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The Microfinance Alphabet

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JEL Classifications: G21, G23, O16, G32, O19, B55.

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Abstract

Much has been learnt in microfinance over the last ten years. But there is yet so much to discover on how to improve financial inclusion and development. This paper offers an—evidently subjective—microfinance alphabet, hoping to so provide the microfinance scientific community with an opportunity to "read together" both where we stand and where we are heading.

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Introduction

The fifth European Research Conference on Microfinance was organized in 2017 at the University of Portsmouth, UK. Previously organized in Belgium (Université Libre de Bruxelles—ULB, 2009), the Netherlands (University of Groningen, 2011), Norway (Agder University, 20013), and Switzerland (University of Geneva, 2015), the conference is a great opportunity for researchers in microfinance to exchange ideas on their common field of interest.

Much has been learnt in microfinance over the last ten years. But there is yet so much to discover on how to improve financial inclusion and development. A child's fifth birthday is a great moment to celebrate. It is also the typical moment where the child discovers the world of reading. Likewise, we are happy to celebrate the fifth edition of the European Research Conference on Microfinance by contributing to this book with a—evidently subjective—microfinance alphabet, hoping to so provide the microfinance scientific community with an opportunity to "read together" both where we stand and where we are heading. We hope you'll enjoy it!

A: Asset and Liability Management (ALM)

ALM refers to the way in which banks address and manage the risks attributable to potential mismatches between the assets and liabilities. Even though ALM is barely considered in the microfinance literature, it is a key challenge for microfinance institutions (MFIs) willing to develop products that meet the needs of the financially excluded. Most MFIs are reluctant to supply long-term loans, and microfinance start-ups pay much more attention to the asset side of their balance sheet—notably to the quality of their portfolio—than to their liabilities. Indeed, recently-created MFIs are mostly financed by seed capital and subsidies, so that their liabilities are often not considered a priority. Later developments make, however, liabilities management necessary to address MFIs' long-term needs for capital. When subsidies dry out, MFIs typically take loans from regular banks, at least in countries where commercial loans are accessible to them. In this way, MFIs can sustain their growth for a certain time provided that the quality of their portfolio remains under control. Otherwise, commercial banks will consider MFIs too risky and cut their financing. But if an MFI's portfolio keeps growing, its debt/equity ratio will at some point reach a level such that bank loans will become difficult to obtain. It is at this point that most MFIs start thinking seriously about collecting savings, which are the only long-term source of funds that allow a financial institution to grow steadily without liquidity issues.

B: Bottom lines

MFIs are usually understood as double-bottom-line institutions. While economists tend to use the social-versus-financial trade-off to describe the objective function of MFIs, management scholars designate these dual concerns by referring to welfare and market institutional logics. Yet, the actual existence of a "simple" trade-off is challenged on both sides. On the one hand, commercialization, which typically downplays the social concern, pushes toward a single business-like objective (see "C"). On the other, some argue in favor of adding a third bottom line of environmental performance, leading to the notion of green microfinance.

C: Commercialization

The microfinance commercialization trend is now well recognized: The Consultative Group to Assist the Poor (CGAP), a consortium of donors active in microfinance, mentioned it already in its 1990s' five-year plans. Yet, the bulk of the commercialization wave developed during the 2000s. Cases in point include the initial public offerings of two leading MFIs: Compartamos and SKS. Some scholars consider commercialization as a pre-requisite for MFIs to address financial inclusion efficiently. By contrast, others see commercialization as a major source of mission drift observed when organizations focus on profits and move away from their social goal. The co-existence of such contrasting views probably explains why we are still lacking a broadly accepted definition of mission drift.

D: Diversification of Products

Microfinance started as microcredit, as illustrated by the fact that the largest meeting in the field was named "The Microcredit Summit Campaign." Later, financial services for the disadvantaged populations were extended to savings, insurance, and money transfers, leading the industry to move from microcredit to microfinance, and more recently to financial inclusion (see "F"). Meanwhile, the conversation evolved around the advantages and drawbacks of providing financial services only—the so-called "minimalist" approach —or combining them with financial literacy, professional training, marketing support, or even business-unrelated services—the "integral" approach.

