds and concepts land on the community from above. Offices are opened, staff come to the village, loans are approved and disbursed, but no borrower will go to another borrower and say: *"Hey, friend, if you don't repay you'll harm my interests!"*

Repayment rate

Over the years, many financial instruments and ratios have been developed to measure whether an MFI is on the right track.[36] I shall not list them all here, except for the repayment rate: what percentage of loans is repaid, and what percentage is repaid on time. The first figure shows the overall performance of the clients towards the MFI. The second figure shows the degree of discipline.

Most of the MFIs Oikocredit finances reach a level of 95% or higher. That proves in retrospect that the approach in general is effective and that, more specifically:

(a) the loans are not too small nor too large;
(b) the repayment periods are not too short nor too long;
(c) the interest is not too high, and
(d) the incentives to repay are working.

Above all, the figure proves that clients can manage these loans. Secondly, it proves that such results are within the reach of *any* properly functioning MFI, even if they serve the illiterate and vulnerable. It is of crucial importance for three reasons:

1. If the repayment is less than 100%, the interest rate to be charged must be higher to cover such a loss. The painful reality is that it is the *loyal* clients who have to make up for the loss and are charged for the other's lack of loyalty.

   Charging the loyalists for the default of others happens in all banks and MFIs alike. A solution is to charge all clients x% more interest and to give at the end a rebate of y% to all clients that were loyal and always on time.[37]

2. If the percentage sinks below - say 90% - a growing percentage of the clients is tempted to join the 10% that seems to get away with non-payment. Such a trend can erode a well-functioning MFI within months, if not weeks.

3. Once the percentage sinks below 80% it is very difficult to reverse that trend, because the virus travels faster than any medicine: *"Why should I repay to an MFI that is likely to go down? Let's wait and see what happens!"*

It is for that reason that a high repayment rate is essential to keeping an MFI on track. Does that mean that an MFI should never be lenient? No, but leniency should be an exception in circumstances that justify such an exception, such as *force majeure*. It should be realised by all the clients that repayment obligations are to be taken *very* seriously, or the MFI will not be able to serve their future needs and those of their community.

It requires also that the loans to be given should not be over-standardised, but should be tailored to individual circumstances and cash-flow predictions, or in the case of the "mother from India", milk-flow predictions. For many MFIs an approach that is tailored to the individual client's capacity is more difficult to administer. However, standards that do not fit do not help and result in inadequate performance.

Could it be more efficient?

Can effective MFIs improve on efficiency? Like in any larger organisation, the answer is likely to be yes. It is clear that - for example - the way Grameen operates is very labour-intensive with 1,200 branches and 11,700 staff members serving 480,000 groups. The strength of their concept is that they know how to clone their operations and how to set new branches on their feet. While the price for high decentralisation is very detailed internal reporting systems. To a certain extent, reduced efficiency is the price one pays for growth and for being the front-runner. Followers, such as ASA and BRAC in Bangladesh, and SHARE in India, could pick and choose from the Grameen experience and start from scratch without having to change the routine of thousands of staff members.

The efficiency question is important, if only because a more efficient approach enables the MFI to reach more people for the same price. Nevertheless one should realise that the first goal remains effectiveness. It does not make much sense to get the first prize on efficiency with activities that are not effective.

Secondly, the efficiency question should always be answered within the context of the development mission: assisting "unbankable" people to take their economic future into their own hands. That requires more counselling, guidance and understanding of the context rather than blind adherence to the headquarters' (or donors'!) efficiency manual.

Example: one of the efficiency yardsticks that is in use is the number of clients/loans per staff member, with the implicit message that an MFI that has 200 clients per staff member is more efficient than an MFI where one staff member is only responsible for 130 clients. Such a yardstick is too mechanical and could lead to wrong conclusions.

A system based on group lending with weekly repayments during training sessions needs more staff than one based on individual clients with monthly repayments, with staff concentrating only on those who are late. In both cases, the number of clients could be too low compared to other MFIs. But the number could also be too high to maintain proper relationships, offer a relevant service to specific clients and increase contacts with new groups.

Organisational context

In principle, one is inclined to say that any organisation that wants to diversify into the field of microcredit and do so properly, should be encouraged and supported: including churches, NGOs, international NGOs, regular banks, credit unions, employees unions and governments. But if one takes the words *"and to do that properly"* seriously, one has to realise that not all organisations provide an MFI with the best possible context. If one looks carefully at their strengths and weaknesses under the Ten Commandments, some have a better chance than others.

Churches may be strong on the first and the last of the Ten Commandments, but are by definition weak on number seven: strict debt collection. Their mission is to preach that sins will be forgiven, that there is always a second and a third chance, that the church has understanding for the weak and the poor and that the church will be the last to add to their problems. Such a context is not the best one for a credit programme, as numerous church lending schemes have shown. Borrowers should realise that promises should be kept if any progress is going to be made, by themselves and by others.

The same applies to most *NGOs,* whose mission is to support the poor. The best ones start from a position where the first and the last of the Ten Commandments are part of their profile, but that image is blurred once they start reprimanding those who fail to pay on time. Within the NGO such activities are likely to create tension between the staff working on the core business and those taking care of the new lending business. As long as most board and staff members are of the first category, the lending staff run the risk that they have to deliver in a non-understanding context.

One should not underestimate these emotions. When the author joined the Oikocredit Board in 1989, the reaction of some donor friends was: *"How can you do that? These Oikocredit people bring money to Africa and insist that it is repaid. With interest! Haven't they read any history books? What is ecumenical about such an approach? The poor need support, not debts! Leaving aside debts to a church organisation!"* That climate has now changed, but the emotions remain.

An extra complication arises when NGOs (and their overseas donors) see microcredit as a diversification that might generate income for the NGOs themselves and therefore make them less grant-dependent. They underestimate that the income earned received by the MFI department should be used to cover the MFIs costs and provisions, and not used to finance other NGO activities.

In fact, there are very few businesses in the world that support part of the costs of an NGO. If we want MFIs to be sustainable, we should not burden them with the obligation to earn money for other programmes.

Another question is what they could do with profits. Once MFIs make a profit, they could consider using part of these profits to support the mother NGO. But they should realise as well, that other MFIs would use that money to strengthen their operations, increase their outreach or lower the interest they charge.

That is why Oikocredit insists in most cases that the microcredit business is separated from the traditional NGO activities, with separate accounts, separate management and a separate Board. Similar problems arise when NGOs request loans for other income-generating activities, whether it is to start a printing business or to run a shop. As long as it is integrated with the traditional programme, one runs the risk that in good years the profit is going to the NGO without any guarantee that in bad years the losses are covered. In fact, it is difficult enough to run a business in the South. If they want that business to be sustainable, they should not burden it with costs no competing business would have.

International NGOs may face fewer of these problems because they arrive on the scene with a clear MFI programme. But as long as they are perceived as overseas initiatives funded by overseas bodies, they run the risk of being seen as a rich uncle who should not be strict on repayments.

> Most donor organisations that have started to give loans under their own name face similar problems. *"Why do you insist on repayment, when at the same time you hand out millions of grant-money to others? Why treat us differently?"*

A further risk is that the parameters of their MFI operations are defined by overseas bodies, who know less about the local context.

In principle *credit unions* might be more obvious candidates. They have experience in running a credit scheme with the savings of their own members, and they should have the best chance and the best context to become a properly functioning MFI adhering to all ten commandments. There are, however, three caveats:

(a) Most credit unions are inclined to serve their present members and to attract new members to strengthen the organisation. To reach out to people who are poorer and weaker may not be the most logical step;

(b) As long as their Board is elected by and from their members, these board members may lack the professional and managerial qualifications that are required for a proper MFI Board. In many cases there is too large a discrepancy between Board and management.

(c) Most credit unions are small, with a few hundred members. They do well because of their internal cohesion. Growth, followed by the employment of a professional management instead of volunteers, may well erode that internal cohesion.[38]

The World Council of Credit Unions (WOCCU) recognised these weaknesses and developed in the late 1980s a deliberate strategy to enable credit unions to develop into properly functioning MFIs.

Employee Unions are a special kind of credit union. Their membership is restricted to employees of the same employer (or of the same production cooperative), such as the SACCOs in Kenya. Their management task is less complex because interest and repayments are deducted from the salaries. These employee unions work well and serve real needs, but do not reach out to the unemployed or self-employed in the informal sector.

There are a number of *Regular Banks* that decided (or were induced by donors) to downscale and open an MFI window. In the countries that belonged to the Soviet Union they do so with special funds entrusted to them, not with their own funds.[39] In Latin America some 70 financial institutions have taken a similar step having learned that microcredit could be profitable. Their experiences range from successful to totally disastrous.[40]

They score high on commandments five to nine, but in general low on the first three and the last. The context required for a well-functioning microcredit scheme is too different from that of a regular bank, which is geared to creating shareholder value. Financing poor people who want to buy a rikshaw, a cow or repair tools requires skills other than those needed for financing trucks and supermarkets. Financing insecure poor people who cannot read or write requires a different attitude than financing confident businessmen. Finally, an MFI needs staff who are dedicated to the mission and the target group, not young bank managers who dream of being promoted to corporate banking or treasury departments.[41]

Most of these downscaled banks serve the top of the microfinance market: the clients that are on their way to becoming formal SMEs. The mainstream of poor microcredit clients remains outside their scope.

In another category are the specialised *Microfinance Banks (MF Banks)*. They were set up in recent years - with funding from donors such as EBRD - in the countries that used to form the Sovjet Union. The difference with downscaled regular banks is the recognition that a proper microcredit operation stands a better chance if it is not embedded in the context of a regular commercial bank. Nonetheless it is somewhat

confusing that these banks use the word Microfinance in their name. In most cases they operate just one layer below the market served by regular banks, but rarely penetrate much deeper.[42]

In terms of reaching the poor, the most promising banking category is not the down-scaled banks or the MF Banks, but the *Upscaled Microfinance Banks (UMF Banks)* that “upscaled” out of NGO-driven MFIs or Credit Unions. Examples are the cooperative banks in Uruguay, such as ACAC, COFAC and FUCAC, FIE and Bancosol in Bolivia, XAC Bank (Mongolia) and Acleda (Cambodia). All of these banks started as NGOs and changed/graduated in the course of time into banks able to accept savings and deposits. They combine the original dedicated NGO mission with proper banking skills. However, they too are faced with risks that might erode their mission:

- When they grow in the course of time they need a strong Board to keep them on the poverty track, against the natural inclination of many staff members to act as their colleagues in other banks and become normal bankers.

- When their shareholders are no longer dedicated microcredit funders, the pressure increases to give priority to the creation of financial shareholder value instead of the pursuit of the original anti-poverty mission.

Finally, the *Government initiatives*. With a few exceptions, such as Bank Rakjat Indonesia, these are weak on all counts because of administrative constraints, lack of contextual flexibility and the danger of political interference and “clientelism”. The lessons learned during the 1970s are that these initiatives have a high rate of failure.

All these observations lead to the conclusion that MFIs should preferably not be part of another organisation, but should stand on their own feet, with own accounts, own management and own Board.[43]

> This does not imply that it is impossible or always unwise to operate a micro-credit scheme within the context of another organisation. There might be circum-stances in which this is the best way to start microcredit operations. In such cases potential disadvantages and conflicts of interest should be clearly identified and addressed as adequately as possible.
>
> The sponsoring organisation could continue to be represented on the MFI Board, but should ensure that their representatives are joined by others who are chosen on the basis of their skills and experience

Once a successful MFI changes into a Microfinance Social Bank, attention should be paid to preserving the original mission in view of the natural tendency to start acting as a normal bank.

