

# 6

## Banks in the Microfinance Market

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### 6.1 Introduction<sup>1</sup>

In recent years, microfinance has taken over from the concept of microcredit. The fight against extreme poverty has become part of a wider objective in the fight against financial exclusion. The supply of products includes other financial services and technical assistance, as well as microcredit. Together with international donors and traditional NGOs, other typologies of microfinance institutions (MFIs) and commercial banks are now present on the market.

The entry of banks and other specialized profit-oriented institutions into the microfinance market has stressed the trade-off between the objectives of economic and financial equilibrium on the one hand, and the social goals of microfinance projects on the other. From this point of view, the chapter offers a new taxonomy for modern microfinance and discusses the definitions of 'sustainability' and 'outreach', identifying the various meanings of these broad concepts. It also analyses the key variables and the operational and management choices that a commercial bank should consider in order to reconcile the aims of sustainability with those of outreach, so as to implement 'ethically profitable' microfinance programmes.

### 6.2 A new conception of microfinance: the role of commercial banks

The expression 'microfinance' most commonly denotes the supply of modest financial services to zero- or low-income clients. Thus, broadly speaking, any small-scale activity characterized by limited funds and low-income beneficiaries may fall into the field of microfinance. Traditionally, microfinance is associated with programmes which benefit clients with

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serious subsistence problems, mostly located in developing countries. For many years microfinance overlapped with microcredit – small loans, often without traditional guarantees, aimed at improving the life of clients and their families or at sustaining small-scale economic activities. The resources, which came mainly from funds donated by states and supra-national organizations, were channelled to their recipients most often through non-governmental organizations (NGOs), as well as local partners (Figure 6.1).

It is, in fact, a shared procedure that NGOs and donor countries operate together with other locally based organizations, such as municipalities, governments, development agencies or others from the third sector, which also help to better identify the needs of local communities as well as to facilitate the screening and management of credit positions. In order to reduce the physical, and often cultural, gap between intermediaries who provide credit and the beneficiaries of the microcredit, many institutions have recourse to a network of local promoters, known as ‘loan officers’, who visit potential clients to gather information during the selection and monitoring phases and, later, to collect instalments for loans granted.

Sociodemographic changes over the last few decades have significantly altered the world economic scene. For microfinance, the new situation has meant potential new beneficiaries, new products, and a greater involvement of financial intermediaries. Exclusion from the traditional financial system, seen as the inability to access basic financial services, effects millions of people today, both in developing countries and industrialized ones. Traditional poverty thresholds have shifted and new categories of ‘poor’ people have appeared, even outside developing countries. New beneficiaries have brought new financial needs with them. Over the past decade, new microfinance services have developed alongside microcredit. This development has also gained momentum from the observation that a more structured financial assistance increases the efficacy of the programmes, while at the same time improving the level of sustainability. The widening of the supplied services has taken at least six directions: credit products that represent alternatives to traditional loans, savings, payment services, insurance

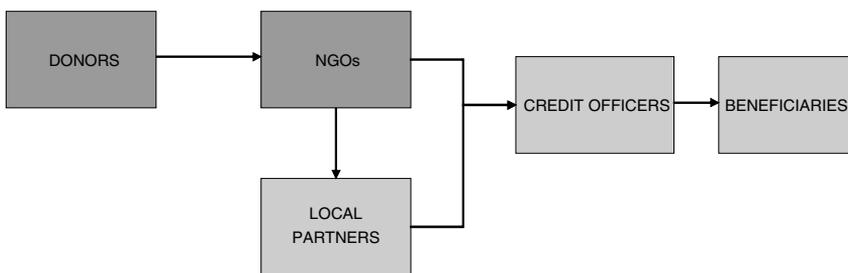


Figure 6.1 The standard microcredit structure

services, structured finance, and technical assistance. It is not surprising, therefore, that in the last few years financial intermediaries in industrialized countries have been taking greater notice of microfinance. It represents a way of reaching and gaining loyalty from new groups of clients and helps to improve corporate social responsibility.

