Microfinance and Microentrepreneurship: Case studies in social innovation

Arvind Ashta

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JEL Classifications: L26, O16, O17, O30.

CEB Working Paper N° 13/046
2013
Microfinance and Microentrepreneurship: Case studies in social innovation

Arvind Ashta
Banque Populaire Chair in Microfinance of the Burgundy School of Business
Associated Researcher at CERMi

Arvind.ashta @ escdijon.eu

Working paper: August 8, 2013

Abstract
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Acknowledgements: My thanks to the participants at the Microfinance and Microentrepreneurship conference in Sonepat, India on August 8-9, 2013, especially Geoff Archer and Surender Mor.
**Introduction**

At the outset of this paper, let us clarify what is entrepreneurship. In Economics, entrepreneurs are a factor of production, just like labour, land and capital. The returns for entrepreneurs are called profits. However, the management theorists usually take Schumpeter's (1951, 1989) definition of entrepreneurship which is doing some new thing (new product/service); doing it in a new way; creating a new market; finding a new sourcing of material; or reorganizing. Notably absent in Schumpeter's definition is the entrepreneur who continues his business, doing the same old thing in the same old way for old customers using the same material source. A key difference therefore is between those who innovate in some way and those who do not. It is noted also that Schumpeter (1951, 1989) distinguishes between innovating entrepreneurs and imitating entrepreneurs. Thus, once an innovation has taken place, other imitating entrepreneurs may also adopt this new thing, new way, new market, new source or new combination.

It is likely that businesses which do not involve any innovation constitute a large proportion of total businesses; and it is possible these non-Schumpeterian businesses constitute a large part of microenterprises concerned by microfinance. Microfinance is the provision of financial services to the very poor and financially excluded. Thus the services are of very small amounts, generating proportionally very high transaction costs. The transactions costs being very high, they were not being delivered by banks and other financial service providers. Therefore, to serve this population, a new way of doing things was required. Thus the microfinance service provider is an entrepreneur in the Schumpeterian sense, even if the microenterprise he is serving is not. The particular form of innovation he is undertaking is a social innovation: solving a social problem by creating new social relations that challenge conventional wisdom and conservative forces, using innovative business models of local actions to empower people in multiple ways.

Social innovations are motivated by a mix of charity and problem-solving (Dees 2012). They require problem-solving and management skills, creating shared values and beliefs, motivating people, creating an appropriate organizational framework of rules. Successful social innovations create effective cultural and political demand for the innovation as well as supply of alternative proposals (Westley and Antadze 2010). This may require representing the innovation in cultural and political contextualization in simple roles such as villains and heroes (Ruebottom 2013). It also uses interaction with eminent but locally embedded actors or "known strangers" (Marti, Courpasson, and Dubard Barbosa 2013). Thus, external partnerships are required to break the vicious circle (Nurkse 1952) through the import of financial, technical, human and social capita. This social capital includes bridging, bonding and linking social capital (Gerometta, Häussermann, and Longo 2005, Lybbert 2008). Such partnerships with others require sharing cognitive beliefs, diffusing them and creating regulatory frameworks for the collaboration to survive (Harrisson, Chaari, and Comeau-VallÉE 2012).

Ashta et al (forthcoming) explain the dialectic institutional process of evolution of microfinance. In this paper, I take in turn some microfinance services and provide examples of social innovations that are brought in to provide these services to microentrepreneurs.

**A. Microcredit and Entrepreneurship**

Entrepreneurship requires financing. Microcredit is the process of providing small loans to poor people. The size of the loans has been growing with time and today the average loan size is about...
US$ 600 today compared to USD $ 250 reported by the median MFI to the MIX in 2000\(^1\). However, most of the growth in average loan size is owing to inflation and growth in GDP per capita. Average loan size as a percentage of GDP per capita has remained between 30% and 35% for most of the period.

However, this average loan size varies a lot from region to region. It is much lower in South Asia where it is $ 150 while in Eastern Europe and Central Asia it is almost $ 2,000. In Latin America it is about $1,000.