36 See for extensive documentation: www.cgap.org and www.mixmbb.org.

37 In 1993 the Community Bank in South Africa, that was started to serve the black majority of the population, discussed the option to charge all clients up front the usual (white banks) rate for black people of 28%, but to give at the end of the loan term a rebate of 5% to all who had always been loyal and on time, as well as a further rebate of 5% in case their branch had a repayment rate >95%. That would bring the interest rate down to the level charged by regular banks to "white medical students at Wits". However, the banking staff assigned by regular banks to the Community Bank to give them a proper start, did not dare to take that step, because they were firm that they needed that extra money to cover for defaults. They ignored that in case >95% would repay there would be no large default. Consequently, the Community Bank was not able to offer their black clients any better deal than regular banks, except that they could ask for a loan in Zulu or Xhosa.

38 See the observations made by Dale Adams Using Credit Unions as Conduits for Micro-enterprise Lending, in Bernd Balkenhol, Credit Unions and the Poverty Challenge, ILO, 1999. "Most credit unions in low-income countries are fragile. They typically have thin capital bases, often lack access to funds to meet liquidity shortfalls, have difficulties diversifying their risks, are easily crippled by inflation, and can be quickly damaged when their members suffer economic reverses. Credit unions also face constraints as they grow: they lose their informational advantages, they are forced to rely on salaried rather than voluntary managers, and they must increasingly count on formal sanctions to enforce contracts. Growth compels credit unions to act increasingly like formal financial intermediaries. With growth, the altruistic motives that may have led to the formation of the credit union are replaced by hard-headed business decisions. This involves altering the ambience in the credit union from one that is borrower-dominated to one that effectively balances the concerns of depositors, shareholders, borrowers and management.

39 See for example the Russian Sherbank, whose microcredit programme is largely financed by the European Bank for Reconstruction and Development.

40 See: Liza Valenzuela Getting the Recipe Right; the Experiences and Challenges of Commercial Bank Downscalers in Deborah Drake and Elisabeth Rhyne, The Commercialisation of Microfinance Kumarian Press Inc. Bloomfield (USA) 2002.

41 In volume 2, Lessons from Indonesia, page 352/354, from her excellent study The Microfinance Revolution, Marguerite Robinson gives a clear analysis of the advantages and disadvantages of operating a microfinance scheme within the context of a regular bank. She sees as main problem that the director responsible for microfinance does not control the major decisions that affect the activities of the microfinance division, while the bank's other directors and CEO are typically not qualified to do so. I would add that even a supportive CEO cannot prevent that the bank's systems on costs, interests, collections, provisions etc. are not fit to absorb "alien" concepts. They force the microfinance division into a straightjacket that is not conducive.

42 See Sarah Forster, op. cit. page 34/35 and 46. The average depth ratio of Microfinance Banks is 553 (meaning that their average loan is 5.5 times the GNP per capita) as compared to 46 (0.46) for MFIs worldwide. See for an explanation of the concept of depth ration page 35.

43 See for an excellent analysis of the tasks, skills and attitudes required for a properly functioning MFI Board Maria Otéro and Michael Chu Governance and Ownership of Microfinance Institutions in Deborah Drake and Elisabeth Rhyne The Commercialisation of Microfinance.

Internationalisation of microcredit

Internationalisation of microcredit

Increased recognition

As stated before, microcredit has gained considerable recognition as one of the few effective instruments in serving the poor. The World Bank has entered the scene thanks to the very strong personal support and commitment of its President James Wolfensohn. So have ILO, UNDP, international development banks and other international organisations and agencies. Central bankers in the South and the East have also come to realise that this instrument deserves fully-fledged support, although many of them remain unsure as to how to do this within the usual parameters of central banks.

To a large extent this increased support is the result of the first Microcredit Summit, and of the work of organisations such as Results Inc. (the convenor of the successive summits), Acción International, Cashpor, FINCA, Grameen, Oikocredit, Opportunity International, Women's World Banking and others.

The ways and means of properly managing a microcredit programme have also become internationalised. The vital role of CGAP should be mentioned, being the Consultative Group to Assist the Poor. CGAP, a donor consortium, is hosted by the World Bank and is instrumental in collecting and distributing best practices. It works as a professional spider in the worldwide microcredit web. Acción International plays a leading role in the dissemination of best practices in Latin America. In Central and Eastern Europe and for the countries that were part of the Soviet Union, the Microfinance Centre in Warsaw[44] fosters microcredit in what was formerly called "the second world".[45] Without such strong international backing and support, there is no chance that microcredit can be brought within the reach of the people who need it the most.

In less than a decade, microcredit has become an industry in its own right with its own rules and standards. The Economics Institute in Boulder, Colorado (USA) stands out as the most advanced training institute, developing highly sophisticated yardsticks and ratios and training thousands of practitioners in vital financial areas. The value of their contribution can hardly be overestimated.

Nevertheless, the present "Microwave" with its almost religious overtones, tends also to result in two risks:

The first of these is that - in spite of all the emphasis on best practices - new practitioners and donors underestimate how difficult it is to start and manage a properly functioning MFI. Although the good news is that since the first Microcredit Summit (1997) many parties want to commit funds for microcredit schemes, without careful consideration there is the risk of:

- explosive growth instead of organic growth;
- donor-driven, instead of community-driven;
- top-down instead of bottom-up;
- reduced attention for the requirements of new, inexperienced players;
- failure, that could tarnish the reputation of microcredit.

Partly as a result of the increased drive of Northern professionals, there is also a second notable risk: the tendency to suck MFIs into "normal business patterns" as defined in the North:

- shift focus from *"how to develop the community"* towards *"how to develop the industry";*
- more emphasis on financial aspects than on development aspects;
- overriding influence of donor views on best practices;
- practitioners in the South being reduced from leaders to followers.

Looking at these trends, there is the risk that a concept that originated in the South, and is designed to benefit people in the South, pays for that recognition with the obligation to meet the hopes and expectations, requirements and best practices as defined by supporters, financers and academics in the North.

To a certain extent this is unavoidable. Firstly because management of an MFI, complete with balance sheets, P&L accounts, repayment records and IT systems, has basically the same requirements and consequences in Bolivia, Kenya, Indonesia or India. Although the contexts and the legal frameworks may be different, a loan is ultimately a loan and repayment is ultimately repayment. If best practices have developed in one part of the world, the chances are very high that such best practices will be beneficial to MFIs in other parts of the world as well. Secondly, no-one can expect supporters and financers to suppress their knowledge about best practices that have proven their value. If wheels are wheels and running well, no-one should be encouraged to re-invent them.

On the other hand, one has to realise that MFIs in the South don't work to fulfil external dreams. They are owners of their own programme for their own people, not sub-contractors of programmes designed and defined by others.

The development of microcredit needs a very systematic and professional approach. But also a strong and well-balanced coalition between "those who need", "those who do" and "those who finance". If one of these three always wins or always loses, the programme risks collapse.

Finding such a balance has not proven to be easy. In fact there is a growing trend, that the above sequence is reversed: "those who finance" set the parameters for "those who do", at times at the expense of "those who need".[46]

Two schools of thought

Even before the Microcredit Summit in Washington, two schools of thought had developed among the Microcredit supporters:[47]

The "sound business school"
This school primarily views microcredit from a purely institutional point of view. They are proud of the achievements of organisations like Bancosol (Bolivia) and want to prove that microcredit is sound business.[48]

Their primary focus is on the development of institutions that function properly and meet well-defined organisational and financial criteria. At the core of this approach is the belief that profitability is within the reach of well-organised institutions and therefore must be one of their primary objectives - because profit is the ultimate proof of effectiveness, efficiency and sustainability as an economic entity. The result is that the definition of success has changed: success is now being defined and measured by the pace of their progression toward ultimate profitability. Cost recovery has become as important as loan recovery.

Adherents of this school promise that once profitability is achieved, microcredit institutions will no longer depend on benevolent funders, but can attract new capital on normal capital markets. They will even be able to "securitise" part of their business (i.e. selling part of their profitable portfolio to banks) and use the proceeds for expansion.[49]

The "development school"
The second school primarily views microcredit not as a business instrument but rather as a development instrument directed at the poor. The primary measure of success is therefore the effect or impact of credit on the lives of the recipients. Adherents of this approach judge the success of an MFI primarily in terms of the loan repayment rate. If that rate is above 95%, it proves in retrospect that the product (i.e. the microloan) is relevant. If that was not the case, their clients would not have been able to increase their income and to produce *en masse* such a repayment rate.

The question of cost recovery, leaving aside profitability, is of another nature. That question is not related to how the *target group* is doing (development impact), but how the *financial intermediary* is doing (in mere financial terms).

The prospect of full cost recovery depends to a large extent on:

- the size of the portfolio;
- the average size of the loans;
- the geographical reach of the programme (number of villages served);
- the degree of labour-intensiveness;
- the cost of living in the country (reflecting on the salaries they have to pay to qualified staff members)[50];
- the interest rate charged.

None of the clients has any control over these factors. The costs resulting from the first five factors should be paid, but the question is: *by whom, and to what extent?*

The Difference in Practical Terms

The differences between these two schools are not only philosophical, but have also consequences for the daily practice:

The first difference is in the setting of the interest rate.

The *sound business* school expects the MFI
- to set the interest rate at such a level that with a proper growth of the portfolio the break-even point/profitability can be reached within a reasonable period of time;
- to relate - like any bank - the interest rate to the costs (cost of funds, operating costs, loan loss provision) plus a mark-up to arrive at a fair profit;
- to compare the interest rate to be charged with the alternative options for "unbankables". As long as the MFI rate is more favourable than the rate money-lenders charge, it is a good and helpful alternative.

The *development* school expects the MFI
- to treat "unbankables" not too differently from "bankables" (the latter label is what they deserve to be called if the repayment rate is higher than 95%);
- therefore to set the interest rate not much higher than the rate "the bankable neighbour" would pay; being the market rate for those who are better off;
- to aim within that context to reach break-even point, which is most likely reached somewhat later than if the clients were charged with the actual costs from the start.

The second difference has to do with growth and outreach.

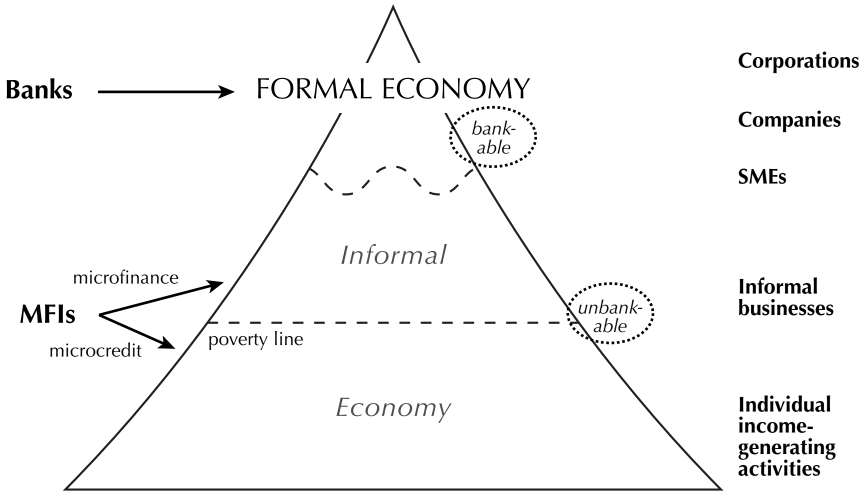
The *sound business* school
- is keen that the scheme's growth does not postpone the break-even point for too long: *"try to become profitable and let your growth not reduce that profitability."*

The *development* school
- promotes organic and gradual growth, seeing how many more clients could be served with this approach;
- is prepared to accept that reaching the break-even point is postponed until the MFI has reached a proper size/outreach;
- believes that as long as sufficient development funds can be mobilised for micro-credit, relevant growth is more important than profitability.