### 6.2.1 The demand for microfinance

Thus, in the last few years microfinance has served different typologies of beneficiaries, largely distinct from the ones normally associated with microcredit. Currently, potential microfinance beneficiaries could also include individuals who, although not living in poverty, experience a general difficulty in gaining access to the financial system. In this way, modern microfinance is broadening its target from 'the poorest of the poor' to all victims of financial exclusion. The phenomenon of financial exclusion has been defined in the literature as 'the inability to access financial services in an appropriate way' (Gardener, Molyneux and Carbo, 2004). Exclusion from the financial system may concern different products and services and can be due to a number of reasons. Firstly, there is *self-exclusion* which stems, in principle, from an individual's feeling of inadequacy with regard to the conditions required by financial intermediaries; 'the poorest of the poor' come under this category. Distance from the financial system may also be due to the failure of potential clients to meet creditworthiness requirements. In this case, we can refer to *access exclusion*, or exclusion following a risk assessment process carried out on clients by the financial intermediaries; in this category we find 'the poor'. 'The poorest of the poor' and 'the poor' are the two categories which represent the traditional target of microcredit programmes. However, as previously mentioned, sociodemographic as well as economic changes have heightened the significance of other forms of financial exclusion and have put forward potential new microfinance beneficiaries.

Exclusion from the financial system can be the consequence of exclusion from the sociopolitical system (*political and social exclusion*): the victims of this are, for example, immigrants or ex-convicts and those who are 'unregistered' and, consequently, 'not bankable'. Furthermore, there are individuals who cannot gain access to the financial system because they are unable to bear the costs and conditions of financial products offered. In this case, the 'disadvantaged' individuals are subject to a *condition exclusion*. Finally, another form of financial exclusion can be identified in those cases in which customers (mainly small-scale entrepreneurs) are considered 'marginal' by the intermediaries since they represent a low-value target when considered according to the traditional customer evaluation models (*marketing exclusion*). The 'unregistered', the 'disadvantaged' and the 'marginalized', despite their common distance from the traditional credit system, are characterized, *ex ante*, by increasing levels of professional skills and managerial ability, and, therefore, they demonstrate respective increasing levels of

creditworthiness. The categories of beneficiaries thus identified are entitled to microfinance support as individuals or in groups. The assistance given to individuals recalls the traditional financing of sole proprietorship and micro-enterprises, whereas the support offered to groups resembles more closely the financing of associations and cooperatives.

The continuing involvement of 'unregistered', 'disadvantaged' and 'marginalized' people determines a greater complexity of the financial structure in microfinance programmes, as well as a greater involvement of financial intermediaries and, thus, a more decisive move away from the traditional patterns of microcredit.

### **6.2.2 The supply of microfinance**

The institutions traditionally involved in microfinance are varied both from an institutional point of view and as far as their aims and objectives are concerned. Among the wide range of definitions adoptable for microfinance institutions, we here propose a taxonomy based on a regulatory approach. From a regulatory perspective, microfinance institutions can be classified into three main categories, depending on the regulatory thresholds of their organizational structures: informal, semi-formal and formal.

*Informal institutions* (self-help groups, credit associations, families, individual money lenders) properly do not have the status of institutions. They are providers of microfinance services on a voluntary basis and are not subject to any kind of control or regulation. *Semi-formal institutions* are usually registered entities, subject to all relevant general laws. They can be defined as microfinance financial intermediaries (MFFIs) and they represent the most traditional category of MFI: they are mostly credit-only institutions which provide various financial services but, generally, they do not collect deposits or, alternatively, they cannot grant credit, as is the case with postal saving banks. Therefore, MFFIs are subject to financial regulatory requirements, according to the wideness of their financial intermediation activities, but they are not under banking regulation. Within this category, it is possible to include different types of institutions with different structural and organizational complexity (financial NGOs, financial cooperatives, credit unions, postal saving banks). The most popular and widespread are, however, financial NGOs that operate principally by offering microcredit as part of development projects, often combined with the offer of technical assistance and other 'social intervention' for beneficiaries. To this aim the NGOs make use, in part or entirely, of funds donated by supranational institutions and agencies, as well as from donor states. Some of the most developed NGOs offer different types of financial services, raise private funds, and collect 'forced savings' from their clients. Finally, *formal institutions* can be further classified into three main categories:

- microfinance banks (MFBs)
- microfinance oriented banks (MFOBs)
- microfinance sensitive banks (MFSBs).

They can all offer credit and they are all deposit-taking institutions: for these reasons, they are all under banking regulation. Within MFBs, it is possible to list a limited number of pure microfinance banks (PMFBs), cooperative banks, and development banks.