The MIX gives the figures for outstanding loans, and these are therefore averaging to half of the full loan size. All these figures therefore need to be doubled. One can therefore say that the average loan size of loans given is about US $ 1,200 today and that this is about 60% of GDP per capita.

The problem

Providing loans of small amounts to poor people generates three major problems. First, transaction costs of processing loans is very high. Second, Information asymmetries make it difficult to select credit worthy borrowers, in the absence of credit histories. Third, poor people lack complementary human and social capital to effectively make the business grow to be able to repay the loan. This is why traditional banks and financial institutions did not supply credit to poor people.

The social innovation: Case study of Grameen model

The social innovation used by microcredit to deliver this product was "a new way of doing things". They used group lending. In the most simple of these models, the Grameen model (Yunus 2003), a group of five women would be formed. Credit would be given to two of them. If they repaid, two other women would be given loans. If all repaid, the fifth woman would be given a loan. Thus, there was a peer group pressure for the women to use the loan well, to guide each other to do well and to repay the loan. Moreover, lending to the group or to many groups in the same visit reduced the transaction costs for the microfinance institution. Other innovative features included progressive lending and small but frequent repayments (Armendáriz and Morduch 2005, Ashta et al. 2013). Figure 1 captures the basic model.

Figure 1

Microcredit as a Social Innovation

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\(^1\) Statistics have been based on data downloaded from the Microfinance Information Exchange (MIX), downloaded on Feb 3, 2013.
Over time, as the credit histories were formed, and individual needs started diverging based on different success rates of their businesses, the group lending gave way to individual lending. The high repayment rates and the high profitability of the sector provided incentives for competition to come in. Instead of lowering interest rates, the impact of competition has been to provide multiple loans to the same individuals. This is now creating over-indebtedness and credit risk (CSFI 2011).

It is estimated that about 200 million people\(^2\), most of them very poor, benefit from microcredit. Taking a family size of five, this means that about a billion of the poor are now obtaining financing. Moreover, even banks are now starting to provide microfinance by imitating the entrepreneurship methods of MFIs.

One problem which remains is that individual loans require collateral, which the micro-entrepreneur may not have. A possible solution is to find someone to provide guarantees.

### B. Microguarantees and Entrepreneurship

In rich countries, with some social mobility between rich and poor people owing to public education systems, churches and other organizations, it is possible to find someone who would guarantee the loan that a microentrepreneur takes. Often, public institutions are available to guarantee loans to small business (De Gobbi 2003). Moreover, enforcement of the guarantee is relatively easy since there is a legal infrastructure.

**The problem**

In poor countries, microcredit reduces moral hazard through groups which provide guarantees. However, once the microentrepreneur graduates to individual lending, the group would no longer provide collateral since the loan size is no longer standardized. The alternative of getting guarantees from rich friends often does not exist since poor people lack the bridging social capital to meet richer people who would be willing to put their assets at risk for helping out the poor.

To overcome this problem, it is usual for mutual guarantee associations or government backed public institutions to guarantee part of banks' loans to entrepreneurs. However, although such guaranteeing institutions are cropping up in developing countries, they do not have the required outreach among the poor.

At the same time, there may be donors who would prefer to provide guarantees rather than provide either donations or loans. However, they do not know who to reach out to the microentrepreneurs who need the guarantees. Thus, the problem is one of information asymmetry.

**The social innovation: case of United Prosperity**

In an innovative case, thanks to technology, we see the development of websites such as UnitedProsperity.org. In this case study, a person in a developed country deposits a small amount, say $100, with United Prosperity in a bank account in the developed country. This money is used as a collateral to provide guarantees in India. Figure 2 illustrates United Prosperity’s model.

