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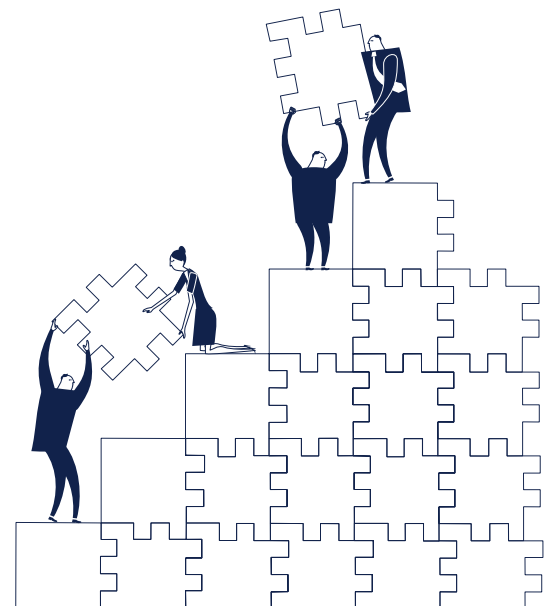


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# Microfinance: A Field in Flux

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# Microfinance: A Field in Flux

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## Abstract

Modern microfinance, a field reaching over 200 million clients worldwide, is undergoing considerable change. The market structure is shifting with organizations increasingly accessing commercial funding through both private placements and initial public offerings. Some markets have overheated and produced substantial criticism, exemplified by the crisis in Andhra Pradesh, India. Recent impact evaluations of microcredit in diverse countries, such as Bosnia, Mexico, and Morocco, are raising similar questions about what microfinance actually can achieve and how it can best meet the needs of the poor. The basic offering is being rethought in terms of products and services, with increased attention on microsavings, microinsurance, and mobile banking. The field can best be characterized as being in a state of flux, with institutions moving in new and, at times, contentious directions.

This chapter is an overview of the current field of microfinance, drawing on both practitioner and academic resources. Sections 1 and 2 provide a brief introduction and clarification of microfinance terminology. Section 3 places microfinance in its historical context, reviewing predecessors such as informal community associations and state-owned development banks. Section 4 describes how the modern microfinance movement began in the 1970s and grew to its present form. In Section 5, the current landscape is then characterized in terms of scale, geographic coverage, institution size, and organizational type. Sections 6 through 8 summarize the most fundamental ongoing debates in microfinance: the critical features of modern microfinance; the appropriate role of commercialization; and the assessment of microfinance's impact. Sections 9 and 10 conclude with implications for the broader field of social finance based on lessons learned from the microfinance movement to date. Throughout the chapter, vignettes are included to illustrate the trends and concepts.

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# Microfinance: A Field in Flux

## 1. Introduction

Microfinance is often cited as the success story of the broader social finance movement. Financial access for poor and low-income clients has expanded dramatically over the last four decades to include over 3,500 microfinance institutions reaching over 200 million clients worldwide (Maes & Reed, 2012). The approach is often viewed as a clear example of using market-based principles to advance a social objective, in this case primarily the use of unsubsidized lending to alleviate poverty (Nicholls, 2006). The movement has also generated extensive public acclaim, such as the United Nations recognizing 2005 as the International Year of Microcredit and the Norwegian Nobel Committee awarding the Peace Prize to Dr. Muhammad Yunus and the Grameen Bank in 2006.

However, to characterize the microfinance movement as an uncontested success story lessens our ability to understand the challenges of pioneering the social finance space. A more nuanced view of microfinance reveals a field in flux faced with unresolved debates and ongoing changes. The market structure is shifting, with organizations increasingly accessing commercial funding (Glisovic, González, Saltuk & de Mariz, 2012). Some markets have overheated, producing substantial criticism (CGAP, 2010). Recent impact evaluations are raising new questions about what microfinance actually can and should attempt to achieve (Bauchet et al, 2011; Banerjee, Karlan & Zinman, 2015). Even the basic offering is being rethought in terms of products and services that will better suit the needs of the poor (Morduch, 2011). Amidst these developments, the global reach of microfinance continues to expand (Reed et al, 2014). In such a state of flux, it is increasingly important to understand both the unifying trends as well as the points of disagreement within the field.

The intent of this chapter is to provide an overview of microfinance by exploring both its historical roots, as well as the significant changes that have occurred over the last decade. To help place microfinance in context, the chapter begins with a brief introduction to terminology and a review of two key historical predecessors that were particularly relevant to the emergence of modern microfinance: informal community associations and state-owned development banks. The following section describes how the modern microfinance movement began in the mid-1970s and grew to its present form. The current landscape is then characterized in terms of scale, geographic coverage, institution size, and organizational type.

The remaining content of the chapter is structured around three of the most fundamental debates in microfinance. Not only have these questions shaped the course of microfinance to date, but they are still unresolved and will likely direct the future of the field. The first topic concerns the critical features of the microfinance model. For decades, practitioners and researchers have grappled with understanding exactly what makes microcredit appear to work (e.g. Stiglitz, 1990; Attanasio, Augsburg, De Haas, Fitzsimons &

Harmgart, 2012). Some institutions are shifting their focus beyond credit, to include such products as microsavings and microinsurance (e.g. Dupas & Robinson, 2011; Karlan, Osei-Akoto, Osei, & Udry, 2011). The second topic addresses the appropriate role of commercialization in microfinance. This issue has become increasingly polarized as organizations have begun accessing capital through public stock markets and sometimes generating substantial profits for shareholders (CGAP, 2007). Whether commercial funding represents a much needed capital source or a move in the wrong social direction may be the most contested issue in microfinance (see e.g. Yunus, 2011). The third topic concerns the actual impact of microfinance. The recent publication of several randomized controlled trials suggests that the impact of credit on microenterprise growth is more modest than originally hoped (Bauchet et al, 2011; Banerjee et al, 2015). However, the upside of such studies is that microfinance programs often produce other unintended benefits for the poor, such as risk reduction and better cash flow management (Morduch, 2011). These findings are useful in that they suggest how microfinance might be reconceptualized to improve its social impact. The chapter concludes with implications for the broader field of social finance based on lessons learned from the microfinance movement to date.

## **2. Microfinance Terminology**

A basic definition of microfinance is "financial services for poor and low-income clients" (Gonzalez & Rosenberg, 2006, p.1). While this definition offers a good starting point, it is helpful to further clarify what is typically associated with the term 'microfinance'. Broadly, the idea and practice of financial services for the poor is not new. For example, informal savings and credit associations for impoverished communities have existed for centuries in many countries around the world (Helms, 2006). However, when the term 'microfinance' is used today, there is a general understanding in the industry that one is referring more narrowly to the movement that has taken shape over the last four decades built around a more specific financial model. It is common for this movement to be referred to as "modern microfinance" (Trezza, 2006, p.20) or the "new microfinance" (Robinson, 2001, p.224). In this chapter, usage of the term 'microfinance' will refer to this more narrow conception.

What are the primary features of the modern microfinance movement? The Grameen Bank, pioneered by Muhammad Yunus in Bangladesh during the 1970s, is often cited as the prototypical example of modern microfinance (Morduch, 1999). There are two key tenets to this type of model: (1) financial self-sustainability of the service provider and (2) targeting clients that are typically excluded from the formal financial market. While not all microfinance institutions achieve financial self-sustainability, the intent is generally to charge interest rates and fees that allow the provider to cover its operational costs. This can be contrasted with the model of many state-owned development banks from the 1950s to the 1980s that were built on the idea that credit to rural farmers had to be subsidized (Robinson, 2001). The second tenet of modern microfinance is social inclusion often with the ultimate aim of poverty alleviation. This is borne out by typically targeting clients in developing countries that are frequently excluded, such as women and the poor (Yunus, 2003).