Business or Development?

Looking at these different approaches, the basic difference seems to be whether the MFI should be seen as a business, be it with a development mission, or as a development body, be it with a business character.

THE CONTEXT:



First of all, the answer depends on the type of clients the MFI wants to serve: if the MFI aims at clients deep down the poverty pyramid, such as Grameen and SHARE, the approach of the development school should prevail. Because the service to be given to these clients is much more than simply providing them with loans and collecting repayments. If they look for clients who could eventually “graduate” to the formal sector, such as the downscaling banks, the sound business school approach is more logical. The problem arises when one of the schools claims the territory that should be reserved for the other one. That happens also when donors make no such distinction and expect MFIs to serve the very poor within a business model that is based on potential graduates.

> The degree to which MFIs are serving the bottom of the poverty pyramid or the less poor is measured by their so-called depth outreach. As instrument for measuring depth outreach is used: *the average loan balance relative to the GNP per capita*. This instrument is not very precise, because poor people may borrow relatively large amounts (compared to the GNP per capita) whereas less poor people may also borrow small amounts. It would be more meaningful to measure the income level of the borrowers before the loan is received, because that defines their poverty level much more precisely than the size of the loan. It would also make it easier to measure impact, by comparing that figure with the income level during the loan period and after the loan has been repaid.[51]

The danger is that the pressure to reach sustainability pushes MFIs up to the higher layers of the pyramid.[52]

The other danger is that they are under pressure to charge higher interest rates to the poor to bring sustainability and profitability within reach. Justification for that approach is that the major problem of the poor is access to credit, not the level of the interest rate.[53] The first half of this statement is true, the second one is half true, because it is only true in cases where potential clients have no alternative.

> In fact, very few poor will challenge the interest rate if they badly need credit. That does not mean, however, that their willingness to accept almost any price should lead to the conclusion that in microcredit the interest level does not matter. In fact, it is somewhat odd to assist the poor to enter the market sector and at the same time make them, and others, believe that the price does not matter. Of course the interest level matters, but the difference between a fair, high or very high price is theoretical for people who have no alternative and no bargaining power.

The discussion is further complicated by the firm conviction of the first school, that microcredit has no future unless it adheres to sound business principles and aims at proper profitability. Reason: in the longer run they will not find sufficient donor funds or "soft" finance to stay in business.

From a business point of view that sounds logical. Moreover, any entrepeneur knows that subsidies undermine continuity, erode the attitude to work efficiently, lead to unfair competition and frustrate normal market developments. Therefore, if you see microcredit as a business, don't hesitate and run it as a business.

44 *See: Sarah Forster, The State of Microfinance in Central and Eastern Europe and the New Independent States, op.cit. See also: www.mfc.org.*

45 *The context of operating a microcredit scheme in the former "Second World" is basically different from doing the same in the Third World. People in the Second World were used to live and work in a collective setting, not very pleasant but predictable. After the downfall of communism, life was still not pleasant but on top of that unpredictable. People were left to their own fate in a society that had never put a premium on initiative. For many of them the light is not at the end of the tunnel, but at their back. Many of the self-employed members of the new MFIs, when given the choice to give up their business and to return to a regular job, find such an offer almost irresistible.*

46 *A clear example of overriding priority being given to financial sustainability can be found in the research published by Manfred Zeller and Richard L. Meyer: The Triangle of Microfinance, Financial Sustainability, Outreach and Impact. John Hopkins University Press/International Food Policy Research Institute, Baltimore, 2002. The underlying dogma is that without financial sustainability microcredit has no future. That is true. But without outreach it fails in its mission and without impact it makes no sense. That implies that all three are equally important and should be kept in the right balance.*

47 *Marguerita Robinson calls these two schools the "Financial Systems Approach" and the "Poverty Lending Approach". Michael Chu, former President of Acción International, speaks about "the sustainability camp" and "the poverty camp". I prefer the "sound business school" and the "development school", because both schools need proper financial systems and aim at sustainability in poverty lending. The major difference is in the priority they give to the interests of the MFI as instrument or to those of the clients as target group.*

48 *True, Bancosol is an exceptional example of an MFI that combines a development mission with business principles but their profitability was the result of larger loans and much higher interest rates, as compared to other MFIs in Bolivia, such as ANED, FIE and Sartawi.*

49 *Some very well-functioning MFIs have indeed been able to securitise part of their portfolio, such as Propesa (Chile) and Compartamos (Mexico). In fact, access to securitisation is the ultimate recognition of stability by the banking sector.*

50 *In India with relatively low living standards, operational sustainability is easier to be reached, than by MFIs that concentrate on the very poor in the pampas of Uruguay. They have to pay qualified staff members Montevideo salaries.*

51 *As concerns impact: close to 50% of the Grameen clients have crossed the poverty line since they joined Grameen. In the case of SHARE, 75% of their clients have experienced a substantial reduction in their poverty; half of them is no longer poor. The average percentages will, however, remain low as long as they continue to attract new clients from the bottom layer of the pyramid.*

52 *The notion that such a trend could frustrate the intention to serve the very poor is reflected in the new law the US Congress enacted in June 2003, instructing USAID (a) to develop better measuring instruments than the size of the loan and (b) by October 2005 to use 50% of its microfinance budget to support poor, who at the start had less income than one dollar a day (State of the Microcredit Summit Campaign Report 2003). Unfortunately, this legislation does not address the question of the interest rate to be charged to these poor.*

53 *See the recommendation by David Hulme and Paul Mosley in Finance Against Poverty, London: Routledge, 1996, quoted in CGAP Focus Note no. 5: "MFIs could charge higher interest rates on smaller loans, thus altering the incentive system that systematically works against relatively high-cost smaller loans." The incentive they refer to is an incentive for the MFI, not for these clients. Moreover, they seem to forget that the microcredit mission is about providing the poor with small loans that help them, not the MFI.*

The case for microcredit

The case for microcredit

Why microcredit deserves another approach

The case for microcredit is different and deserves another approach than the sound business approach for the following reasons:

(a) Microcredit is an instrument to fight poverty, in fact one of the very few development instruments that reaches the very poor in the informal sector. In development terms, microcredit should rank alongside programmes to combat HIV/AIDS, illiteracy and child-mortality. No one insists that such programmes should be profitable. Above all they are measured by their effectiveness.

(b) There are far more potential clients at the bottom of the pyramid than graduates potentially capable of crossing over into the formal sector. True, these potentials need support, but the emphasis of microcredit as an "industry" should be deeper down the pyramid: enabling people below the poverty line to cross that line.

(c) *Microcredit is **not** based on a sound business approach*. In fact, it goes against what sound entrepeneurs would do on at least three counts:

1. Microcredit concentrates on the very poor, the least educated, instead of on those with better educational backgrounds and prospects. No conventional banker would ever do that. It is precisely for that reason - the exclusion of the poor by regular banks - that microcredit was developed. As a development instrument, not as a new form of doing business.
2. It provides these very poor with the smallest possible amounts, resulting in very high handling costs. If conventional bankers have the choice between giving one loan of 100,000 US dollars or a thousand loans of 100 US dollars, they would invariably go for the first alternative.
3. Microcredit provides these loans without the usual collateral. Sometimes they work even with a "negative assets test": *"are you poor enough to qualify?"* Once again, no conventional banker would ever do that.

Consequently, microcredit is not "business as usual". It is *unusual business*.

(d) It is questionable to on the one hand accept and endorse the basic characteristics of microcredit, including the abovementioned very un-businesslike (but very developmental) points of departure, and then to judge the outcome primarily on financial sustainability merits, not to mention profitability. Development instruments should be judged primarily on their effectiveness and efficiency in meeting development needs.

(e) It is true that in the longer run financial sustainability is an important aim to be achieved. The question is *"how long may that run be?"* That question should be

answered on the basis of the development aspects of the programme: *"What kind of people do they serve? How many people do they serve? How well do they serve these people? How many people could they reach if they were allowed to expand? Are funds available to allow them to do that?"*

(f) The promise that sustainable and profitable MFIs will find a willing capital market to finance them is seriously to be doubted:

1. Like their clients, MFIs are not able to offer unqualified bankable collateral. Collateral is only bankable if it keeps its value when the client defaults or disappears. The only asset MFIs can offer as security is a loan portfolio consisting of thousands of small and largely unsecured loans. That portfolio has value as long as the MFI is doing well, but its value evaporates rapidly once the MFI is in trouble. In the case (part of) the portfolio is being pledged to a commercial bank as collateral, at the end of the day the loan counts as an unsecured loan, for which the bank has to make an adequate provision.[54] That makes commercial lending to MFIs much more costly than to normal clients.

In Oikocredit this handicap plays no role, because serving unbankables is its mission. Moreover, Oikocredit is not a regulated bank, is not financed with savings but with share capital and is therefore free to adopt other provision rules.

2. If MFIs were to issue bonds on the capital market, such bonds would get a very low rating, close to junk bonds. Not because the MFI does not operate well, but because in case of emergency these bonds do not hold water.[55]

3. Equity financing is even more complex and unattractive in the absence of a clear exit scenario, in which shares could easily be sold to a willing buyer for cash. Who will in - say - five years time be a willing buyer for such shares? And at what price?[56]

Shares with a nominal value of 100 and an average return of only 2% will not trade for much more than 25% if the prevailing interest rate at the time of sale is 8%. Alternative investors may be willing to pay more, but they would like the extra money to go to the programme, not to increase the assets of the departing shareholder.

Oikocredit solved this problem in house by making the commitment to its own shareholders to redeem their shares at their nominal value, unless the intrinsic value is lower. Since the start in 1975 Oikocredit redeemed the nominal value. In case the shares would have been traded on the market, their value would be much lower because of their maximum financial return of "only" a modest 2%.

4. The current financing of MFIs by commercial banks is minimal. There are some signs of change, but not to the extent that is required to make banks major parties in the financing of MFIs.[57]

5. True, as mentioned before, there are a number of banks that have decided to downscale, i.e. serve clients "beneath" their normal level. Either because they were induced by donors to do so, or because microcredit had a clear advocate at board level. However, *"downscaling as an approach is far from showing signs of vigorous growth and long-term stability"*.[58] And one can never be sure whether such a microcredit activity will survive the retirement of such an advocate. With a few exceptions, these banks are not serving the poorest of the self-employed poor, but the potential graduates.

6. As mentioned earlier, there are also some specialised microfinance banks. Most of them are inclined to serve the top of the microfinance market - the clients that are on their way to becoming a formal SMEs - and do not intend serving the potential microcredit clients at the bottom of the pyramid.[59]

An innovative exception in this category is the group of MF Banks financed by IMI (Internationale Micro Investitionen AG, Germany), an initiative of Internationale Projekt Consult GmbH.

IMI started in 1998 when it took a majority shareholding in two MFIs in Bosnia and Albania. It has since increased its portfolio of majority holdings to 18 MF Banks, nine in the East and nine in the South. In 2004 IMI, with the support of its shareholders, decided to buy out the other shareholders, to rename almost all its holdings "ProCredit Bank" and to manage them as one group, dedicated to microfinance.[60]

Future Funding of Microfinance Institutions

Under such circumstances, what should be the funding source of microcredit in the future?