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\(^2\) Microcredit Summit Campaign: 205 million in 2010, 195 million in 2011.
Since not all loans are unpaid, a $100 guarantee can serve as a collateral for loans of three times as much. Therefore, the developed country Bank's $100 can serve as collateral of loans up to $300 to a bank in a developing country who is financing microfinance institutions, who in turn is financing microentrepreneurs. As and when the borrower pays the MFI and the MFI repays the Indian Bank, the Developed country bank will repay the $100 to its own guarantor. In fact, since microfinance has a high repayment rate, the guarantees are never invoked and the money does not travel abroad and there is no foreign currency risk.

The scaling up power is even higher: as MFIs get loans from a bank and repay them, their credit rating improves and other banks are also willing to finance them. They can then provide even more loans to microenterprise.

C. Microinsurance and Entrepreneurship

The role of insurance is to reduce risks incurred by shocks and accidents. Microinsurance is good for business, both directly and indirectly. Firstly, business insurance is directly good for business because it helps to outsource the risks. Secondly, personal insurance permits the entrepreneur to keep microcredit solely for business. An improved health leads to higher productivity and reduced expenditure on healthcare (Hamid, Roberts, and Mosley 2011). If households are insured against health risk, they may also invest more in business because they do not need to hold highly liquid assets for precautionary purposes.

Today, the ILO estimates that 500 million poor people are receiving microinsurance of some form or another, while 2.5 billion others remain uncovered. Many of the poor were not provided

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microinsurance because the transaction costs of reaching them were very high or owing to lack of trust.

A number of innovations have been brought in different fields to overcome these problems. For example, in Brazil one can find insurance produces available at banking correspondents; in South Africa, they are available at pharmacists and general stores. In many countries, they are being delivered through micro-finance institutions. An innovative use of technology is through RFID identification of cattle to reduce fraud in claim settling: otherwise, the insurance company cannot ensure that the cattle who died was the one insured. In other countries, the government is subsidizing the premium for the poor so that existing private operators can deliver the insurance: an example is India’s *Rashtriya Swasthya Bima Yojana* (RSBY) scheme for health insurance. A more socially innovative scheme brought out by a private operator for health insurance is described below.

The problem

Microcredit is diverted to consumer loans because there may be sudden medical expenses, funerals and/or a need to smooth household cashflow. The poor lack the capacity to withstand the consequences of many shocks (Cohen, McCord, and Sebstad 2005). Poverty and vulnerability reinforce each other in an escalating downward spiral. The vulnerability is directly related to the ability of households to manage risk (Barlet 2004).

The high transaction cost of selling insurance to the poor and educating them on the benefits of insurance makes microinsurance expensive. Moreover, even if the poor take a health insurance policy, there will be no hospitals where they can take treatment. The state of public hospitals is market by very few beds, few specialists and high chances of infections owing to congestion. As a result, the success of surgeries is low and patients take longer to recover.

People prefer to go to private hospitals. But private hospitals need to be paid in advance. This means that the poor have to either sell the family jewels or borrow money. A survey has found that when people are treated well, they can repay loans. So MFIs have a vested interest in protecting their clients from health related financial shocks so they can increase assets and become more stable consumers of their microfinance services.

The social innovation: Case of SAS

Dr. Arjun has started SAS healthcare which is now providing a low cost mutual to fund private treatment of poor people. There are four stakeholders: SAS Healthcare, NGO / MFI partners, clients and clinics. The NGO / MFI puts the poor in contact with SAS Healthcare. This allows SAS to enrol thousands of poor people and scale up quickly. The poor, who become members, pay annual fees of about 3 Euros per family member. SAS then links the patients with clinics and hospitals in the area and provides information on the best clinic. If a member falls ill, SAS pays hospital fee which is Rs 10 for their client instead of Rs 100. The hospital agrees to do this because it also gets many more patients.

The Physician of SAS reviews claim in the online system. SAS approves and settles the claim amount immediately to enable the clinic to operate with less working capital. The member is treated and discharged and the treatment is cashless. Figure 3 illustrates the model.
According to a recent presentation SAS program has about 300,000 members, 126 network hospitals, 96,000 outpatients, and 4200 in-patients treated and health benefits of Rs. 17 million provided since inception.