A further aspect of terminology that is useful to clarify is the distinction between microfinance and microcredit. Microfinance is a more general term that refers to a variety of financial services; microcredit is a subset of microfinance that specifically refers to the provision of small loans. In addition to loans, microfinance can also include financial services such as deposits, insurance, payment services, and money transfers (Daley-Harris & Awimbo, 2011). Historically, the focus of microfinance has been on providing microcredit via group loans. As a result, the majority of microfinance research to date has explored the features and effects of providing such loans. However, over the last decade there has been a substantial shift in attempting to provide a more complete set of services beyond microcredit (Armendáriz & Morduch, 2010).

### **3. Historical Predecessors of Modern Microfinance**

The idea of financial services for clients excluded from the formal market has a substantial history. In development finance, it has been a perennial question as to why certain populations seem to be cut off from the global credit market (see e.g. Braverman & Gausch, 1986; Stiglitz, 1990). In response to this question, several reasons have been suggested as to why providing loans in developing economies is difficult. Given the small loan amounts and high transaction costs, an institution needs to be highly efficient and maintain low default rates if it is to be financially sustainable. While this challenge is not insurmountable, a lender typically faces the additional difficulties of: scarce information on potential clients before issuing the loan; limited ability to effectively enforce the loan once it has been disbursed; and, a lack of collateral to rely on if the client goes into default (Besley & Coate, 1995). Taken together, these challenges create a daunting environment for an institution to be financially sustainable. Faced with such circumstances, what financial models have been used in the past?

Two types of predecessors are particularly important for understanding the current movement: community associations and state-owned development banks. Community associations, in particular Rotating Savings and Credit Associations (Roscas) and Credit Cooperatives, have been in use for centuries and are relevant for their use of group lending. These models are thought to have played a role in inspiring Yunus' ideas for the solidarity groups of Grameen Bank (Morduch, 1999). State-owned development banks are relevant for their use of subsidized lending. They are of interest predominantly because their failed attempts from the 1950s to the 1980s provided such a strong impetus for the new microfinance model (Armendáriz & Morduch, 2010).

#### ***Community Associations***

The roots of group lending can be traced to a type of community association known as the Rosca (Geertz, 1962; Besley, Coate & Loury, 1993). Ardner defines a Rosca as an informal association "formed upon a core of participants who agree to make regular contributions to a fund which is given, in whole or in part, to each contributor in rotation" (1964, p.201). Roscas serve the function of allowing members to pool their money into lump sums without the involvement of formal institutions. If a member receives the lump sum earlier in the rotation, it can be viewed as that member having received a loan from the

group. If a member receives the lump sum later in the rotation, the Rosca has functioned more as a savings device for the member. This basic arrangement is used extensively around the world with a high degree of similarity (Geertz, 1962).<sup>1</sup> Since the 19th century, Roscas have been documented under different names; for example, in China they have been referred to as *hui hui*, in Nigeria as *esusu*, and in Scotland as *menages* (Ardner, 1964). There is written evidence of Roscas being used in Japan as far back as 1275 (*ibid*).

An important feature of Roscas is that the members typically know each other socially. They rarely start with a formal management or organizational structure, yet they typically have very high repayment rates. Many researchers have asked how the repayment rates are maintained. Roscas seem to avoid default problems by relying on the social cohesiveness of the group (Geertz, 1962; Ardner 1964; Besley et al, 1993). Not only can members provide positive support and solidarity, there can be significant social cost in terms of pressure, embarrassment, or exclusion. Such social mechanisms are key features of the modern microfinance model involving group loans.

A more formalized community organization for financial access is the Credit Cooperative. In contrast to Roscas, these cooperatives often have a formal charter and some legal status (Armendáriz & Morduch, 2010). Loans also tend to be larger and are paid back over longer periods. In the cooperative model, the members are all shareholders, but not all the members are expected to take out loans. The concept of community lending is still central to the model as members have a say in setting the terms of credit access and an ongoing interest in ensuring that the loans are repaid. Cooperatives emerged in Germany during the late 19th century and are now seen internationally in countries as diverse as Ireland, France, Kenya, Malawi, and India (Huppi & Feder, 1990).

### ***State-Owned Development Banks***

While community associations are historically relevant for their often successful use of local cohesiveness, state-owned development banks are relevant for demonstrating the limitations of subsidized credit programs. From the 1950s to the 1980s, there was a focus on development via government-mediated subsidies for the rural poor (Armendáriz & Morduch, 2010). Using external funding and formalized organizational structures, development banks hoped to scale up financial services to the poor. Subsidized credit for farmers was the most common approach. Despite positive intentions, the results of such programs were broadly deemed a failure (*ibid*). See the following vignette on India's Integrated Rural Development Program for a detailed example.

The programs often failed to achieve their development goals and resulted in very high default rates. Most government-subsidized credit programs in Africa, the Middle East, Latin America, and South Asia produced default rates between 40-95% during this period (Braverman and Guasch, 1986). Failure of these programs is often attributed to an inability to enforce the loans, corruption within the institutions, and the diversion of funds to better-off clients (*ibid*). The experience of state-owned development banks led many to question whether such programs were a viable approach for extending financial access to the poor.

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<sup>1</sup>There are notable variations on the basic model including organizer fees, group size, fund amount, frequency of repayment, determination of payout order, etc.

**Vignette: India's Integrated Rural Development Program**

*India's Integrated Rural Development Program (IRDP) during the 1980s is an example of an ineffective attempt at development by means of government-subsidized credit. Approximately \$6 billion USD in subsidies was directed to the rural poor throughout the decade (Armendáriz & Morduch, 2010). The government's intentions were decidedly focused on social impact for farmers: "The imperative laid down for the plan for rural areas of the country is increasing productivity through a strategy of growth with social justice... More specifically, it involves a sharp focus on target groups comprising small and marginal farmers, agricultural labourers and rural artisans..." (Rath, 1985, p.238).*

*Given the amount of money invested, the results were startlingly unimpressive. Why did the IRDP fail to achieve its goals? Critics often blame the performance of IRDP on several factors: endemic corruption, lack of infrastructure, and poor administration (Dreze, 1990). Others more generally disagree with subsidized credit programs, arguing that they are not sustainable and disrupt the financial market. The impact on poverty alleviation was a disappointment and default rates were over 40%. "More than any positive historical precedent, it is the repudiation of these negative legacies that has driven the microfinance movement to look to the private sector for inspiration" (Armendáriz & Morduch, 2010, p.11-12).*

## 4. The Modern Microfinance Movement

Following in the wake of the disappointing subsidized credit programs, the greatest accomplishment of modern microfinance has been the demonstration that poor clients can be reliable bank customers (Cull, Demirguc-Kunt, & Morduch, 2009). The rapid spread of the microfinance model has been described by some as a financial 'revolution' (Robinson, 2001). What is different about the modern microfinance movement and where did this innovative model come from?

Accounts of the pioneering microcredit institutions suggest that the model originated from real world experimentation in low-income countries like Bangladesh, Indonesia, and Bolivia (Armendáriz & Morduch, 2010). Credit is often given to Muhammad Yunus for developing the prototypical design of the Grameen Bank in Bangladesh during the 1970s. In his own words, Yunus was not attempting to fix the financial market, but rather to address a social problem: "I had no intention of lending money to anyone; all I really wanted was to solve an immediate problem.... the problem of poverty which humiliates and denigrates everything that a human being stands for" (Yunus, 1998, p.12). The late 1970s was an experimental phase for Yunus and his colleagues: "We did not know anything about how to run a bank for the poor, so we had to learn from scratch. In January 1977, when we started,

I looked at how others ran their loan operations, and I learned from their mistakes" (ibid, p.104).

Since the beginning, Yunus focused his lending scheme on female borrowers. He was particularly driven by their unjustified exclusion from the banking sector. Yunus began by providing small loans to groups of women. He thought that the group feature made the loans easier to keep track of for the bank. Furthermore, groups could provide positive support and social pressure to smooth out behaviour patterns. In terms of collection, he also experimented with very small and frequent repayment amounts, believing that lump sum repayments cause psychological hurdles for the borrowers. For a 365 taka loan (approximately \$15 USD) he would require the borrower to simply pay back one taka every day (Yunus, 1998). Building on these principles of female inclusion, group lending, and small frequent payments, Grameen was formalized as an independent bank in 1983.