(a) Both schools agree that in the starting-up period MFIs should be financed with grants because during that initial period their operating costs are by definition higher than their interest income. Secondly, they need to receive (at least part of) the capital for on-lending as grants, because as long as they do not earn enough to pay for their operating costs they also do not have any funds for an adequate loan loss provision. That means that possible loan losses reduce the capital.

(b) Once the interest income is sufficient for covering the operating costs and the loan loss provision, an MFI does not need operational subsidies anymore, other than for upgrading their systems or increasing their outreach. From then on there is no reason to finance the new capital for on-lending with grants, and they can accept concessionary loans.

(c) Compared with normal market conditions, these loans should be concessionary on four counts:

1. the repayment period;
2. the currency;
3. the interest;
4. the collateral.

Ad 1. *Repayment period:* it makes no sense to provide MFIs with capital for one year only. Because in that case the growth of the microcredit portfolio during the first six months must be reversed from month seven to get the money back from the fields in time. The ideal form of financing is with long-term loans: two or three years grace on repayment of capital followed by five to seven years of gradual repayment. Such repayment schemes enable the MFI to grow.

Alternative is a bullet repayment at the end of - say - five years. This implies that at the end of that period the entire loan has to be refinanced, either through the original lender or another party.[61]

Ad 2. *The currency:* because on-lending takes place in local currency, the financing should preferably also be in local currency. As long as local banks are reluctant to finance MFIs (with all the required concessionalities) the MFI depends on overseas funders to carry the currency risk. Foreign commercial banks do not take such currency risks for periods longer than one year, let alone five or seven years. Donors could and should consider doing so. The purpose of the exercise is to allow the Indonesian poor to grow in the Indonesian economy, not to load them with currency risks their bankable neighbours do not have.

For Oikocredit that is to a large extent funded with euro and dollar investments of middle class people in the North, it used to be very difficult to give local currency loans and to accept the excessive currency risk on local currency loans. During the Asian currency crisis it became clear however, that the partners in the affected countries could not carry the excessive currency risk either. The solution was to start a Local Currency Risk Fund, that is funded with grants from donors, and that absorbs the currency risk. Since Oikocredit avails of this LCRF lending in local currency has grown fast and at the end of 2003 already 18% of total project funding was in local currency.

Ad 3. *The interest:* the interest could range from 0% to the market rate. As long as a major part of the capital consists of yesterday's grants, the average cost of funds will be below market. Nevertheless, funders have to realise that higher funding costs will lead to higher on-lending rates. Before they decide on market rate they have to look on a case-by-case basis at the effect on the on-lending rate. Assuming that it is the poor they want to assist, the MFI is not a goal in itself, but a transmission belt.

Secondly, they have to look at the interest rate charged by other properly functioning MFIs in the area. Enabling one MFI to undercut another through cheap funding effects the operations of others.

Sooner or later MFIs operating in the same area will compete on the interest rates they offer. There is nothing against this, but such competition should not be dis-

torted as the result of cheaper funding rates. It is the funder's obligation to preserve a level playing field.[62]

Ad 4. *The collateral:* this has been discussed above. Funders could request that (part of) the portfolio be pledged to them, if only to prevent other funders demanding that security at a later stage. However, they should have no illusion about the nature of a security that - unlike a mortgage on a building - cannot easily be executed. At best the portfolio could be sold to someone who believes he is able to collect thousands of small loans given by an MFI that failed, but the price he is willing to pay is anybody's guess. In addition it is quite a decision to hand over the portfolio of people you wanted to *support* to a ruthless loan collector because their MFI failed.

(d) Taken together, these four concessionary elements illustrate that funding of MFIs is no business for regular banks. It requires specialised agencies or funds that are prepared to do what normal banks will not do. It is in the interests of all stakeholders (MFIs, their clients and their financers) that such specialised agencies or funds get the financial means to do what should be done, either in the form of grants, concessionary loans or bonds.[63]

The advantage of using specialised agencies as intermediaries is that they understand the business. The disadvantage is that every in-between layer has own operating costs and must make a loan loss provision, in case they take loans for on-lending to MFIs. Both cost factors push up the on-lending rate to the MFIs. In order to keep that rate down at a concessionary level, the rate charged to the specialised agency should be even more concessionary.

In Oikocredit's case it are the shareholders that make available their capital for a - concessionary - maximum dividend of 2% only. The reason for this limit is, that at the start in 1975 Oikocredit received tax freedom from the government, provided it would never pay a higher dividend than 2%. This 2% is therefore both the target and the limit. Nevertheless the obligation to pay dividend is important. It makes Oikocredit a business venture, just as its partners. Moreover it brings Oikocredit in a much more credible position to insist on repayment of loans, than donor organisations. Because it is clear to all, that these funds were made available to Oikocredit by small investors to use them, not to lose them.

(e) What will be the future scope of funding with bonds? The attraction of bonds as compared to loans is that, in principle, a 5% bond can be sold on the market. The price will depend on the prevailing interest rate at the time of the sale, and on the maturity date of the bond. Bonds that are placed by MFIs with friendly investors below market rate - say at 2% - are not marketable, unless one is prepared to take a loss.

A second handicap for the marketability of MFI bonds is, that in most cases they will receive a low rating. That will prevent most institutional investors from taking them.[64] Only very few MFIs have such a financial reputation that they can issue

bonds on the strength of their balance sheet. That implies that bond financing is for the winners (in financial terms) and not for mainstream MFIs.

(f) What will be the future scope of funding with equity? In principle that scope is limited as long as there is no certainty that these shares can be sold to other friendly shareholders or on the market. As mentioned before, friendly buyers prefer an investment that benefits the MFI and/or its clients rather than the departing shareholders.

One of the instruments that increases the marketability of shares is an attractive dividend. But when a new shareholder buys such shares because of this dividend, he will most likely expect an even more attractive dividend in the future. He is in the business of moneymaking through investments, not in the business of microcredit.[65]

That implies that the good news brought by market recognition will be followed by the less good news of reduced scope for costly labour-intensive service to the poor.

(g) The conclusion that microcredit is not a business for normal commercial banks should not mean that they should be left free to turn their back on microcredit or MFIs. They should realise that they are the ones who exclude millions of people from participating in the economy of their country. For good reason, but nevertheless. As key economic players, the fate of these poor may be *"none of their business"*, but it should be *"part of their concern"*.

It is unwise, however, to put pressure on commercial banks to start their own microcredit department. They should find other ways and means to support microcredit. See the recommendations at page 86/87.

(h) Finally, it is imperative that national governments take part in the funding as well.[66] They have their own responsibility for the poor in their own societies. They should not simply leave the funding to overseas bodies, but accept their own share as part of *their* development strategy and budget. See the recommendations at page 82/83. One of the reasons for the present abstinence of many national governments is that most overseas' donors want their money to go to visible initiatives that benefit the community. As a consequence it is these visible initiatives that are selected by overseas funders. The flip side of the coin is that national governments more or less surrender these initiatives to overseas' donors, with only a reduced role for themselves. Such a policy threatens to erode the responsibility of national governments for such activities. Moreover, in such a context, NGOs are too easily perceived as agents of overseas agencies, operating at a distance from the government in fields that should be part of the governments' concern *and* budget. This is an unhealthy situation.[67]

Of course, most NGOs would not like to be under government control. The crux, however, is not the absence of control but the absence of support.

Savings and deposits

In the future, the best possible funding source for MFIs will beyond doubt be savings and deposits. Not only from clients, but notably from the general public in the region. The inflow of funds from outside is vital for the development of the programme. If not - as mentioned before - the lending capacity of the MFI is limited to the collective saving capacity of its clients, which is far below their earning capacity. If that mother near Hyderabad had to wait for her loan from SHARE until her neighbours had saved enough, there would have been no loan, let alone a loan for all.

A crucial obstacle is that most national banking laws do not allow non-regulated institutions to take savings and deposits from the general public, but only regulated banks.[68] In some countries MFIs are permitted - not always openly - to use savings from their members (not from the general public) as if they were credit unions. In other countries even that is not allowed.

The option of becoming a regulated bank is in many cases not an option, because that might put constraints on the way they want to operate. Regulation of banks is strict and should be strict. The underlying motive for that strictness is protection for savers and depositors. A bank that uses client' savings for on-lending is under very strict control to prevent unnecessary risk taking. On-lending with insufficient collateral is a banking sin that gives regulators a fright. Regulation obliging MFIs to only give properly collateralised loans would strangle the special nature of their business. Banks are for people with money and assets, MFIs are for poor people without.

That means that for MFIs special regulations are required that recognise the special nature of the business. That also recognise that group guarantees could serve as a substitute for bankable collateral, even if the members of the group are equally poor.

Such regulations should also allow properly functioning MFIs to take savings and deposits, provided the MFI has a consistent track record and that the risk of default is minimal. Until now, few countries have defined such special rules.[69] Most legislators and National Banks are still very hesitant to open a special box for MFIs.[70]

> The Microfinance Centre in Warsaw (MFC) has developed a special programme to assist legislators, National Banks from Central Europe and the countries that were part of the Soviet Union to draft such regulatory rules. They have made substantial progress in winning the minds of local authorities and experts. Once the results are in, the models developed in the East could be imported by the South and open the door to attracting local funds.

Conclusion: *as long as there is no special regulation for MFIs that allows them to take savings and deposits, the major source for financing at the start are grants, in the course of time substituted by concessionary loans from special funds and agencies.*

Question: will such funds be sufficiently available? As long as there are billions of dollars available for development aid, and microcredit continues to prove its extraordinary value as an instrument to assist the very poor, there is a convincing case to allocate part of these billions to microcredit.

The danger of grants

The sound business school strongly believes that grants are a dangerous virus which prevent grant-funded MFIs from doing the right things in the right manner. It is true that grants can erode the economic attitude required to make a business sustainable, and if one looks at MFIs simply through a business perspective this fear is understandable. The danger is that the business will be managed within the available grant budget, instead of within the parameters of its earnings.[71] This has been illustrated by grant-funded business initiatives all over the development world, which started at cost-levels no local business would ever consider. Grants can be poisonous.

Secondly: grants can be addictive. It is much easier to go overseas and to ask for renewal of a grant, than to increase earnings and reduce costs.

If one looks at MFIs through development eyes, however, one should realise that there are tens of thousands of NGOs in the developing world that are financed primarily, if not exclusively, by grants - for the simple reason that there are no other funds available. True, not all of them are managed well and not all of them are cost-conscious, but not all of them are the victim of the grant virus either. Many of them fulfil vital roles and continue to receive grant funding in recognition of that role.

> The disadvantage of being grant-funded is that the future of these NGOs not only depends on the quality of their work, but also on the willingness of third - often overseas - parties to continue that support. If a major donor decides to withdraw from their country, even excellent NGOs have no defence and will fail.[72]

Within that world of NGOs, MFIs belong to the small group that is different on four counts:

- They have financial management that is conversant with financial ratios and disciplines, much more than the average NGO. They produce detailed accounts, not only yearly but also monthly. Most of them have these accounts properly audited by external auditors, not only because that is a donor requirement, but also because their own board insists on it. Without this financial discipline they could not run their business, would not have survived, and would not have received new funding.