E: Ethics of Randomized Control Trials (RCTs)

RCTs are often considered as the gold standard of impact evaluation in microfinance. RCT results are known for their high internal validity in terms of causal linkages, associated with limited external validity due to their poor degree of generalizability. Nowadays, prestigious economic journals refrain from publishing non-RCT empirical studies due to endogeneity concerns. Strikingly, the RCT conversation focusses on methodology and the ethical issues are left aside. Yet, RCT ethics committees would gain from internationally binding guidelines based on strict, universal ethical rules as is the case in medicine when it comes to, e.g., patient consent and providing ex ante equally attractive options to the treated and control groups, a rule known as equipoise. The serious history of mistreatments of third world populations by past medical experiments is a strong incentive to increase our vigilance in that regard.

F: Financial Inclusion

Financial inclusion is increasingly replacing microfinance in the alphabet of financial services to the poor and the unbanked. In fact, this change in language broadens the scope of the sector since it goes beyond MFIs and includes new service providers, such as fintech, and new technologies, such as mobile banking. It might however obscure the original objectives of poverty alleviation and empowerment of the disadvantaged populations.

G: Governance

Any microfinance alphabet *must* address MFI governance. This topic encompasses the role of the boards, which is increasingly investigated quantitatively with international datasets. Governance studies also check whether the decisions of MFI executives match the mission of the organization they serve. Top executives gain both increased legitimacy from stakeholders, such as donors and public authorities, as well as extra financial manoeuvre room from commercial fund providers. Some relevant governance mechanisms are internal, such as boards, organization charts, incentive structures, and corporate culture. Others are driven by the environment, such as accounting standards, regulation and supervision requirements, as well as

the due diligence of debt providers. Corporate governance in microfinance points to major risks, as pinpointed by the Banana Skins reports[2].

H: Human Rights and Microfinance

Muhammad Yunus considers that microcredit should be a human right. He states that access to credit is instrumental to economic development, poverty alleviation and the improved welfare of all citizens. This view is challenged by those arguing that credit is not a universal need. Moreover, credit that is too easily obtainable can have perverse effects like over-indebtedness. Meanwhile, other financial services, such as savings and money transfers, are and less risky and sometimes even more useful socially than credit.

I: Interest rates

The interest rates charged by MFIs have been criticized since the early days of microcredit in the 1970s. Outsiders find it hard to understand why lending to the poor is costly. MFIs must cover three types of inevitable costs: the cost of funds, the operational costs, and loan loss provisioning. Well-managed MFIs can limit both their costs of funds and loan loss provisioning, but reductions in operational costs are difficult to achieve since numerous small proximity loans imply costly features, such as multiple branch and frequent home visits. But this evidence is not a reason for charging *abusive* interest rates, and more so from MFIs benefitting from a monopoly/oligopoly power over financially vulnerable clients. Excessive interest rates have been exposed since the emergence of microcredit, but criticisms have grown widespread of lending practices in leading MFIs in certain countries, such as Mexico.

J: Juggling with Financial Products

Microfinance clients juggle with formal and informal sources of funds and financial services. They use a variety of financial tools, linked to informal networks, local merchants, family and

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[2] The Banana Skins reports are published by the Centre for the Study of Financial Innovation (CSFI), a non-profit think-tank, established in 1993. They provide a barometer of the risks facing the banking, insurance and microfinance industries (CSFI website, consulted on 3 December 2018).

friends, and various providers of financial services. The dark side of this resourcefulness is the risk of over-indebtedness, and subsequently an increased frequency of credit defaults that can undermine the microfinance sector.

K: Keeping an Open Mind

Microfinance is not a panacea against poverty. And microfinance alone cannot tackle all the complex issues associated with poverty reduction. MFIs do however respond to a real demand from the poor and unbanked populations for reliable financial services. At the very least, like banks, MFIs help smooth income. The question raised by Richard Patten "If microfinance is the answer, what is the question?" is still relevant.

L: Loan Officers

Loan officers are key players in the microfinance arena. Not only are they the visible side of the organization, but they are also those who screen clients and enforce loan reimbursements. The typical day of a microfinance loan officer is made up of many house visits, so that they become an integral part of the community they work in. Loan officers face conflicting challenges: They are the partners of their clients analyzing their needs and providing them counseling, while also having to promote their employer's agenda including portfolio growth—which implies pushing credits—and timely repayments—with various forms of pressure. Even though the role of loan officers is fundamental, it is only recently that scholars have started studying them specifically.

M: Microfinance Promise

Researchers in microfinance typically start with reading the influential and most quoted article on the sector, "The Microfinance Promise" by Jonathan Morduch. This paper was published in 1999 in the *Journal of Economic Literature*, at the same time as Jonathan's other seminal paper "The Microfinance Schism" published in *World Development*. Twenty years later, these two papers are still a wonderful introduction to understanding the very essence of microfinance.