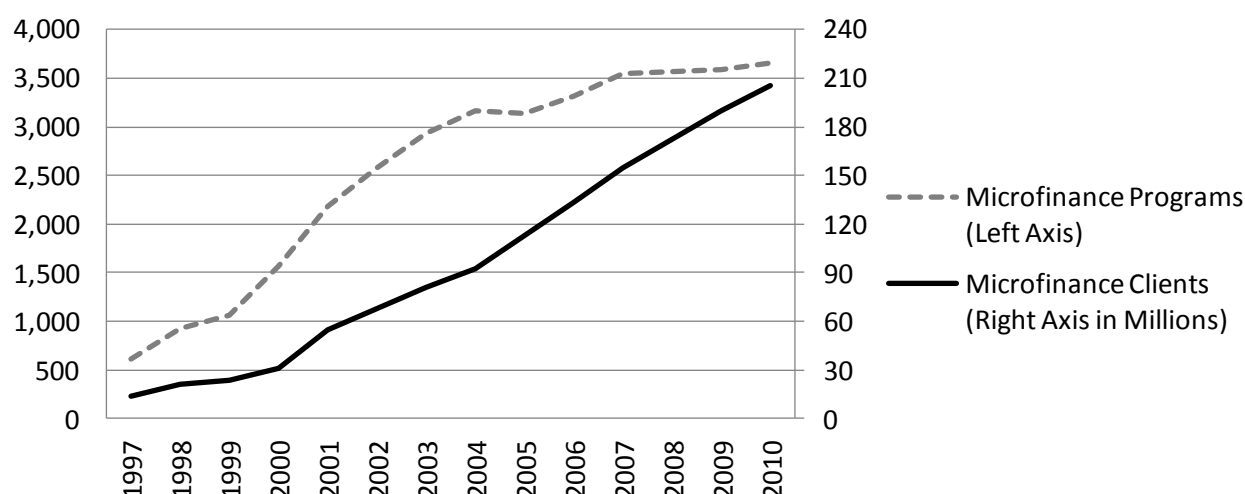
Around the same time, institutions in other countries were pioneering similar approaches for providing microcredit. In Indonesia, the microbanking division of Bank Rakyat Indonesia (BRI) underwent substantial reform in 1983. Aided by the government's major financial deregulation package, BRI was able to produce a large-scale commercially-sustainable microfinance system with unusual speed and success. By the end of the 1980s, both the Grameen Bank and BRI had demonstrated that microfinance institutions could reach over 1 million borrowers and maintain high repayment rates (Robinson, 2001). In Bolivia, BancoSol was established in 1992 to provide microfinance on a national scale (Rhyne, 2001). A substantial portion of BancoSol's funding was from international investment firms, further sparking global interest. There were differences in approaches taken by such pioneering organizations, but the common thread was an interest in developing financial methods to reach the poor without subsidy. Organizations were designing new financial products based on group and individual loans, reassessing appropriate interest rates to cover operational costs, developing new management and information systems, and rethinking appropriate training and incentives for staff members. By the late 1990s, microfinance had transitioned from a collection of institutions to a rapidly growing industry (Robinson, 2001).

Accurately quantifying the growth of microfinance is a challenging task as many of the institutions are small and informal. However, several research organizations have made estimates of microfinance at the global scale. The largest primary-source collection of microfinance data has been produced by the Microcredit Summit Campaign (MSC). Figure 1 provides the number of registered microfinance programs and their clients according to the MSC (Maes & Reed, 2012).<sup>2</sup>

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<sup>2</sup> For alternative market estimates see CGAP ([www.cgap.org](http://www.cgap.org)) or Microfinance Information Exchange ([www.mixmarket.org](http://www.mixmarket.org)). Also note that the Microcredit Summit data includes growth based on existing programs registering for the first time, so may inflate year over year growth. For further detail on the Microcredit Summit data see: [www.microcreditsummit.org](http://www.microcreditsummit.org).



**Figure 1: Growth of Microfinance Programs and Clients**

*Data Source: State of the Microcredit Summit Campaign Report 2012*

In 2010, the number of microfinance programs registering with the MSC was 3,652. These programs reported reaching a worldwide total of 205.3 million clients with a current loan. During the period from 1997 to 2010, the number of total microfinance clients reported to the MSC grew on average by 23% per year. A more conservative estimate of microfinance growth over the period from 1998 to 2004 was produced by the Consultative Group to Assist the Poor (CGAP) by accounting for pre-existing institutions that start reporting to the MSC for the first time. This approach resulted in a growth estimate of 12% per year (Gonzalez & Rosenberg, 2006).

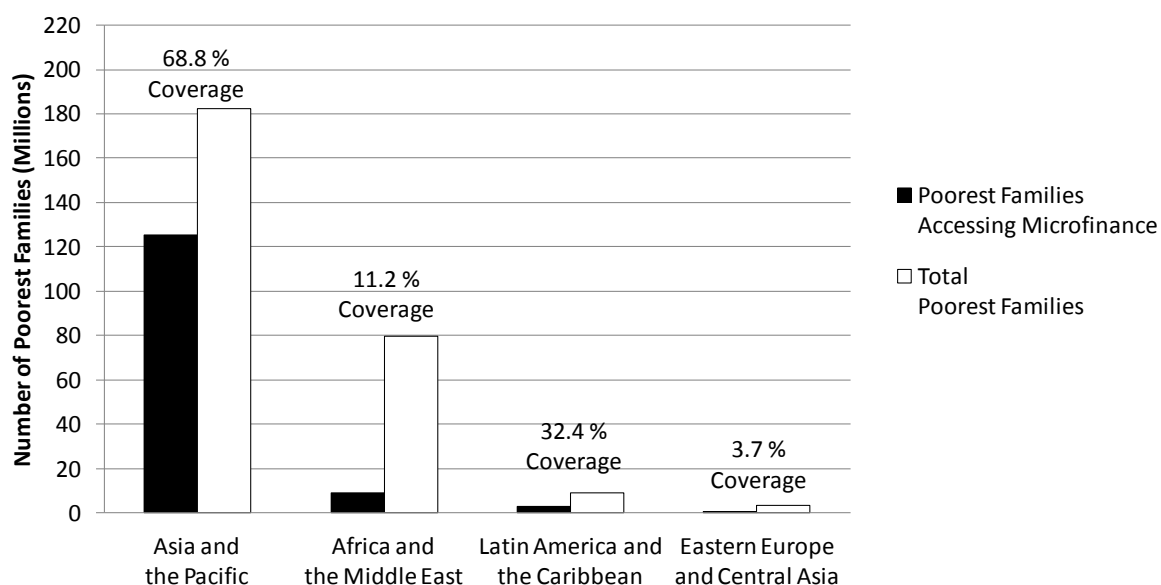
## 5. The Current Microfinance Landscape

Given the origins and growth of the field, what does the landscape of microfinance providers look like today? The landscape is populated by a diverse set of institutions. To name just a few dimensions, organizations vary considerably in terms of mission, targeted clients, product offering, and funding source. As more varied actors continue to enter the microfinance space, what qualifies as a microfinance provider is becoming increasingly blurred (Helms, 2006). In this section, an overview of the landscape of microfinance is provided by examining three basic dimensions: (1) geographic coverage, (2) institution size, and (3) institution type.

Figure 2 summarizes the geographic coverage of microfinance based on the number of 'poorest' families reached in 2010. 'Poorest' refers to those living on less than \$1.25 USD a day adjusted for purchasing power parity (Maes & Reed, 2012). The figure provides an estimate of percentage coverage for each geographic region by comparing the number of poorest families accessing microfinance to the total number of poorest families. Microfinance in Asia and the Pacific is the most extensive both in terms of the absolute number of clients and in terms of the percentage of the relevant population that has been

reached (68.8% coverage).<sup>3</sup> Since the 1980s, as was described with Grameen Bank and BRI, many of the pioneering institutions of microfinance have been located in Asia.