- Unlike the majority of NGOs, these MFIs have own earnings and a professional drive to increase these earnings, if only to cover their own operational costs under the scrutiny of their funders.

- The capital grants they receive for on-lending are not consumed within the contract period - as is the case with most NGOs -, but are recycled time and again. If their capital for on-lending shrinks disproportionally, they would create doubt about their capacitiy to properly run a microcredit scheme and would destroy their access to new funding.

- For funders it is easy to monitor an MFI's performance. The same applies to their cost-consciousness by comparing their costs per dollar lent to those of other MFIs of the same size in the same country.

Within such a context, the chance the MFIs are afflicted by a grant virus is minimal, or at least much smaller than in the case of normal NGOs. From a donor's/funder's perspective, financing MFIs is far more attractive and easy to monitor than financing most NGOs.

Of course, if grant funding is continued for too long, it can become a poison that erodes the business mentality vital to continuity. It is therefore imperative that both MFIs and donors recognise the danger and address it. It can be done, as large numbers of MFIs have proven. Thanks to the funders who allowed them to prove it, through grants![73]

The second reason why the first school is reluctant about grants is their conviction that grants won't be available forever, whereas commercial credit will always be available if institutions are profitable and well-managed.

"The sustainability group argues that any future which is dependent on donors and governments is a future in which few microfinance clients will be served. Donors and governments, both notably prone to fads, are unlikely to continue subsidizing micro-finance indefinitely, and are not generous enough to do so on a major scale."[74]

At the level of an individual MFI these words may be true. Sooner or later they must stand on their own feet. At a macrolevel - the MFI industry in general - these words are in my view not true, at least not in the foreseeable future. Worldwide there is a growing emphasis on drawing people in the informal sector within the various development strategies, be it PRSPs (Poverty Reduction Strategy Papers), the Millennium Goals, or the strategies defined for the United Nations "Microcredit Year" in 2005. That implies that larger amounts are likely to become available for financing microcredit. Not because it is a fad, but because it is effective.

The above quote continues with:

> *"This group believes that the only way to assure access by the poor to financial services is to ensure that the private sector finds it profitable to provide such services. Only the private sector has plenty of resources and will stick with a moneymaking activity even if it is not in fashion."*

This boils down to a verdict on the future of microcredit, unless it becomes as profitable as regular investments for people who want to make money. That goes a lot further than breaking even or reaching sustainability. It implies that unless the poor are prepared to pay substantially more than bankables, microcredit has no future.

I beg to differ. Not because I do not realise that profitable ventures have better opportunities to attract investors' funds than unusual investments in poverty alleviation. But because this view surrenders microcredit to moneymakers as if there are no other allies around, and as if no other allies could be mobilised. It was those allies that put microcredit on the map during the past decade, enabling the industry to increase its reach from 13.4 million families in 1997 to over 50 million in 2003. There is no reason to declare that road to be a dead end. And no reason to assume that the private sector will ever be more *"generous"* than people and organisations that share the ultimate goals of microcredit.

What will be available in the years to come is grant-funding and concessionary funding that recognises the specific characteristics of MFIs, both from donors (who like their funds not to evaporate but to be recycled time and again) and from specialised agencies, funded by donors and/or alternative investors. Who give priority to high social returns over high financial returns, if only for part of their savings.

In spite of the dividend prospects of max. 2%, Oikocredit has been able to attract 182 million euros/US dollars in share capital, with an average yearly increase of approximately 15 million euros the last couple of years. Close to 50% of this capital is provided by committed middle-class people, some of whom remember the days they were poor themselves. And who now want their savings to assist others. They go for careholders' value instead of shareholders' value.

Will these amounts be enough? No, because the demand for capital for on-lending will grow and microcredit has to compete with other development goals, such as the Millennium Goals for which billions are required. But it is not a bad policy to gradually climb up the funding ladder, even if there is no certainty that at the end the ladder will reach the top.

On-lending interest rates

Because of the profit requirement of private sector investors, the 'sound business school' stands firm that rates to be charged to the target group should be enough to cover all costs, including a fair profit. The ceiling is, in principle, what the market can bear.

Moreover, they are convinced that the market can bear quite a lot, as long as the rate is lower than the rate to be paid to the next alternative: the moneylender around the corner.

> Richard Rosenberg (Senior Advisor to CGAP) in CGAP Occasional Paper #1 (also quoted in Marguerite Robinson's *The Microfinance Revolution* page 32): *"For the past ten years, the author of this paper has been asking in conferences and internet newsgroups whether anyone present has ever heard of a microfinance programme that ran into trouble by driving away clients with interest rates that were too high. No one has yet pointed to a single example. The limit is probably considerably higher than what even the more aggressive MFIs are presently charging".*

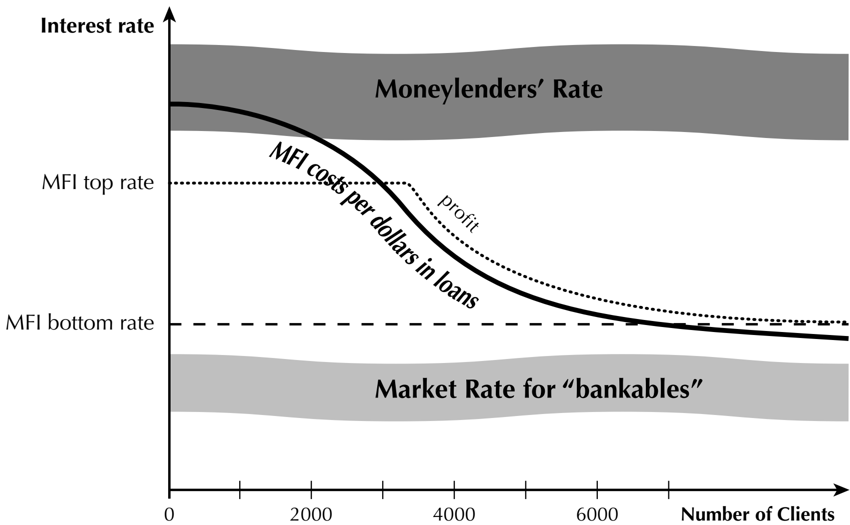
I beg to differ again. Leaving aside that charging higher rates in a situation where clients have no real alternative deserves a question mark - Microsoft was heavily fined for that - I have heard a lot of complaints about excessive interest rates. True, not from people that were driven away, but from people that had no alternative but to stay and pay. Secondly from funding agencies, that made concessionary loans available to assist the poor and were quite alarmed to find out later what excessive rates these poor were charged.

Moroever, if grant funding can lead to the danger of MFIs being not sufficiently cost-conscious, the same applies to MFIs that feel free to charge high interest rates in a region where there is no competition from other MFIs offering lower rates.

> Irene Sievers from Bolivia, Lutheran minister and now manager of a small MFI near Lake Titicaca: *"Given the fact that in the businesses of the poor things like capital, salaries and depreciation are not accounted for, it is easy for them to fall into the trap of accepting an interest rate above the rate that can actually be sustained by their particular economic activity. That means that the future growth and development of that activity will be very limited.*
>
> *In fact, the clients of certain institutions pay a sort of subsidy, making it a very profitable lending business, sustained by the poor they pretend to benefit. This deplorable fact becomes less visible as demand for credit grows. People will accept the loan at virtually any rate, hoping to figure out a way to make it work."*[75]

Can't we do better than that?

THE RATE TO CHARGE



From this graph it is clear that at the start the costs per dollar lent are far too high to be covered by interest income. It is also clear that these costs will go down as the number of clients increases. The choice any new MFI has to make is to what extent these costs should be passed on to the clients they want to serve, or should be added to the funding request they make to donors.

In the opinion of the 'development school,' the benchmark should not be the moneylender around the corner, but as a matter of principle *"what the 'bankable neighbour' is charged for the same loan by a normal bank."*

A benchmark is like a beacon at the entrance of a port: you are supposed to keep an eye on it, not to hit it. The bankable neighbours' rate will never be enough to cover all the MFI costs, because MFIs have by definition higher costs per dollar lent than normal banks. The justification of using that benchmark is, however, that it keeps the principle alive that loyal clients that behave as if they are bankable deserve to be treated as if they were bankable. Without a surcharge that is not caused by *their* performance, but by the fact that their MFI is too small or must employ more staff than the portfolio can carry.

It is not wrong if an MFI charges - for example - 26% or 28% if the market rate for bankables is 22%. Some surcharge is justified in view of the much higher costs. But if an overseas MFI charges 86% in Uganda, while the "bankable neighbour" in Kampala pays only 22%, the question *"Why?"* is justified. The answer *"Look at our cost level!"* is good as an explanation but not as a justification. The answer: *"Don't worry, because moneylenders charge over 100%"* is also correct, but even less of a justification. As a

matter of principle, MFIs should never compare themselves with loans sharks, but with normal banks. Especially if the MFI is funded at very low cost by agencies that want to enable the poor to stay out of the grip of loan sharks.

If this MFI had asked its funders: *"Are you prepared to give us some extra support, to enable us to charge these clients an interest rate that is closer to the level bankable people pay?"*, most funders would agree wholeheartedly. Not asking that, because you want to prove that you are able to run an MFI profitably, introduces another goal: *"Let's prove that we know how to assist the poor and nevertheless make a profit"*. That is turning a development programme into a management game and presenting the bill to the wrong party.

Subsidised interest rates?

Some advocates of the first school reply: *"What you want is subsidised interest rates. All economic theories speak out against that. MFIs that subsidise interest rates are bound to collapse. No client will benefit from such a downfall."*

Misunderstanding: the theory about not subsidising interest rates is correct, but pertains to market rates, that is the rates that "bankable" people pay. To offer rates below the market attracts all kind of "bankable" people who want the benefit of a cheaper loan. That distorts both the mission and the market. In this case there is no distortion whatsoever when the client pays the market rate (or slightly more). The fact that the MFI is subsidised to make that possible, does not mean that the *client* is subsidised.

Secondly, the reason why MFIs collapse is more often the result of inadequate management and ignoring one or more of the Ten Commandments, rather than the interest rate they charge. Provided, of course, they can obtain subsidy as long as these rates do not cover all their costs.

Question: is it a sign of bad policy or bad management to qualify for subsidies? Why is it that schools, universities and public transport systems all over the world are subsidised, and that MFIs with their essential social service should not be subsidised? Why should "sustainable" mean "subsidy-free or grant-free"? We do not say that about the Red Cross, the Royal Philharmonic Orchestra, the churches or the mosques. We do not say that either about UNDP, UNICEF, the solution of the debt-crisis or the ODA (Official Development Assistance). Why should we impose such a condition on a vital instrument to assist the poor?

A cap on interest?

Some governments in the South have intervened in this debate by putting a cap on interest rates. The first school has warned against such a policy because it could put the future of potentially sustainable MFIs in jeopardy.

In doing so they did not recognise the obligation of good governments to protect people against usury (the charging of excessive interest rates). The judgment as to what constitutes excessive is not related to the costs, the profit or the noble (or less noble) motives of the lender, but to the position of the vulnerable borrower compared with less vulnerable ones. Capping interest rates is not a restrictive measure, but a protective measure. It is one of the instruments of good governments "to assist and protect the poorest".

Of course, one should not suffer from the illusion that such an anti-usury rule will be observed by moneylenders and loan sharks. Especially the latter operate in the shadow of society. That should be no reason for governments to not define the point at which interest rates become usurious.