D. Microequity and Microentrepreneurship

Microequity is the founder's money, love money from friends or relatives of small amounts invested by micro-angels in the microenterprise. As opposed to credit, which has to be repaid with interest, equity holders expect dividend only if the firm is profitable.

The problem

An over-reliance on microcredit imposes stress on microborrowers. During the last couple of years, we saw possible abuses of the system, highlighted among the farmers of Andhra Pradesh in India, harassed by their creditors to suicide. Ashta, Khan and Otto (2011) had done some macro/sociological analysis of the relationship of microcredit with suicides and had commented that there may be some cause for stress in the relationship between the credit agent who needs to show a 100% recovery and the borrower who cannot always ensure this.

Knowing that it is impossible for a company to have a harmonious development without equity, and that the availability of equity has an impact on sustainable growth rates (Ashta 2008, Higgins 1977), it is evident that this is true for microenterprises also. What poor entrepreneurs need is somebody to take the risk of putting their money in their risky enterprise. Somebody, who will not ask for money back if they are a failure and thus remove downside risk and the effect of loss aversion (Quattlebaum 1988, Tversky and Kahneman 1991, Ashta and Otto 2011). Somebody, who can guide them, professionally as well as emotionally, in change management inherent in a new entrepreneurial project. Banks cannot use savings deposits of their customers and fund such risky initiatives. Banks, with their high cost structures, do not have time to advise such small enterprises.

The social innovation: case study of CIGALES

http://www.developmentoutlook.org/2012/11/access-conference-reducing.html
CIGALES are investor clubs in France (Taupin and Glemain 2006, Russo 2007). Each of their members is a micro-angel. They are working people and retired people, there are top managers, senior managers, middle managers and junior managers. They are social workers with no management experience. As illustrated in Figure 4, all of these micro-angels get together and form a club called CIGALES. Each angel contributes between 7.50 Euros per month to 450 Euros per month depending on how micro (s)he is. Once the combined savings of the club is large enough they finance projects which require equity of as little as 1000 Euros to projects where many clubs may get together to invest 25000 Euros. And, their magic wand is such that when they accompany projects, 75% are still surviving five years later as opposed to 50% on average for new ventures in general.

Figure 4

**Microequity based models of CIGALES**

How do they do this? Like their macro counterparts, they believe in proximity and provide advice and mentoring to the entrepreneur (Ashta et al. 2012, Estapé-Dubreuil, Ashta, and Hédou 2012). However, if the mentor is unable to answer the question, he uses the combined human capital of the entire club to get an answer. And if they cannot, the members use their network to find people who can help the entrepreneurs. Finally, once a CIGALES club is associated with a project, a strong signal is given to other financiers, including banks, that the project is good and therefore loans also come in where otherwise bankers feared to tread.

The CIGALES investor clubs have existed in France since 1985 and today there are 2,800 CIGALES micro-angels.

**Concluding Remarks**
The delivery of financial services to the poor was plagued by problems of high transaction costs, lack of complementary social and human capital, and asymmetric information. These problems have been viewed as opportunities by a large number of social innovators. For each financial service, depending on its nature, different social innovation models have emerged. This short chapter has provided four short case-studies explaining four such social innovation models. There are of course many hundreds, and the four we have chosen randomly may not be representative. They have been chosen to highlight diversity. A more detailed study of the process of social evolution of the microfinance industry as a whole is provided by Ashta, Couchoro, and Musa (Forthcoming).

In addition to social innovation, microfinance also requires technological innovation if it is to reduce operating costs and make the financial services affordable at a reasonable price. These technological innovations include MIS, mobile banking, online crowdfunding, biometrics, credit scoring, and many others (Ashta 2011). The use of these advanced technologies is creating new social innovations in the market place.

Ashta, Arvind, Mawuli Couchoro, and Abu Saleh Mohammad Musa. Forthcoming. "Dialectic Evolution through the social innovation process: from microcredit to microfinance." *Journal of Innovation Economics*.