**Figure 2: Geographic Coverage of Microfinance**



*Source: The World Bank and State of the Microcredit Summit Campaign Report 2012*

A second key dimension of the microfinance landscape is the size of institutions. Currently, a small number of large organizations account for the majority of clients, producing a fairly concentrated market structure. See Table 1 for a breakdown of the market structure based on MSC data. Of the 3,652 microfinance organizations that registered with the MSC in 2010, the largest 21 organizations provided loans to over 75% of the total poorest clients worldwide. In contrast, there were thousands of small organizations that each served fewer than 2,500 clients and accounted for only 1.1% of the global market.

<sup>3</sup> It is known that some clients have outstanding loans at multiple organizations. This results in some amount of overestimation of the number of microfinance clients and the coverage percentage. However, based on individual MFI data, it is currently not possible to accurately gauge the overlap of borrowers (Gonzalez, 2008).

**Table 1: Microfinance Market Structure by Institution Size**

Institution Size - Type	Number of Institutions	Combined Number of Clients	Percentage of Total Clients
Networks	8	65,105,273	47.3%
1 million or more	13	40,267,670	29.3%
1000,000 - 999,999	64	17,095,196	12.4%
10,000 - 99,999	361	10,877,810	7.9%
2,500 - 9,999	558	2,731,044	2.0%
Fewer than 2,500	2,648	1,470,448	1.1%
Total	3,652	137,547,441	100.0%

*Note: Size refers to number of 'poorest clients' (below the \$1.25 USD a day threshold)*

*Source: State of the Microcredit Summit Campaign Report 2012*

Finally, what does the current landscape look like in terms of institution type? The Microfinance Information Exchange (MIX) provides a public source of institution types. Here the institutions are divided into five categories based on legal status:

- **Bank:** a licensed financial intermediary regulated by a state banking supervisory agency
- **Cooperative - Credit Union:** a non-profit, member-based financial intermediary
- **Non-Bank Financial Institution:** this category is often created specifically for microfinance composed of financial intermediaries that provide similar services to those of a bank, but may have lower capital requirements or restricted service offerings
- **Non-Government Organization:** an organization registered as a non-profit, typically not regulated by a banking supervisory agency
- **Other**

Figure 3 provides the market structure in terms of the legal status of microfinance institutions in 2011. NGOs are the most common institution type although they are comparatively small, accounting for 23.6% of borrowers. Historically, NGOs accounted for a larger share of the microfinance market. Currently, the increasing commercialization of the field is expanding the presence of banks and non-bank financial institutions. It can be argued that these different institution types are serving different segments of the microfinance market. An analysis by Cull et al (2009) found that NGOs typically have a stronger focus on social objectives. NGOs tended to provide the smallest loans, target the greatest number of women, and reach the poorest clients. The arguments for and against commercial funding are discussed in greater depth later in this chapter.

**Figure 3: Microfinance Market Structure by Institution Type**

Legal Status	Number of Institutions	Number of Borrowers	% of Borrowers
Bank	114	19.0	26.0%
Cooperative	110	1.5	2.0%
Non-Bank FI	308	34.2	46.9%
NGO	316	17.2	23.6%
Other	48	1.1	1.5%
<b>Total</b>	<b>896</b>	<b>73.0</b>	<b>100%</b>

*Note: Number of borrowers in millions*

*Data Source: MIX Market 2011<sup>4</sup>*

## 6. Critical Features of Microfinance

So far in this chapter, an overview of microfinance terminology, historical growth, and current landscape has been provided. With that background, the focus now shifts to three central debates in microfinance. Focusing on unresolved debates is useful for understanding a field currently in flux. The topics highlight alternative views regarding what has worked to date and potential future directions for microfinance.

The first debated topic concerns the critical features of microfinance. Given the historical emphasis on credit programs, much of the research to date has focused on loan features. Microfinance pioneers often innovated along multiple dimensions simultaneously. This produces a situation in which it is difficult to disentangle the factors that may have been the most effective in prior programs. Understanding the underlying mechanisms is particularly important when attempting to replicate the model in different cultural contexts. It remains an open question as to which features of microcredit are necessary, as well as how additional services and products should be incorporated in the microfinance offering. Here the debates around five features of microfinance are summarized: (1) group versus individual lending, (2) necessity of public repayment, (3) optimal repayment frequency, (4) impact of dynamic incentives, and (5) breadth of product-service offering beyond credit.

<sup>4</sup> The allocation is based on 896 institutions reporting to the MIX Market in 2011. The criteria used to define what qualifies as a microfinance provider can produce different characterizations of market structure. For an alternative view, see Helms (2006).

## ***Group versus Individual Lending***

One of the most discussed features of microfinance is the use of joint-liability group lending.<sup>5</sup> Instead of offering loans to individual clients, microfinance institutions often offer loans to groups of clients, such that if a borrower defaults, the other group members are held financially responsible. Organizations have used a variety of group sizes and structures. On one end of the spectrum, BancoSol provides loans to 'solidarity groups' as small as three borrowers. At the other extreme, 'village banking' models are based on groups of up to 50 borrowers. Such village banking models were pioneered by the Foundation for International Community Assistance (FINCA). The Grameen Bank began with a nested structure between these two extremes: subgroups of five borrowers were linked as 40-person groups.

Why are group loans particularly relevant to the poor? The basic motivation is that financial institutions often lack information on potential clients, are unable to effectively enforce the loan, and have little collateral to seize if a borrower defaults. These problems often make traditional lending in such markets financially unsustainable. Group lending seems to overcome some of these challenges by leveraging the social relationships of the group. Researchers have suggested that group members are in a better position to screen, monitor, and enforce on each other (Ghatak, 1999; Stiglitz, 1990; Besley & Coate, 1995).

However, group lending has also been argued as placing too great a burden on borrowers. One issue is that group lending transfers more of the risk from the bank to the group members, even though the bank is often in a better position to bear the cost of a defaulting client (Stiglitz, 1990). A second concern is that group lending can produce substantial social costs for the borrowers as well. One can easily imagine how positive support to repay could turn into a harmful form of group pressure (Woolcock, 1999; Brett, 2006). Moreover, survey research indicates that when the question is posed to clients as to whether they would prefer a group loan or an individual loan, most respondents favor not being held jointly liable (Murray & Lynch, 2003; Ditcher & Harper, 2007).

Do the benefits of group lending outweigh the additional costs for the borrowers? A first step towards answering that question is understanding the impact of liability type on repayment rates. If the institution's operational benefits from group lending are small, a strong case can be made that the social costs of group lending outweigh the marginal economic benefits. Studies that directly address this issue are limited to date, but are beginning to gauge the effect of liability type on repayment. Giné and Karlan (2014) conducted two experiments in the Philippines regarding individual versus group liability. In the first experiment, existing clients of a rural bank were assigned either to continue on with joint-liability contracts or to switch to individual-liability contracts. In the second experiment, villages were randomly assigned to individual or group contracts from the outset. In both experiments, the researchers found no significant difference in repayment rates between the individual and group contracts.

An experiment by Attanasio, Augsburg, De Haas, Fitzsimons, & Harmgart (2012) in Mongolia also found no difference in repayment rates, although other positive effects of group lending were noted. In their study, different villages were randomly assigned to

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<sup>5</sup> In this document, group lending refers specifically to the use of a joint liability contract. Other social aspects of microcredit, such as public repayment, are discussed in later sections.

receive access to group loans, individual loans, or no access. While they did not find a difference in default rates based on contract type, they did find that group lending produced an additional positive impact for the borrowers in terms of business creation and poverty alleviation. Attanasio et al argue that group lending ensures greater discipline in borrower behavior, notably better project selection and long-term execution. A recent study conducted in Sierra Leone by Sabin and Reed-Tsochas (2014) found that variation in a microcredit group's social structure has a significant effect on its economic performance. The study shows that group features, such as average spatial density and fragmentation, help us to understand why groups behave differently in terms of repayment.

To date, it is still unclear how crucial group lending is to microfinance. However, a general trend in the field is a shift away from joint-liability contracts. Armendáriz & Morduch (2000) suggest that while group lending may be relevant in some situations, it is time to focus on other mechanisms that may be more important to microfinance and less socially costly.