"Hold on," the same advocates say, *"no target group will benefit if MFIs collapse because they cannot charge the rate they need!"* With due respect to their concern, the message: *"try to raise some extra funds, but don't overcharge the poor"* does not destroy MFIs. It only invites/obliges them to work with another scenario. Moreover, that scenario is not new to them, nor to their funders, because that was their scenario for the first few years anyway.

As a matter of principle, in defining development strategies one should think twice before the longer term interests of the development bodies, in this case the MFIs, are given priority over the immediate interests of their clients, as perceived by themselves (and sometimes by their own government). The prospect of serving future clients is important, but not more important than the mission to serve present clients in a proper way.

Sustainability, now or later

Within the world of microcredit there is unanimity about the extraordinary relevance of this instrument for the poor. There is also unanimity that MFIs, as transmission belts of microcredit, sooner or later have to stand on their own feet as sustainable bodies.

In that respect, lessons have been learned from the unsustainable rural development banks and credit schemes, that were launched by governments in the 1970s to bring credit to the poor in rural areas.[76] With greater - political - emphasis on rapid disbursements rather than repayments. With politicians promising that they would defend and protect people that were unable to repay. Or even promising in their election campaigns that these loans would be written off. The damage that was done was not only that the funds evaporated, but also that poor people felt they could *"get a loan and take it for granted"*. This affected not only the institutions, but also well-functioning rural banks. In the end it also affected the credibility of the poor.

One of the major lessons is that governments are not the right bodies to run credit schemes. The risks of political interference, administrative straightjackets and lack of flexibility are far too high.

There are a number of reasons why emphasis on MFIs becoming sustainable is important:

(a) For any institution that provides a relevant service to poor and vulnerable people, it is vital that the service continues and that people can count on it.

(b) Grant-funded institutions are by definition vulnerable because they depend on third parties whose priorities may change, even if the institution is working well.

The strategy to enlist the support of more funders helps to reduce vulnerability, but also increases the risk that funders might find it more easy to withdraw.

(c) For MFIs, the drive towards sustainability - in the sense of being less donor dependent - helps to make borrowers realise that the future of *their* MFI is in *their* hands. The repayment obligation is serious. Default affects not only the borrower, but also their fellow group members and the future of the MFI itself, because MFIs with a high default rate will not be able to attract the extra funds that are required to give new and higher loans. Leaving aside that they will never be allowed to take savings from the general public.

(d) Borrowers should also realise that one loan doesn't do the trick. The real value of a microcredit scheme is that loyal borrowers can return to the MFI for second and third loans. That they can enter into a kind of standing relationship in which their loyalty is rewarded with continuous support. Therefore, continuity of the MFI is important. Not only because the MFI owes that to its staff or its funders, but also to its loyal borrowers and to the community at large.

The difference, therefore, is not about the necessity to become sustainable, but to what extent and at what speed *the poor* should be the ones who should foot that bill. Especially during the time the MFI has higher costs than can be recouped by charging market rates.

A balanced approach

Tensions between the immediate needs of the target group and the long term interests of the intermediary are not unique to the field of microcredit. Look at the health sector, where patients are to be assisted by hospitals, but hospitals must be sustainable to be able to assist patients. Nonetheless, there is full agreement that the primary goal of health service is to bring health within the reach of patients, not to bring profitability within the reach of hospitals. Their sustainability is a *condition*, not a goal in itself, let alone a goal to which the interests of the patients are to be subordinated.

Goals and conditions are, however, interrelated. Decisions in one field have effects in the other field. What is required is a *balanced* approach, a trade-off that carefully calibrates in which case and to what extent the interests of one party should prevail over the interests of the other.

In microcredit this balance gets lost if reaching sustainability becomes a goal in itself, and if interest rates charged to the poor become the fuel to make this happen. The poor should not be punished for being poor by charging them interest rates no “bankable” person would have to pay.

The proper balancing of the various priorities has to be supervised by the MFIs Board on which both financial and developmental experts should be represented.

Does that imply that donors or funders have no say in that matter? Of course not. They may insist that their funds are used in a specific manner. They may insist that the MFI follows best practice. They may also insist that the MFI continues to serve the poor at the very bottom of the pyramid. But the question is whether they are the ones to insist that higher rates are charged and/or a different public is served.

There is good reason to believe that Grameen with a rate of 20% is on a better “poverty” track than that overseas NGO in Uganda with 86%. There is good reason to believe that the world of donors will continue to underwrite such an approach. While there is no reason to assume that commercial banks are ready to step into their footsteps, at least not to the extent that is required.

Should one demand that Grameen bring its profitability to normal levels within two years, they could easily do that by:

- giving much larger loans
- to clients with better education, skills and prospects
- by increasing their interest rates
- by laying-off 40% of their field staff.

But the price Grameen (and their clients in Bangladesh) would pay would be a substantial reduction of their development impact.[77]

One of the best examples is Bancosol themselves. They used to charge more than 60% interest to become profitable. Now they charge 24%. It was yesterday’s clients that financed their road to profitability. It could have been others.

54 Moreover, under the new Basel rules of the Bank for International Settlements, bank loans to MFIs are likely to require between 8% and 12% own capital and therefore reduce the lending capacity to more bankable clients.

55 An exception to that principle can be made, when an MFI has such a strong financial track record, that it can be financed on its financial strength rather than the strength of its portfolio. Only a small number of successful MFIs, such as Bancosol and Compartamos have been accepted in that category and were able to issue bonds with an A+ rating.

56 An alternative to taking equity is to give a subordinated loan. In most jurisdictions such loans count as equity to establish the own capital of the MFI, but both the interest rate and the repayment schedule are fixed and come for the account of the MFI, not an unknown future shareholder.

57 See footnote 5. If private funds constitute only 11% of the worldwide financing of microcredit and Oikocredit's share is 4.4% (= 40%), this leaves only 6.6% for commercial banks.

58 Liza Valenzuela, Getting the Recipe Right, The Experiences and Challenges of Commercial Bank Downscalers, in Deborah Drake and Elisabeth Rhyne The Commercialisation of Microfinance. She analyses the progress of 18 banks that discussed their microcredit plans together in 1996. Of these 18, five years later seven were doing well, whereas eleven showed limited growth, exited the microcredit market or failed as banking institution. In her survey of 2001, 41 banks participated from all continents with an average number of loans of 7,413 and an average loan amount of 1,253 dollars.

59 See Sarah Forster, op. cit. page 34/35 and 46. The average depth ratio (see page 35) of Microfinance Banks is 553 (meaning that their average loan is 5.5 times the GNP per capita) as compared to 46 (0.46) for MFIs worldwide.

60 IMI is in turn financed with equity by 10 public and private institutions, including IFC (the International Finance Corporation, connected with the World Bank), FMO (the Dutch Development Bank) Stichting Doen/Postcode Lottery (Netherlands) and KfW(Kreditanstalt für Wiederaufbau, Germany).

Looking at their consolidated portfolio, the majority of their clients receive loans below 1,000 US dollars, but 95% of the outstanding capital is in higher loans. In fact, 50% is in - what IMI calls - small loans (10,000-50,000 US dollars) and medium loans (>50,000 US dollars). That implies that their funds are largely employed in the formal banking sector, be it at the lower end of the spectrum, but much higher than what the industry would call microfinance. Nevertheless the IMI approach is creative and valuable, because they combine skills, experience and capital to promote state of the art banking in 18 countries, focused at the lower end of the formal sector. And - as part of their mission - they adopt in each country a substantial number of clients from the informal sector.

61 If no such other party can be found, the original lender is in fact hooked: he has to agree to roll-over the loan for more years, because the funds are in the fields and calling the loan would break the MFI and would jeopardise the repayment.

62 In the field one can notice that this golden rule is sometimes ignored:

- *in Armenia a sustainable MFI is pressed by its funder to charge a 12% higher interest rate in the city than in the countryside, because other - not yet sustainable - MFIs, funded by the same overseas agency, charge higher rates in the city and should not be undercut;*
- *in neighbouring Azerbeidzjan a major funder comes in and enables (instructs?) newly started MFIs to charge substantially lower rates than the existing MFIs and even lower than market, because they want to bring their funds to the fields within the period set by their superiors.*

63 An agency that is to a large extent grant funded, can supplement its capital with loans and bonds, but should not promise to be in the business of creating shareholders' value. They receive grants and concessionary loans to support others, not to pay higher dividends to shareholders.

64 A way around these problems is at present tested by Blue Orchard (Switzerland). They place a 60 million US dollars bond themselves and use the proceeds to finance some 10 highly successful MFIs. In that way the risk is spread and the rating higher. But also in this case the benefits are for the winners with a stable track record, not for the mainstream MFIs.

65 In that respect Bancosol is - from a mission point of view - on a risky track. Over the year 2003 they declared a dividend of 15% (representing a profit pay-out of 90%). That sets a level that will attract "normal" shareholders. Once they have acquired shares from the original friendly shareholders, it remains to be seen whether they will permit Bancosol to continue giving costly and labour-intensive loans below 500 US dollars, because stopping with such activity would immediately boost the profit.

66 Governments should preferably not get involved in direct financing of MFIs, but leave that to specialised agencies. History has shown that direct funding of credit schemes by governments exposes them to burocracy and inadequate interventions.

67 One of the examples is Tanzania, where some 3,000 NGOs are working in a great variety of community development. All these NGOs depend on overseas funding, including the Dar es Salaam Chamber of Commerce. None of them gets government funding from Tanzania's state budget, as if the work they are doing is not of part of the governments' priorities.

68 In fact, in most legislations the definition of a bank is "an institution that is permitted to take savings and deposits".

69 The Philippines, Pakistan, Nepal, Uganda, Mexico, Venezuela. Surprisingly, Bangladesh is not on this list as yet, except for Grameen, for which a special law was enacted in 1983.

70 In the second volume of her study on the Microfinance Revolution (Lessons from Indonesia, page 354-356) Marguerite Robinson lists eight aspects on which the regulatory framework for MFIs should differ from that for regular banks: a different cap on interest rates, different accounting and reporting requirements, different rules for loan classification, different requirements for new branches and registration of collateral and different supervision of savings.

71 Marguerita Robinson (The Microfinance Revolution, page 7) is however going too far: "Donor-financed subsidised credit (…) may often not reach the poor. In addition, many such institutions have high arrears and large losses. Access by the poor tends to be low; despite the subsidies, the costs of borrowing may be high because of widespread inefficiency and corruption." These words do injustice to the hundreds of successful MFIs that started grant funded and were not infected by the grant virus.

72 We have seen that for example in South Africa, where after the change of 1994 many donors withdrew their funds from a vibrant NGO community, assuming that the new majority government would step in. It didn't. On the contrary, the best staff members were sucked into the new government, leaving vital NGOs orphanised as unintended victims of the victory. We see it now again, when the USAID budget available to partners in the Third World was almost overnight severely cut because of the huge funding required for the reconstruction of Iraq.

73 It should be noted, that the most prominent members of the first school are grant funded themselves CGAP, Acción, Women's World Banking, Finca etc. They could be slightly more proud of their own track record in spite of their being grant-funded, and be somewhat more confident that properly managed MFIs will act with the same prudence.

74 Elisabeth Rhyne in "The Yin and Yang of Microfinance: Reaching the Poor and Sustainability" Microfinance Bulletin 2.

75 Quoted in Leonel Roland, (Oikocredit Regional Manager for Uruguay and Bolivia) "A Ship in the Mountains", Montevideo 2001, page 141.

76 See Gordon Donald Credit for small farmers in developing countries Westview Press, Boulder, 1976. In this study he builds on the 1972/1973 Spring Review of USAID, which contains a very critical appraisal of government sponsored programmes.