N: Non-Governmental Organizations (NGOs) and Savings and Credit Cooperative Societies (SACCOs)

Historically, the vast majority of MFIs started their operations as NGOs or SACCOs. NGOs have played a major role in the microfinance industry as their basic characteristics allowed them to be particularly innovative. These characteristics include being non-regulated institutions as they were not collecting savings and being largely financed by subsidy providers. Key methodological principles of microfinance, such as group lending and progressive lending, were originally tested by NGOs. Nowadays, NGOs still represent a significant segment of microfinance, but their overarching dominance has faded.

Originally created in the 19th century in Germany and Britain, SACCOs have spread all over the world and are now part of the financial landscape in general, and microfinance in particular. The comparative advantages of SACCOs are twofold: They are imbedded locally, and they benefit from members' voluntary workforce. On the flip side, their growth can be detrimental to the interactions between members and executives, resulting in threats to their governance (see G).

O: Ohio-State-University Pioneers

The pioneering contributions of Dale Adams, Claudio Gonzalez-Vega and Richard Meyer had an influential role in the field of microfinance and financial inclusion. These scholars have left their mark on a variety of topics. They argued that "cheap credits" from donors and subsidized credit lines and grants can prevent the entry of private actors, and therefore be detrimental to the development of rural financial systems. These pioneers stressed the relevance of micro-savings and proved that some informal markets are less irrational and exploitative than originally thought.

P: Portsmouth

Following Brussels, Groningen, Kristiansand, and Geneva, Portsmouth was the fifth city to host the European Research Conference on Microfinance. The event was perfectly organized, and all the participants enjoyed the enthusiasm and dedication of the host institution. Portsmouth will remain present in the collective memory of the European microfinance community. We extend our special gratitude to Joana and Michael, the editors of the current volume.

Q: Quantitative Models

The role of models in economic theory is much debated. Regardless, the common wisdom equating mathematical modeling with the tenets of neoclassical economics is misleading. Mathematical models can be adapted to various objective functions, provided that they are formally well-defined. Microfinance models have addressed relevant issues, such as the consequences of the double-bottom-line approach (see B) to financial services in the context of informational asymmetries. By making trade-offs explicit, mathematical models can bring to light the real challenges facing MFIs and help go beyond the often-simplistic rhetoric of unconstrained 'good-doing'. Even though most—if not all—arguments can be made without any equation, the role of mathematics stems from its capacity of holding the formal strictness of reasoning. Importantly, the purpose of mathematical modeling is to address a theoretical research question with minimal working assumptions rather than reflect the full complexity of the real world.

R: Regulation and Supervision

Originally, public authorities viewed reluctantly the development of MFIs. They thought that, if lending to the poor were a feasible and sustainable economic activity, it would already have existed for a long time. This attitude evolved with the success of major MFIs worldwide. Nowadays, authorities are contemplating ways of nurturing microfinance, notably thanks to specific Non-Banking Financial Institutions (NBFIs). Typical regulatory frameworks permit various types of MFIs: Simple institutions cannot collect public savings and are therefore only lightly controlled, while those providing multiple financial services are subject to rules similar to those imposed on banks. Altogether, many countries have invested significant effort in microfinance regulations. But the same cannot be said about supervision: Most authorities lack properly trained manpower. As a result, officially supervised MFIs do sometimes look safer than they are.

S: Subsidies

Subsidies have always played an important role in the funding of MFIs. Most microfinance pioneers were supported by grants or concessionary loans. After decades of microfinance practice, many MFIs still receive significant subsidies and are even subsidy-dependent. Only a minority of MFIs are true commercial actors and totally un-subsidized. While grants and concessionary loans still exist, subsidized equity – equity holders with below market expectations - represents the largest type of subsidy.

T: Time-Inconsistency

Procrastination, under-saving, and over-consuming are typical features of human behavior, grouped by economists under the label of time-inconsistency. These features contrast with the textbook characteristics of the so-called *homo oeconomicus* who makes time-consistent decisions. Even though time-inconsistency affects agents with any income level, its consequences are far more harmful to cash-constrained individuals than to those who are better-off. MFIs address the hypothetical time-inconsistency of their clients by supplying illiquid financial products meant to discipline financial impulses. While discipline can be a useful commitment device to counteract temptations, they are counter-productive for poor people confronted by adverse shocks. Poor households are coping not only with income variability and unpredictability, but also with uninsured idiosyncratic risks, such as sickness and robbery, as well as systemic risks, including the consequences of climate change and political unrest. To address these tough issues, the poor badly need access to flexible products.