### ***Public Repayment***

One such alternative mechanism for microcredit is public repayments. Repayment in front of fellow community members leverages a social incentive without the full joint-liability contract. Research has found that the borrower's motivation to avoid embarrassment and social stigma can improve repayment rates (Rahman, 1999). Furthermore, public meetings can offer additional opportunities for training borrowers. Often viewed as an innovator in the field, Grameen Bank revised its group lending approach in 2001. As part of the approach, Grameen no longer requires joint-liability loans but still administers loan collection in large public groups (Yunus, 2003). The importance of public repayment is also well illustrated by the practical example of recent innovations in mobile phone banking. See the M-Pesa and Group Lending vignette for a more detailed account.

**Vignette: M-Pesa and Group Lending**

*In 2007, Safaricom-Vodafone launched a new mobile banking platform in Kenya called M-Pesa. The platform allowed clients to transfer money via their mobile phones. Within four years, M-Pesa had been adopted by over 14 million customers and over 70% of households in Kenya (Suria, Jack, & Stokera, 2012).*

*M-Pesa actually started as a pilot program in 2005 to facilitate the loan disbursements and repayments of a microfinance institution called Faulu Kenya (Kumar, McKay, & Rotman, 2010). During the 6 month pilot, Faulu realized that if borrowers could make their payments using their mobile phones, public meetings to collect payments were not necessary. However, the management and staff at Faulu were concerned that without these public meetings, group cohesion - a key component of their lending model - would deteriorate. Following the pilot, Faulu decided not to use M-Pesa for loan repayments.*

*Other MFIs have come up with a hybrid approach that integrates M-Pesa with public meetings. The Small and Micro Enterprise Programme pioneered an approach in which borrowers can make their payments via M-Pesa before group meetings, but attendance at the meetings is still required (ibid). This results in less meeting time spent on cash collection and leaves more time for discussion of business problems and financial education. Such an approach integrates the latest banking technology with the well-known benefits of public meetings for group cohesion.*

**Repayment Frequency**

Another questioned aspect of microfinance is the appropriate frequency of loan repayment. The basic tension arises because more frequent repayments typically reduce delinquency but are more operationally costly. If payments are not frequent enough, borrowers are faced with the challenges of repaying a larger lump sum. Repaying a lump sum is difficult for practical reasons, e.g. borrowers often do not have savings accounts, as well as for psychological reasons, e.g. there is greater temptation to prematurely spend the money on consumption needs (Fischer & Ghatak, 2011). Furthermore, Rai and Sjostrom (2004) argue that frequent payments produce more opportunities to gain information on the status of borrowers' projects. This offers the lender greater insight into whether a defaulting borrower is truly unable to pay or is simply unwilling to pay. Analyzing empirical data, Silwal (2003) found that greater frequency of repayment (weekly versus monthly) is correlated with lower delinquency rates.

However, if payments are scheduled too frequently an unnecessary cost is placed both on the lender and the borrower in terms of time and resources. Grameen Bank initially

experimented with daily payments, expecting these to be the easiest for borrowers to make. However, Yunus found that daily payment was logistically burdensome and eventually switched to weekly payment (Yunus, 1998). Lenders worldwide are still experimenting with credit products to achieve the right level of repayment frequency for their specific cultural context and the needs of their borrowers.

### ***Dynamic Incentives***

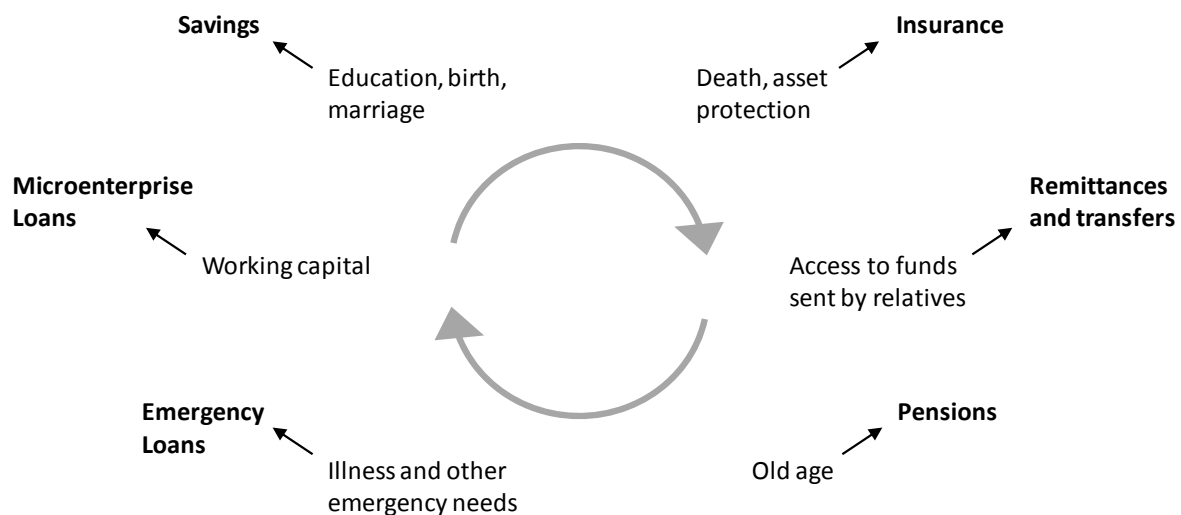
Another feature that is often attributed to the success of microcredit is the use of 'dynamic incentives' or 'progressive lending' (Hulme & Mosley, 1996). This practice refers to a lender offering a progression of increasing loan amounts to the borrower. For example a progression of four six-month loans might proceed in the amounts of \$100, \$125, \$150, and \$200. With dynamic incentives, relatively quick access to a greater amount of capital can serve as a strong incentive to pay back the current loan (Tedeschi, 2006).

Programs based on dynamics incentives make it clear to the clients from the outset that the way they perform on their current loan directly affects the amount they can qualify for on the next loan. In the case of default, access to all future loans is typically cut off. This method has been used by microcredit providers of both individual and group loans. In group loan situations, if one member defaults and the other group members are not willing to repay, typically all the members lose access to future loans. Morduch (1999) notes that dynamic incentives may not produce an effective repayment mechanism if borrowers have easy access to loans from other organizations. For example, if a borrower can default on a loan and subsequently receive a loan from a different organization that does not know his or her repayment history, there is less incentive to repay the current loan. This suggests that without credit bureaus that can link repayment history across multiple lenders, the impact of dynamic incentives will decrease as the microfinance industry matures. An increase in the saturation of microcredit providers will make it easier for borrowers to strategically default and take another loan elsewhere.

### ***Breadth of Product-Service Offering***

So far in this section the debated features of microfinance have focused on microcredit. This is reflective of the industry's historical focus on credit. However, during the 1990s a shift in terminology began in which 'microfinance' replaced 'microcredit' as the standard industry descriptor (Helms, 2006). This shift was spurred on by an understanding that the poor needed access to a fuller set of financial products. See Figure 4 for an overview of additional microfinance products. Though most microfinance providers are still credit-focused, today we see a greater number of providers offering a combination of credit, savings, insurance, money transfers, and 'plus' services. Pro Mujer based in Latin America, offers a clear example of the 'microfinance plus' model. In addition to providing microcredit, Pro Mujer offers business training and healthcare support for women.



**Figure 4: Need for Broader Range of Microfinance Products and Services**

Source: CGAP 2006

Why has attention only recently broadened to a fuller set of financial products for the poor? In the case of microsavings, proponents have argued for its relevance for decades, referring to it as the forgotten half of rural finance (Vogel, 1984; Gonzalez-Vega, 1994). Microsavings can serve the dual purpose of providing the financial institution with an additional source of capital and offering clients a product that is critically needed. Resistance to offering savings is often driven by the perceived difficulty of administering small deposit accounts in developing countries. Financial institutions often expect that such accounts would be unprofitable (Robinson, 2001). While there has been a realization that there is significant demand for complementary products such as savings and insurance, as of yet there have been no breakthrough innovations on the supply side of these products in the same way that the industry experienced breakthroughs regarding the implementation of the microcredit model (Armendáriz & Morduch, 2010). This may currently be changing as practitioners experiment with new banking platforms, such as mobile money (Scharwatt et al, 2015). Further discussion of microfinance programs with extended offerings is included in the *Impact of Microfinance* section.