77 Grameen reported over 2002 a profit of appr. 1 million US dollars on a total asset base of 360 million US dollars. That is 0.27%. Looking at this very small profit, it is more appropriate to say that Grameen more or less breaks even, than to rank it among the profitable MFIs.

Recommendations for tomorrow

Recommendations for tomorrow

The year 2005 has been designated by the United Nations as the "Year of Microcredit". This is an extraordinary opportunity to put microcredit high on the agendas of governments, international agencies and the world of finance. It is essential that - prior to 2005 - the various parties within the microcredit world get their act together about the progress they want to achieve. The following recommendations are not a complete set, covering the whole range. I leave that with pleasure to others.

The microcredit industry

1. If we want microcredit to come within the reach of millions of poor people, the best vehicles are existing MFIs with a good track record. If they serve 3,000 clients well, they could serve 6,000 or even 15,000 clients, provided this growth takes place gradually and systematically. All efforts should be directed at enabling them to gradually increase their outreach.

   This emphasis on increasing the outreach does not imply that microcredit becomes supply driven. On the contrary, experience has shown that there is widespread demand, be it that in many areas this demand is dormant: amongst poor people who don't believe that they would ever be eligible to receive credit.

   This does not exclude support for new initiatives, the so-called greenfield MFIs. They deserve that support, especially if they are the result of local initiatives and firmly rooted in the community. However, the immediate growth will come from the first group.

2. The main obstacle for growth is the lack of funding, i.e. the availability of capital for on-lending. Microcredit is after all a capital intensive business. Successful MFIs need more and more capital to meet the demands of new clients and the demand for higher loans from successful clients. What is needed is a number of bodies at an international level, that inventorise the funding demands of MFIs and work as an efficient interface with the world of potential funders.

   There are a number of such international bodies, such as Acción International, Finca, Women's World Banking, which fulfil this role for their members; however, they do not cover "the world at large". MFIs outside their network have to run their own race. It would be helpful if these MFIs could file their need for funds with a special agency that is in touch with and recognised by a wide range of potential funders. That agency should develop clear qualitative criteria for MFIs in their various stages of development.

3. The same type of agency is needed on national level in the South. It should act as an interface between MFIs, national funders and the international agencies for overseas funding.

In Bangladesh such a national agency (PKSF) has been established and has assisted in the training and financing of more than 140 smaller NGOs engaged in microcredit. Early 2004 Indonesian MFIs established a similar national agency, GEMA, with a similar mandate.

4. MFIs themselves should be invited to give a clear justification of the interest rates they charge and how these relate to rates bankable people in their country/region pay.

Part of the Oikocredit appraisal-system is to verify that the MFI does not charge excessive interest rates to its clients as compared to market rates. The Oikocredit shareholders would never accept that.

They owe this transparency to their clients as well as to their funders. Also the rating agencies, such as Microrate, should include this information in their rating.

5. It would be helpful to make a much clearer distinction between the lower MFIs that serve poor people on or below the poverty line and the higher MFIs that serve the "less poor" who have the potential to enter the formal sector. Clients of the lower MFIs need another approach and other instruments of support than clients of the higher MFIs. For them the road towards sustainability is also longer.

   Most MFIs have a mix of clients, if only because most of their clients graduate in the course of time to higher layers. Nevertheless, to understand the business of the MFI it is essential to know on which layer the MFI focuses when attracting new clients.

6. The choice which layer of the poor is to be served has to be made by the MFI. Donors and funders should respect that choice and refrain from pushing the MFI up to higher layers and/or charging their clients much higher interest rates to reach sustainability earlier. As the graph on page 72 shows, reaching sustainability is in most cases a matter of size and time.

7. Funders should refrain from enabling non-sustainable MFIs (or government programmes) to offer interest rates that undercut the rates of sustainable MFIs in the same country, that focus on the same layer of the poverty pyramid. They should be conscious of maintaining a level playing field.

Governments in the South

8. Governments in the South should recognise their own responsibility for the proper functioning of MFIs. That includes the funding of specialised agencies which in turn provide the MFIs with the necessary funds, be it in the form of grants or concessionary loans.

As mentioned above, governments should refrain from managing MFI funding programmes themselves, but leave it to specialised agencies.

9. Governments and National Banks/Superintendencies should, in close consultation with MFIs, define a proper framework for regulation and supervision of MFIs.[78]

   Such regulation should recognise that in a well-proven context group guarantees from poor people can constitute sufficient collateral. It should also include regimes for reporting that recognise the different nature of this business as compared to that of regular banks.

10. Under such regulations, properly functioning MFIs with a clear track record should be allowed to accept savings and deposits, not only from their members but also from the general public.

    MFIs that have shown over the years a repayment rate of >95% have given convincing proof that they are as good as normal banks (if not better) in managing credit without losing the funds that were entrusted to them. They deserve to be recognised as prudent managers of savings.

11. Governments in the South should consider a special tax regime for MFIs. It makes no sense to support MFIs in reaching the very poor (with income levels far below the minimum taxation level) and then to tax the MFIs as if they are conducting a normal business, thus forcing them to pass on these taxes to the "untaxables".

12. Governments in the South should consider establishing their own "De Soto" agencies that systematically monitor which rules and regulations are unnecessarily *"contra-poor"*. These agencies should have the authority to propose amendments to legislative bodies.

    Such agencies are a logical and necessary complement to the initiatives in the development world (from World Bank and UNDP to NGOs such as Oxfam and the Microcredit bodies) to develop strategies and instruments of *"pro-poor growth."*[79] It should be noted that the poor benefit much faster and much more directly from rules and regulations being made less contra-poor, than from most blue-prints that are pro-poor.

13. One of the most important steps De Soto has identified is the need to give the poor legal title to the land they live on, so that they can borrow against the security of that land, enabling them to use the capital twice.

    Of course, the introduction of such a scheme takes time and its implementation (surveying; title research) takes even more time. But the question is not how long it may take, but when it will start. Bearing in mind that - apart from the administrative costs - *it does not require capital* to recognise the ownership of land in cases where no one else - except maybe the government - is legally entitled to any such claim. This unlocks the door to economic participation and growth.[80]

Governments in the North

14. Taking into account that most development budgets of governments in the North are motivated by the wish to contribute to the alleviation of poverty, it is surprising how little budgetary recognition is given to microcredit as an effective instrument to reach the very poor. Most of the economic aid is directed at the formal sector and has only very indirect benefits for the poor, if any benefit at all. Now that microcredit has established itself as effective instrument, Northern development budgets should specifically allocate funds for microcredit activities.

    These funds should be used to increase the funding base of specialised international funding agencies and of national agencies, supplementing the amounts made available by national governments.

15. Governments in the North should consider following the example of the Dutch, and use tax instruments to foster investments in poverty alleviation by private individuals. In an economic age where shareholder value has become the driving force and seems to have pushed out all other values, people who want to make alternative investments, focusing on *careholders' value*, should receive clear government support.

    The Dutch government, at the initiative of Oikocredit and with the full support of the Minister of Development Cooperation, enacted in 2000 a special facility for private investors in poverty alleviation. This facility consists of tax freedom under the wealth-tax, plus a tax credit under income tax, to a total value of 2.5%. It applies to investments up to euro 51,390 per person. The same facility was already in place for green investments. In 2001 Oikocredit was recognised as the first investment fund under this tax regime.[81]

Commercial banks

A major effort has to be put into convincing commercial banks that they have a role to play in the financing of microcredit.

In 2002, J.F. Rischard, World Bank Vice-President for Europe, wrote an extraordinary book in which he emphasises that the problems the world is facing require concerted action and are too large to allow business to turn their back on them.[82] The usual business reaction:

"We provide society with goods and services and we do that well, otherwise we would make no profit. Moreover we create employment, pay dividends and taxes. These are our contributions to society and they are very valuable. Governments and others should address other issues, we are in business!"

is no longer good enough. If any progress is going to be made in solving these major problems[83], business leaders must team up with others, such as governments, inter-

national agencies and NGOs. Because business is the driving force that runs the world economy and leads to economic progress. And business, compared to all the other actors, also scores substantially higher on getting things done.

Just as the accountability of the pharmaceutical industry in the fight against HIV/AIDS goes beyond efforts to protect their patent rights, commercial banks cannot simply shelve the responsibility that millions of unbankables are excluded from credit. Even less so now that microcredit has proven to be an effective instrument in addressing the needs and the potential of these millions.

As stated above, microcredit may be *"none of their business"*, but it should be *"part of their concern"*. That does not mean that commercial banks should be pressured to start diversifying into microcredit themselves - if only because microcredit deserves another business context than most banks can offer. Commercial banks should be invited not to adapt, but *to adopt*. That adoption could take various forms, but should include a structural financial commitment. They should not be asked to increase their costs, because such a request is bound to fail, but instead to allocate part of their profit to specialised microcredit funding agencies (and then only in cases where these banks do better than expected).

Banks in the South

Banks in the South should be invited:

16. To allocate 10% of their profits, after an allowance for inflation, to a National Microcredit Fund (NMF) or to an own foundation, that in turn assists local MFIs with grants, concessionary loans or guarantees. The reason for such a self-taxation is that this encourages banks to accept point-blank co-responsibility for the poor in their own society. People who are entitled to be seen as fellow citizens and who need support in a form they can't provide themselves.

    This formula means that when their return on equity is 14% where inflation is 9%, they commit 10% of the difference - 0.5% of their profits - (before taxes) to the NMF.

    In order to provide such a NMF with continuity, the banks' commitment should be for a minimum of five years, with a notice period of two years. The NMFs should be managed by representatives of these banks and of MFIs, and become the local centres for funding, training and best practices.[84]

17. To allow local MFIs to piggy-back on their offices and systems.

    There are already many examples of such cooperation. See four small Village Banks in South Africa that collect the pensions for their members and run small credit schemes. The scheme is managed by the Village Bank, but one of the major commercial banks holds the VB account and takes care of the sub-administration.

18. To provide qualified staff with the right attitude to serve as board members or as special advisors to MFIs.

19. To assist in the creation of an adequate regulatory framework for MFIs.

International banks in the North

These should be invited:

20. To allocate 10% of their unforeseen profits to development of microcredit, either through an own foundation or via an International Microcredit Fund.[85] Unforeseen profit being defined as the profit they make in any fiscal year in excess of their own budget before the start of that year.

    This formula means that if they have budgeted 14% return on equity and make 17%, 10% of the difference - 0.3% of their profits - (before taxes) will go to the YMF. If they make 14% or less, they have no obligation to contribute. This 10% of x% does not hurt the bank its shareholders in any way. It is only 10% of the *unforeseen extra* profit. They retain the remaining 90% of the extra benefit.

    These commitments should also be made for a minimum of five years with a notice period of two years. At the end of the third year an evaluation should take place to verify if the YMF is on the right track.

A valid reason for major international banks to commit themselves to such support activities is the growing acceptance of Corporate Social Responsibility and Socially Responsible Investments (SRI).[86] Banks that want to rank high in these two categories in order not to lose the investments of University Endowment Funds, Pension Funds such as Calpers, Alternative Investment Funds such as Calvert, Church Funds, Trade Unions and committed individuals, should do more than *not* financing pollution, drugs and child labour. They should also prove that they are doing the right thing.

Once 10 or 15 major international banks join the YMF and set the tune, other banks are likely to follow their example.

21. To participate in share capital and/or provide concessionary loans to specialised agencies, recognising that not *every* dollar has to yield a maximum return.