U: Unfair Discrimination in Lending

Discrimination in lending against vulnerable groups—such as women and minorities identified by their ethnicity, religion, caste, disability, and sexual orientation—refers to unfair stereotypical criteria used in loan allocation. The most common definition of discriminatory loan allocation relates to a lender's practice of deviating from profit-maximization logic. According to this view, a biased lender is identified by the fact that it denies loans to the targeted group members more frequently than to the other applicants, all else being equal. The problem with this approach arises from its implicit assumption that both the group members and the others loan applicants are equally creditworthy. In some cases, however, this assumption can

be wrong. For instance, evidence in microfinance suggests that women tend to reimburse their loans more swiftly than men, for reasons that are still obscure and not captured by the usual control variables used to stick to the "all else equal" statistical requirement. If the assumption of equal creditworthiness does not hold, then even equal denial to both groups, with all else being equal, can end up being unfair.

V: Village Banking

Village banks come under various forms. Some are old and have hardly changed in decades. It is the case of the Indonesian BKD (Badan Kredit Desa – literally village credit organizations), which is among the oldest worldwide. Other village banks, such as Finca, were initiated more recently by international players. All village banks share the ideas of starting small, at the village level, and being collectively managed. In some cases, the bylaws impose that the leader of the bank is a locally elected person, such as the village's mayor. Village banks are stable institutions, able to provide financial services to customers typically disregarded by other MFIs. The main challenge facing village banks founded with international support is surviving the sponsor's exit.

W: Women's Empowerment

Many MFIs claim to target women. Nevertheless, recent evidence suggests that microfinance commercialization is associated with a decline in the share of female clients. A possible explanation is that women are poorer than men on average and are therefore less profitable clients. Accordingly, female borrowers and savers would be less attractive to profit-oriented financial institutions. Another, and potentially complementary, rationale is that commercialization brings along the typical biases plaguing the banking industry, such as unfair discrimination (see U) of some groups of loan applicants. When women's empowerment stops being viewed as a moral priority, the common stereotype that links business capacities and masculine traits makes it more difficult for female entrepreneurs to raise capital and business loans. Further developments on this issue could pay more attention to the characteristics, including gender, of microfinance leaders, managers, and loan officers (see L) who are willing to empower women. Hypothetically, gender affinity—and, more generally, homophily—is a promising theoretical avenue to understand the determinants of the segments served by MFIs.

X: The Unknown Author Who Will Answer All Our Questions and Doubts

What is the future of microfinance? Are most MFIs doomed to become either another type of bank or philanthropic institution? Will microfinance institutions still exist in twenty years or will mobile banking and traditional financial providers overtake the microfinance market? Will subsidies in microfinance dry up soon? Will RCTs adopt generally-agreed ethical rules? Is green microfinance going to scale up and have a strong environmental impact (see B)? Will anybody be able to be Yunus's (see Y) successor? Will commercialized microfinance actors totally integrate the mainstream financial sector? Should MFIs focus on remittances? Will the double-bottom-line narrative survive the move toward financial inclusion? Will pro-social financial institutions learn from corporate-governance crises? How should governments supervise MFIs properly? These questions and many others are awaiting X!

Y: Yunus, Muhammad

Muhammad Yunus is the iconic figure of microfinance. Born in 1940 in Bangladesh, he was awarded the 2006 Nobel Peace Prize, together with the Grameen Bank, for promoting the concept of microcredit. His notoriety allowed the microfinance community to become a priority for donors and enter business circles. Yunus is not only the central figure of microfinance, he is also seen as the poster child for social entrepreneurship and one of the most well-known among the Fellows of the famous Ashoka network of social entrepreneurs.

Z: Zero Default

A striking figure of microcredit is, crises aside, its overall low probability of default. Many leading MFIs have experienced a low portfolio at risk compared to traditional commercial banks active in the same country. Does this mean that zero default is the ultimate goal? Certainly not, for two reasons. First, lending money is a risky business, and a zero-default score would signal an overly restrictive lending technology. Targeting zero default means taking very low risks, which can eventually harm the social bottom line of MFIs. Second, a loan portfolio with zero default sounds too good to be true, and probably is.