## 7. The Commercialization of Microfinance

The second core debate concerns the appropriate role of commercialization in microfinance. It is useful to clarify at the outset what is typically meant by 'commercialization' in this discussion. As most microfinance providers use market-based principles to reach their objectives, the polarizing issue is not so much an issue of organizational design, but rather the use of commercial capital, i.e. funding with a profit motive (Armendáriz & Morduch, 2010). Opponents of commercialization argue that expectations of generating profits for investors will necessarily result in mission drift and ultimately harm the poor (see e.g. Bateman, 2010; Yunus, 2011). In contrast, proponents of commercial funding view it as a positive and much-needed source of capital, not incompatible with the social focus of microfinance. They argue that earning profits will attract more capital to the industry and enable institutions to better meet the global

demand for microfinance (see e.g. Akula, 2010; Rangan, Chu, & Petkoski, 2011). Armendáriz and Morduch (2010, p.10) describe that "[i]f there is one unresolved tension that animates those who spend their days working on microfinance, it entails how to navigate the trade-offs between maximizing social impact and building strong, large financial institutions. It is a healthy tension, but an inescapable one."

In 2004, C.K. Prahalad's conception of 'The Fortune at the Bottom of the Pyramid' brought further attention to the idea that profits could be made while alleviating global poverty. The microfinance industry has leveraged commercial funding through debt for a considerable time. Much more recently, the industry has begun to be seen as an appropriate place for equity investments, private and public. Several microfinance institutions have made initial public offerings (IPOs) on stock exchanges: Bank Rakyat Indonesia (2003), Equity Bank in Kenya (2006), Banco Compartamos in Mexico (2007), and Swayam Krishi Sangam (SKS) in India (2010). The two latter IPOs, both approximately 13 times oversubscribed (CGAP 2007; MicroCapital, 2010), generated a significant amount of public controversy with critics claiming the organizations were unnecessarily profiting from the poor. These IPOs have received the bulk of attention, both positive and negative; however, significant equity investments in microfinance have also been made through private placements (Glisovic, González, Saltuk, & de Mariz, 2012). Table 2 summarizes the recent growth of private equity transactions both in number and value. Those in support of increased commercial interest in microfinance see these trends as a natural progression. Michael Chu, former president of Accion, argues that worldwide demand for microfinance cannot be met unless profit-oriented capital is drawn in. Increased competition should eventually bring interest rates and profits down to consumer-friendly levels (Rosenberg, 2008).

**Table 2: Historical Private Equity Transactions in Microfinance**

<b>Year</b>	<b>Transactions (number)</b>	<b>Value (\$US million)</b>
2005	28	106
2006	37	20
2007	37	60
2008	63	144
2009	32	230
2010	37	205
2011	68	292
<b>Total</b>	<b>302</b>	<b>1057</b>

*Note: CGAP-JPMorgan estimates that this sample covers 70-80% of microfinance PE activity*

*Data Source: CGAP Research, Global Microfinance Equity Survey 2012*

What is the argument against the commercialization of microfinance? Muhammad Yunus offers one of the clearest views as to why increased commercialization is the wrong direction for microfinance. He argues that expectations attached to commercial funding cause microfinance providers to act as a new "breed of loan sharks" (Yunus, 2011, p.A23). It is argued that commercially funded institutions will need to raise interest rates and engage in aggressive loan collection to satisfy profit-oriented shareholders. The demands of ever-increasing profits will cause a shift in the mission of microfinance that ultimately defeats the purpose of improving the lives of the poor. For those sharing Yunus' views, the IPO of Banco Compartamos was a striking example of his concerns. Leading up to the IPO, Compartamos was charging an average annual interest rate of approximately 100% to its clients (CGAP, 2007). During the IPO, the owners of Compartamos sold 30% of their stock for a total of \$458 million USD. Critics claim that such interest rates and profits cannot be morally justified. Yunus argues that an additional downside of such transactions is that they further burden the poor with financial risk. Instead of creating funds based primarily on local deposits, organizations pursuing IPOs are accessing capital from volatile global markets and then transmitting this volatility to poor borrowers who are ill-equipped to mitigate the risk (Yunus, 2011).

A middle-ground view on the commercialization debate starts with the perspective that commercial funding will inevitably increase. The primary concern then becomes how it can best be integrated into the industry. There have been multiple occurrences of commercial funding causing microfinance markets to overheat. For example, in Bolivia during the 1990s, there was an influx of commercial funding and the market became so oversaturated that default rates soared and the market nearly collapsed (Rhyne, 2001). In more recent years, the microfinance market in India has struggled with instability. See the vignette on 'The Crisis in Andhra Pradesh' for more details. However, some empirical analysis has suggested that high growth of microfinance institutions is not inherently detrimental to portfolio quality, except in the most extreme situations (Gonzalez, 2010). Portfolio deterioration can be mitigated if providers focus on growing *expansively* instead of *locally*. By looking to less developed geographic markets, the risk of creating a locally saturated market can be reduced.

Another reason why commercial and non-profit funding may constructively coexist in the industry is that these sources of funding tend to focus on different social objectives and market niches. Commercial microfinance banks are more likely to involve individual lending, make larger loans, and target fewer of the neediest clients (Cull et al, 2009). Nongovernmental microfinance organizations are more likely to involve group lending, make smaller loans, and actively target more of the neediest clients (*ibid*). Furthermore, even though the microfinance industry is populated by a diversity of institutions of different sizes and types as described in a previous section of this chapter, commercial funding raised through IPOs and private equity investments to date has concentrated on the larger, more established microfinance institutions (Glisovic et al, 2012). This suggests that while multiple sources of funding are entering the microfinance industry, they are often directed towards organizations with different and potentially complementary objectives.

**Vignette: The Crisis in Andhra Pradesh**

*The state of Andhra Pradesh in India is an example of a microfinance market to recently struggle with oversaturation. The Indian market had been one of the strongest areas of microfinance growth over the preceding five years, accounting for over 65% of client growth worldwide (Maes & Reed, 2012). Andhra Pradesh was home to four of the largest Microfinance Institutions (MFIs) in India and many state-supported self-help groups (SHGs) providing similar microfinance services. Combined, the MFIs and SHGs were reaching over 23 million clients in Andhra Pradesh as of 2010. In July of that year, the explosive growth of the market was exemplified by the initial public offering (IPO) of India's largest MFI, SKS Microfinance. The IPO raised over \$155 million USD and made substantial profits for its shareholders.*

*However, Andhra Pradesh was headed for crisis. Microfinance clients in the area were highly over-indebted, with upwards of 80% of clients responsible for loans from multiple MFIs. Most of the MFIs did not have guidelines in place to gauge a client's level of indebtedness. The breaking point of the crisis occurred in late 2010 when allegations were reported of suicides resulting from the coercive collection practices of MFIs. This ignited a political debate in which some political figures urged MFI clients not to repay their existing loans. The loan recovery rate dropped below 10%. Many MFIs were unable to continue their operations and the microfinance sector in Andhra Pradesh was almost wiped out.*

*Some describe the crisis in Andhra Pradesh as a primarily political issue. Others see it as a case of overaggressive growth fueled by the interests of commercial profits. Following the crisis, legislators in India have been working on passing regulation aimed at stabilizing the market and preventing such occurrences in the future. (This vignette draws primarily on material provided in CGAP, 2010 and Maes & Reed, 2012)*

## **8. The Impact of Microfinance**

The third debate concerns the actual impact of microfinance. In recent years, there has been increased attention placed on moving beyond the promise of microfinance towards rigorously assessing its effects. In general, research studies and the experience of practitioners suggest that microfinance can make a positive impact on its clients, but recent randomized trials suggest that the magnitude of the impact is often modest and the manner in which it benefits the poor is often not as originally anticipated.