    If 3% of their investments yields 2% only and 97% yields an average of 8%, their total return is 7.82%. That is only 0.18% lower, i.e. less than the change in the value of their investment portfolio in one single day. That implies that investing 3% at 2% is not a financial decision, but a policy decision. If they are nevertheless reluctant to make a 2% investment, they could consider making a grant of 0.18% to their own treasury department. That would bring the return of such a 2% investment to the average level of 8%.

22. To assign staff to strengthen the microfinance industry; to assist in training, the development of management information systems, computer systems etc.

23. Banks that offer SRI asset management services to investors with specific SRI aims, should not only concentrate on selecting "the best in class in SRI terms" among the best financial performers, but also offer their clients the choice to invest part of their money in funds with a moderate financial but high social return. It is up to these clients to say yes or no. As explained above, the financial consequences of such a decision are minimal.

If at the end of 2005, the Year of Microcredit, progress has been made on all these points, there is reason to look at the prospects of microcredit with confidence. Without surrendering a successful instrument to "the market of moneymakers" - which is by definition not the natural ally of the poor. They deserve other allies.

78 *One of the best examples of an adequate framework that was made in close consultation with all the various stakeholders is Bolivia. See: Leslie Théodore and Jaques Trigo Loubiere, The Experience of Microfinance Institutions with Regulation and Supervision, in Deborah Drake and Elisabeth Rhyne, The Commercialisation of Microfinance.*

79 *This concept of "Pro Poor Growth" has gained considerable influence over the past years and rightly so. It aims at growth models that bring disproportionate benefits to the poor that narrow instead of widen the gap. Nevertheless, one should be careful with this expression. It sounds like a peace treaty between economists who aim at growth and developmentalists who aim at the poor. However, there is no such peace treaty. If we want 'pro poor growth' to get beyond the level of a politically correct mantra, deliberate policies and steps are required to safeguard that both elements are linked.*

80 *Early 2004, Egypt took the lead, invited De Soto and launched such a programme on a nation-wide scale. That will result in a major break through in a society where 88% of the business is in the informal sector (source: Steve Forbes, 16th February 2004).*

81 *Recognition of the ASN-Novib Fund and Triodos Fair Share Fund followed in 2004.*

82 *J.F. Rischard, High Noon, 20 Global Problems, 20 Years to Solve Them, Basic Books, 2002.*

83 *Poverty, HIV-Aids, Clean Water, Drugs, Corruption, Arms trading, Conflict Prevention, Terrorism, Digital Divide, Money laundering, Deforestation, Desertification, etc.*

84 *Such National Microcredit Wholesale Funds are in place already in Bangladesh, the Philippines, Pakistan and Nepal.*

85 *To avoid confusion with the IMF this fund could be named YMF. The Y stands for the first word in its mission statement: "Why are we in business?" The Y also symbolises that the participating banks have grown beyond their "one track mind" oriented primarily at creating shareholder value only, and recognised the need for a second track, aimed at society.*

86 *See the extraordinary work of Amy Domini, Calvert etc., that made SRI investments a very visible concept in the USA, the importance of which is widely recognised in financial circles, as well as in Board rooms. Similar work has been done by ASN Bank in the Netherlands and in Germany and Switzerland.*

Conclusion

Conclusion

Microcredit is here and is here to stay. Thanks to the commitment of tens of thousands of workers in the fields, millions of clients, thousands of supporters in the North and more than one hundred funders. The question is not whether microcredit will survive. The question is how many people it will reach.

Fifteen years ago that question was abstract because microcredit was not much more than a concept that might or might not prove to be effective. Now, fifteen years later, we know that microcredit has grown to support some 50 million people. That is surprisingly good for a new business concept. However, that is only 5% of the one billion people who try to survive outside the formal economy on less than one dollar a day. Who - in spite of all the efforts of development experts - remain beyond the reach of any (other) instrument that gives them the chance to earn an income.

Now that microcredit has proven to be an effective instrument, any question as to its potential is no longer academic. It is a matter of policy, political will and planning. It is clear that an instrument that supports 50 million people could also serve 200 million, if not 500 million. Provided MFIs operate as adequate transmission belts and do the right things in the right way with the right support.

> That does not mean that the instrument is effective per se, that all MFIs are working well and that all clients are doing well. It needs a lot of work and discipline to make this particular instrument truly effective; to ensure that it doesn't turn sour, for its clients and/or for the instrument itself.[87]

In view of the magnitude of the task ahead, the debate between the two schools about sustainability/profitability versus outreach is somewhat surprising if not parochial. There is no disagreement on the need to increase the outreach. There is disagreement about the time that it may take to become sustainable without subsidies and the price to be charged to the poor. Those are no trivial issues, but it would be unwise if they would divide the movement.

To a certain extent this debate seems to be the result of the industry having adopted the business model. In the wake of that choice a whole lot of "business principles" and ideas entered the frame and offered themselves for incorporation, such as:

- profit is the ultimate proof and yardstick as to whether a business is successful;
- if there is no profit, in the longer run there will be no business;
- grants and subsidies are wrong, they distort the working of the market;[88]
- a free market will bring the cost price down and therefore benefit all.

All these principles are correct, but for social ventures - ventures that have a mission other than creating shareholder value - they are too simplistic and too dogmatic. Social ventures can be very successful and sustainable without necessarily making profit of a size that makes them attractive to moneymakers. They can be subsidised

without distorting any market (which in many cases does not exist for the services they render). They can benefit many without harming any.

Examples are provided in public transport, universities, hospitals, schools for the handicapped or blood banks. In those cases sustainability rather than profitability is a condition for survival. They are sustainable once they are perceived by the public sector or private sponsors to give an essential service to society and are sufficiently effective and cost-conscious to be supported. The mere fact that these bodies are subsidised does not change them into charities. The passengers, the students, the patients, the parents and the users have to pay. In their eyes the institution treats them as any business would do. Quite correctly.

In cases such as these, subsidies are not given to distort the market, but to bring essential services to the market and within the reach of the target group at an affordable price. In some cases this can imply that certain groups get these services for less than cost price. Take for example an electricity company that is invited to bring electricity to the other side of the mountain. No one expects the people living there to pay the full cost price of that operation, but rather to be charged roughly the same price as people in the cities. Nor does anyone expect people at the other side of the mountain to put more postage stamps on letters than people in cities do, because it costs more to get the letters out.

Microcredit is a scheme to serve the poor. To bring credit to “the other side of the mountains”, to the rural areas, the slums and the shacks. When, years ago, the early MFIs chose for the business model, they did not do so because of the four business principles mentioned above, or because they had discovered a new niche for profit-making. They did so because they realised that managing a financial services scheme requires a business approach. With strict standards and high level of discipline. Not like the soft-bellied NGO approach. With hindsight that was the right decision. It was made to bring discipline and predictability in the *downstream* relationship with their clients, not to change the *upstream* relationship with their funders or donors, or to marry poverty-focus with profit-focus.

True, such a marriage would be an interesting experiment. Never say never. But it would be unwise to surrender the future of microcredit to the constraints and conditions of such an experiment. Microcredit has more logical allies.

At the end of the day, when the 100 million target is reached, a number of MFIs will be totally subsidy free and even profitable. Provided they are allowed to get their funding from savings and deposits. Depending on their profitability, they might also be financed by the capital market, although the question remains as to what extent this quest for profitability will have pushed them away from the bottom layers of the pyramid, or forced them to charge interest rates no bankable person in the same country would be required to pay. But even if this should be the case, they will be supporting people that deserve to be supported for as long as they are not bankable in the eyes of regular banks.

A much larger number of MFIs will still depend on concessionary loans, because of their mission to serve clients deeper down in the pyramid. That does not imply that they will not be sustainable or that they are doomed to fail. As long as they prove to be effective conduits for bringing financial services to the poor they should qualify for outside support.

A good example of this second category is CRECER, a Freedom from Hunger initiative in Bolivia with a good reputation. Their question is: why should the microcredit industry accept as a definition of sustainability *"without external support"*? In other words: why emphasise a condition that would force an effective *development* instrument not to enlist the support of others?

> *"Because our name is Freedom from Hunger, not Freedom from Subsidy, we have to stop a moment to think about where all this is leading us and the microfinance movement. What is most important here? It is to build social enterprises that can last long enough to bring about major improvements in the lives of very large numbers of people? Or is it to become certified as totally subsidy free - not now, not then, not ever? I will not pretend to speak for all social enterprises, but in the case of CRECER, and many other microfinance institutions, the goal is not to become totally subsidy free. That is neither necessary, nor sufficient to achieve our true objectives."*[89]

Finally, 2005 will be UN Microcredit Year. A moment to take a major step forward and to allow the CRECERs, SARTAWIs and SHAREs to double their reach. All the elements required for such a step are there:

- the poor are there;
- the demand is there;
- the commitment is there;
- the skills are there;
- the discipline is there;
- the track records are there;
- the funding … is there as well.

With one important footnote: it rests to a large extent still in the bank account of potential funders.

However, since the first Microcredit Summit of 1997 the reasons for potential funders to put microcredit on their agenda have gained in strength. As it has proven to be a relevant and effective instrument to enable the poor to take their economic future into their own hands.

87 See the devastating description of possible wrongdoings by David Hulme, Is microdebt good for poor people? A note on the dark side of microfinance, in Malcolm Harper (ed), Microfinance, Evolution, Achievements and Challenges, ITDG Publishing, London, 2003. Although he is too much absorbed by the potential negative aspects, his warnings are relevant.

88 It should be noted that in spite of this firm conviction, the North spends 300 billion US dollars per year on agricultural subsidies. That amount is 5 times the 60 billion US dollars per year spent on development aid and 300 times the total amount that is made available to finance microcredit.

89 Christopher Dunford: The Holy Grail of Microfinance: "helping the poor" and "sustainable" in Malcolm Harper, Microfinance, Evolution, Achievements and Challenges, ITDG Publishing, London, 2003.

Notes

MICROCREDIT

SOUND BUSINESS OR DEVELOPMENT INSTRUMENT

Microcredit - or microfinance - has captured the attention of the development world because of its extraordinary relevance to enable the poor to improve their economic situation. In this publication Gert van Maanen elaborates on a number of aspects that influence the success (or failure) of Microfinance Institutions (MFIs).

In particular he deals with the question whether microfinance should be seen as a business that - like all businesses - should aim at profitability or as a development instrument that should aim primarily at increasing its outreach and effectiveness. In his view the latter approach should prevail. Without, however, ignoring the need for any MFI to sooner or later stand on its own feet, without being dependent on friendly donor capital.

Towards the end he makes some innovative proposals to mobilise the banking sector in the South and the North to adopt microcredit, because the future of the poor *"may be none of their business but should be part of their concern"*.

This publication is written for whomever takes an interest in microfinance as effective development instrument, but aims especially at new board- and staffmembers of MFIs in the South and funding agencies in the North, that want to prepare themselves to play a relevant and effective role in this field.

Gert van Maanen was until his retirement in June 2001 Managing Director of Oikocredit (Ecumenical Development Cooperative Society U.A.). Before joining Oikocredit on a full-time basis in 1994 he was Member of the Executive Board of ING Bank, Vice-chairman of ICCO and Board member of Oikocredit. At present he is Board member of MFC, the Microfinance Centre in Warsaw, and Board member of CORDAID. This publication is an upgrade of the paper he presented during his farewell symposium in June 2001 at the Royal Tropical Institute in Amsterdam.

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