Before examining the studies, given the strong growth and high repayment rates of microcredit, why is impact assessment a critical concern? First, the magnitude of the impact

is important because investing in microfinance draws on financial and human resources that could be invested in other poverty alleviation activities. If the impact of microfinance is positive but weak, perhaps development-dedicated resources could make a stronger impact on poverty alleviation if they were invested elsewhere, for example towards large, labor intensive enterprises in developing countries (see Karnani, 2007). Second, understanding impact is increasingly important as a broader range of investors with mixed performance objectives enter the microfinance space. The philanthropic Rockefeller Foundation in conjunction with J.P. Morgan have set an agenda focused on 'Impact Investing' (O'Donohoe et al, 2010). See the vignette 'Rockefeller Foundation and J.P. Morgan: Impact Investing Initiative' for more details. Such investors are often interested in measuring impact using both social and financial performance indicators. Third, impact assessments will play a critical role in influencing the future of microfinance. Careful impact studies can provide insight into how the services need to evolve to better meet the needs of clients and the goals of the institutions.

**Vignette: Rockefeller Foundation & J.P. Morgan - Impact Investing Initiative**

*'Impact Investing' captures the idea that investors can pursue financial returns while simultaneously addressing social and environmental problems (Bugg-Levine & Emerson, 2011). Investing for non-financial returns has a substantial history; however, an initiative was recently launched by the Rockefeller Foundation and J.P. Morgan aimed at defining and unifying this space. A report by the Monitor Institute on social and environmental investing found that the state of the market was fragmented, lacked widely accepted impact metrics, and had few platforms for intermediation (Freireich & Fulton, 2009). To begin addressing such challenges, the Rockefeller Foundation and J.P. Morgan produced 'Impact Investments: An Emerging Asset Class' (O'Donohoe et al, 2010), in which they attempted to clarify and size the potential market. They estimated that the market offered the potential over the following ten years for invested capital of \$ 400 billion to \$1 trillion USD.*

*How will the increasing momentum behind impact investing affect the microfinance field? Though not restricted to developing countries, impact investing targets the 'base of the pyramid' as defined by the World Resources Institute as people earning less than \$3,000 USD a year. The 2010 Impact Investments report (ibid) identified microfinance as one of the key sectors in which the initiative is to be targeted. Impact investors come in a variety of types, ranging from private foundations such as the Esmée Fairbairn Foundation, to large-scale financial institutions such as Citigroup. There is significant variation in the return expectations of such impact investors, with financial aims ranging from competitive to concessionary. This points to the importance of effectively matching the interests of investors to the social-financial mission of microfinance institutions. As the infrastructure for impact investing continues to develop, the interests of investors will fuel the demand for additional performance measures of microfinance institutions.*

**Challenges of Impact Assessment**

The fundamental question driving microfinance impact assessments is typically some variant of “How are the lives of the participants different relative to how they would have been had the program not been implemented” (Karlan and Goldberg, 2011, p.17)? However, reaching an informative answer to this question is challenging for several reasons. First, accurately gauging how the lives of clients might have changed even if they were not involved in microfinance can be difficult. During a study period, clients not involved in microfinance may also experience some improvement in their financial situation due to other factors, for example the macroeconomic environment in the country may have improved or there may have been increased investment in community infrastructure. In order to accurately determine what amount of impact should be attributed to involvement in microfinance versus other such factors, it is necessary to have a valid measurement of the

counterfactual, i.e. how lives would have been had the program not been implemented (Karlan and Goldberg, 2011). Gauging the counterfactual is usually accomplished by comparing the change experienced by those involved in microfinance to the change experienced by those not involved.

This comparison raises a second basic challenge of microfinance impact studies: selection bias. Often the individuals that want to be involved in microfinance programs differ systematically from those that do not choose to become involved. For example, those that choose to get involved in microfinance may already have stronger businesses and feel more confident that they will be able to repay a loan (Hashemi, 1997). A simple comparison of microfinance participants to non-participants may significantly overinflate the effect of microfinance involvement by not accounting for this selection bias.

A third assessment challenge particularly relevant to microfinance is the necessity to account for individuals that drop out of the programs (Armendáriz & Morduch, 2010). For example, under group lending contracts a borrower is often removed from the group for poor performance. In such a case, microfinance may have had a negative effect on that particular client's life, but he or she often drops out of the assessment which leads to an overestimate of impact.

Finally, defining the measures of impact is a challenging task because effects of microfinance may reach into many dimensions of a client's life. The most common measures of microfinance impact are related to enterprise income and household consumption (Karlan & Goldberg, 2011). However, there is wider interest in other social impact measures as well, such as consumption smoothing, healthcare, education, and female empowerment (Armendáriz & Morduch, 2010). Understanding the interaction of these different measures is important because they can often be interrelated, e.g. an increase in one measure causes a drop in another (Karlan & Goldberg, 2011).

The challenges of assessment mentioned here are not minor concerns. If such issues are not appropriately addressed, they can affect the results of impact measurements by up to 100% or even reverse conclusions (Armendáriz & Morduch, 2010).

### ***Results of Randomized Controlled Trials***

To overcome the challenges of impact measurement, there has been increased attention in microfinance placed on the use of Randomized Controlled Trials (RCTs) (Bauchet et al, 2011). An RCT mitigates many of the challenges listed above by comparing the effects of a treatment group (e.g. those that receive access to microfinance services) to a control group (e.g. those not offered access to microfinance). By drawing on a large enough sample and randomly determining the groups that are designated as treatment and control, the groups serving as a control population are expected to have on average the same basic characteristics of the treatment population and provide a clean estimate of the counterfactual (Karlan & Goldberg, 2011). While the RCT method poses several benefits for research, it is useful to keep in mind that it can raise important ethical issues by selectively offering access to some potential clients and not others, who may be equally in need.

Several RCT studies on the effects of access to microcredit have been conducted over the last decade in different cultural contexts. Banerjee, Duflo, Glennerster, and Kinnan (2010) studied the effect of offering access to microcredit in randomly selected slums in Hyderabad, India. Crépon, Devoto, Duflo, and Parienté (2011) conducted a similar study providing access to selected rural villages in Morocco. Augsburg, De Haas, Harmgart, and Meghir (2015) randomized loan access to marginal applicants at the individual level in Bosnia and Herzegovina. In 2015, these studies, along with three additional RCTs from Ethiopia, Mexico, and Mongolia, were formally published and compared in a volume of the *American Economic Journal* (Banerjee, Karlan & Zinman, 2015). In what ways did these studies find similar or differing results?

It is striking that the findings from these RCTs, despite their different contexts, are predominantly consistent. They found on average "modestly positive, but not transformative, effects" for those given increased access to microcredit (Banerjee et al, 2015, p.1). These studies consider various categories of outcome measures. As a first step, does increased microcredit access actually result in more potential microentrepreneurs taking out loans? The take-up rates across these studies fall in a range from roughly 17% in Morocco (Crépon et al, 2011) to 31% in Ethiopia (Tarozzi, Desai & Johnson, 2015). These take-up rates can be interpreted in two very different ways depending on one's expectations. On the one hand, this is a relatively high rate of the relevant population interested in seeking a business loan. On the other hand, if one expects microcredit access to serve as a cure-all for poverty, it is directly affecting a relatively small percentage of the target population.

A second impact question is does microcredit access enhance business activity, as measured by increases in assets, investments, or profits? The majority of studies found positive and economically significant average impacts on business activity, however there is interesting variation (Banerjee et al, 2015). For example, the study in Mongolia (Attanasio et al, 2015) found that the creation of new businesses increased significantly, but only for those clients involved in group loans (a 10% increase over controls). However, there was no significant change for those recipients of individual loans.

Do the average increases in business activity actually translate into downstream improvement in household income and living standards? The potentially surprising result is that the studies did not find consistently strong effects on these household outcomes. However, though the average level of these outcomes did not change significantly, there was a difference in their compositions. For example, there was a shift in the composition of household income resulting from a reduction in wage income offset by an increase in business income (Banerjee et al, 2015). In this sense, while microcredit access may not be directly transformative in terms of poverty reduction, "it does afford people more freedom in their choices (e.g., of occupation) and the possibility of being more self-reliant" (*ibid*, p.12). Likewise, the studies did not find an overall increase in living standards as proxied by household consumption. However, there was some evidence for a change in the composition of expenditures. Most notably, they found decreased spending on discretionary goods, such as temptation goods and entertainment. Such behavioral shifts may have more substantial effects downstream.



An important caveat of these microcredit RCTs is that they are limited in their ability to gauge long-term impact. The experiment durations in these studies ranged from 14 months (Augsburg et al, 2015) to 24 months (Crépon et al, 2011). While these studies generally did not find significant effects on social indicators, some outcomes may take longer to materialize, such as education and health impacts.

Such findings on microcredit impact over the last decade have elicited mixed responses. For critics of microcredit, the findings suggest that it is failing to meet its lofty expectations. Accordingly, one should consider funneling more resources into alternative approaches for poverty alleviation. In contrast, the strong proponents of microcredit suggest that excessive weight should not be placed on such a small number of relatively short-term studies.

A different view of loan access considers that though microcredit may not be revolutionizing microbusinesses as expected, it is positively impacting poor households in a variety of unanticipated ways (Morduch, 2011). There is a growing body of evidence, drawing both on formal evaluation studies and other forms of descriptive research (e.g. Collins et al, 2009), that suggests the real impact of microfinance is not its effect on microbusinesses, but rather on managing tight cashflows in poor households. The studies suggest that microcredit is more often used to cope with financial risk (e.g. pay for funeral expenses), to make household investments, or to pay for food, medical bills, and school fees (Morduch, 2011; Bauchet et al, 2011; Karlan & Zinman, 2011). Microcredit recipients are adapting the product to suit their own needs. Often long-term business growth is not the most pressing issue.

Such evidence lends further credence to the idea that the basic microfinance model should move beyond credit to involve a broader range of products. Though the findings are still preliminary, new impact evaluations focusing on other microfinance products, such as savings and insurance, have found stronger effects on the lives of clients (Bauchet et al, 2011). A study by Dupas and Robinson (2011) on microsavings in Kenya found that there was strong demand and usage of savings accounts. Women that received access to a savings account increased their business investment, had more money available to purchase food for their households, and were better able to deal with health shocks as compared to those in the control groups.

An evaluation of microinsurance for farmers in Ghana also found positive effects on household welfare, with members of the households that received access less likely to go without meals (Karlan, Osei-Akoto, Osei & Udry, 2011). These studies suggest that though the rhetoric of microfinance has almost exclusively focused on the mechanism of microenterprise growth, there are substantial opportunities for improving welfare through products focused on cashflow management and risk mitigation (Bauchet et al, 2011).

A similar approach is based on the idea that offering additional individual financial services is not enough; rather, a more holistic set of products and services need to be offered simultaneously. One example is the Graduation program designed and originally implemented by BRAC (Banerjee et al, 2015). The program provides six complementary services: productive asset transfer (e.g. livestock or microbusiness inventory); consumption support in cash or food (to reduce incentives to liquidate the productive asset for immediate consumption); technical skill training on managing the chosen asset; high

frequency home visits and coaching to encourage productive use of the asset; access to a savings account; and health education, such as nutrition and hygiene training. The motivation of this approach is to provide a "big push" that may be necessary to help the extreme poor break out of a poverty trap (*ibid*, p.773).

RCT studies have been conducted on this multifaceted approach and the results are promising (Banerjee et al, 2015). Findings from six different countries indicated that the Graduation program produced consistently positive impacts along multiple dimensions: income, food security, living standards, and mental health. The studies found that the effects persisted even after the program had ended (results three years after initial asset transfer and one year after the end of household visits). The researchers note that while this approach is more expensive than some alternative efforts at poverty alleviation, they suggest that the program benefits are sustainable and cost effective (*ibid*).

## 9. Implications for Social Finance

Over the last four decades, the pioneers of modern microfinance have wrestled with developing an effective means for extending financial access to the poor. The evolution from a handful of organizations to a worldwide industry has been shaped both by innovative advances as well as some unfortunate missteps. What implications can be drawn from the experience of microfinance for social finance more broadly? Three implications present themselves based on the content reviewed in this chapter.

First, the history of microfinance suggests that the details of the financial model and product features are not minor concerns, but are at the core of the movement's success. Microcredit did not dramatically expand over the last several decades simply because there was demand for credit access and an available supply of capital. The generally unsuccessful attempts of government-subsidized credit programs for the rural poor from the 1950s to the 1980s demonstrated that good intentions and available funding are not enough. Rather, a key differentiator of modern microfinance was the early demonstration of a model for credit that was financially sustainable and scalable (Cull et al, 2009). Seemingly subtle innovations such as group lending, frequent repayment, and dynamic incentives were at the heart of the new movement. For the broader field of social finance, this suggests that the details of the financial products and services will play a central role in determining success or failure. As illustrated by the growing interest in impact investing, it is likely that the available capital for social investment will continue to increase dramatically over the next decade (O'Donohoe et al, 2010). The challenge lies in developing innovative products and delivery systems uniquely suited to their objectives, rather than relying on loose-fit adaptations of preexisting models.

Second, several missteps of the microfinance movement offer a cautionary word against extreme growth fueled by commercial funding. In various markets, such as Bolivia during the 1990s and India during the late 2000s, institutions leveraging commercial funding contributed to the markets' dramatic increases in scale. However, these markets also became so quickly saturated that they reached crisis points and nearly collapsed (Rhyne, 2001; CGAP, 2010). Social finance is particularly at risk of excessive growth because it often targets markets that are urgently in need of social change. Often these markets are less

developed and lack significant infrastructure to mitigate system-wide risk. In the example of microfinance, Bolivia and India lacked independent credit bureaus for tracking a client's individual level of indebtedness across institutions. In such markets, it is easier for unrestrained growth to result in collapses that ultimately harm the intended beneficiaries of social finance.

Third, as the public awareness of microfinance has grown, impact assessment has played different roles. Early on, the story and promise of microfinance played a primary role in building global awareness. Once the microfinance model gained international attention, controlled studies have played an increasingly important role. Furthermore, the case of microfinance suggests that quality evaluation studies can do more than gauge impact. Rather, evaluation studies can also be effectively used to shed light on the specific deficiencies of a program and how they should be revised. For microfinance, a combination of practitioner experience, qualitative research, and evaluation studies has reinforced the idea that the basic microcredit product for enterprise growth has not been meeting the most pressing financial needs of the poor (Morduch, 2011). Clients were using products in unanticipated ways to suit their own needs for cash flow management and risk reduction, suggesting that further advances in microsavings and microinsurance are needed. For social finance more broadly, this indicates that there may be substantial benefits in viewing impact studies as more than straight-forward assessments of program success or failure. A nuanced understanding of why a program does not work as expected can in itself reveal alternative paths forward.

## **10. Conclusion**

This review of the development and current state of microfinance illustrates the rapid change occurring in the industry. The field is in flux along several dimensions. Access to new commercial sources of funding is shifting the market structure. The landscape of microfinance institutions is becoming increasingly diverse in terms of organizational design and mission. Some microfinance markets have overheated in recent years, highlighting the risk of markets becoming oversaturated. Rigorous impact assessments are raising new questions about what microfinance can actually achieve. This is causing many to rethink how the standard microfinance product-service offering should evolve to better suit the financial needs of the poor.

Muhammad Yunus goes so far as to say that some of the new commercial institutions entering the industry should not be allowed to leverage the term 'microcredit' with their business models (Yunus, 2011). He argues that the term has been built up over the preceding decades to connote a certain level of commitment to social objectives, a way of dealing with the poor based on trust and respect, and that the term can now be easily used to misrepresent an organization's business activities. Whether one endorses or eschews Yunus' view, it is true that microfinance is increasingly a diverse space and distinguishing organizational objectives is not obvious. This tension exemplifies the flux occurring in the field and highlights the need for an awareness of the diversity of models that constitute modern microfinance.

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