PMFBs are banks specialized in offering only microfinance services. These may be the result of the upscaling of NGOs specialized in microcredit that have converted to banks in order to maximize the economic sustainability of their initiatives and widen their client base. Alternatively, such intermediaries may result from a process of privatization of public banks, with the aim of providing financial support to the local community. Lastly, they may be newly created banks which aim to enter into the microfinance market, attracted by the large profits and positive performances achieved by intermediaries specialized in micro-enterprises.

Microfinance services can also be offered by different types of cooperative institutions, which operate exclusively, or mainly, for the benefit of their own members. These include more organized credit unions – such as those based in the United Kingdom and Ireland – which offer credit and other services to their own members; the Rotating Savings and Credit Associations (ROSCAs), more common in developing countries, which provide rotating credit to their own members using resources from a centralized fund made available by the savings of the members themselves; and cooperative credit banks. Despite their differences, the common characteristics of these institutions lie in the legal status of cooperative companies and in the possibility to collect time deposits, mainly through partners. The chance to offer demand deposits, on the other hand, is largely prohibited by regulatory authorities, due to the higher complexity that would derive for those institutions in liquidity management, as well as for the higher contribution to the systemic risk. Development banks are large, centralized, and usually government-owned banks created to support specific sectors (small business development banks) or geographic areas (rural development banks); in some developing countries they can also take the form of private banks. Finally, in recent years, within formal microfinance institutions, it has been possible to include some commercial banks, banking groups and financial conglomerates. Here, two categories of intermediaries can be identified: microfinance-oriented banks and microfinance-sensitive banks.

In the area of microfinance-oriented banks it is possible to group together all the banks or financial institutions which are specialized in financing small to medium enterprises and micro-enterprises, and which are therefore professionally inclined to take an active part in microfinance programmes. These are mainly small, local banks, strongly rooted in the local territory, as well as financial institutions which come directly from local bodies. Finally, in the sphere of microfinance-sensitive banks it is possible to place all the banks and financial intermediaries that, for economic reasons or for the positive externalities deriving for their own image, view microfinance as an

attractive opportunity. These consist, mainly, of banking groups, particularly large ones, or financial conglomerates which decide to enter into the micro-finance sector – downscaling their traditional activities – albeit to a limited extent compared to their own core business, creating specific companies or specialized divisions within their organizations.

### **6.2.3 Products and services in microfinance**

Traditional microcredit programmes have based their success on simple structures. The progressive extension of target beneficiaries, from the category of the 'poorest of the poor' to that of 'disadvantaged people', has brought about the need to combine credit supply with the offer of other services. This requirement is based on two main factors: on the one hand, new target beneficiaries mean new financial needs to be met; on the other hand, some categories of entrepreneurs, especially disadvantaged and marginalized people, have a greater ability in organizing themselves in groups and bring about a greater complexity in the organization and running of the financed group. This, in turn, is combined with more sophisticated financial needs and calls for stricter controls by the microlenders.

For these reasons, it is necessary, in the context of modern microfinance programmes, to put in place a financial framework which provides other services, as well as supplying credit. These can be categorized as financial services in the strict sense or extended to non-financial services. In the first case, it is possible to identify the offer of deposits, as well as of insurance products. The need to channel the savings of beneficiaries appears stronger as the 'bankability' of the beneficiary himself increases, mainly because the percentage of the profits generated through their entrepreneurial activity, and not used for the self-subsistence of the customer, increases. Moreover, a higher rate of 'bankability' of the beneficiary generally coincides with a more structured organization that often outlives the project and that, to be sustainable, requires the setting up of a complete financial cycle. In this way, insurance products are also designed, on the one hand, to cover the specific technical and financial risks of the project and, on the other, can be extended to the whole economic activity of the financed companies.

Moreover, the organization of beneficiaries in cooperatives, or in other structured organizations, often goes with greater managerial autonomy. In such cases, the role of the investor is two-fold: to put controls in place to check respect of good managerial criteria, and to provide technical assistance to the project activities. Such assistance may concern the financial and administrative management, but can be extended to offering specific non-financial services. It is not uncommon, for example, for such well-organized beneficiaries need support in the commercialization and distribution of products, in particular when the sustainability of the project requires an opening into markets outside the local context.

### 6.2.4 A new taxonomy for microfinance

In light of the classifications made, it is possible to build a matrix of modern microfinance determined by the possible combinations of 'beneficiaries-services-institutions' (Figure 6.2). The new scenario identifies different business areas in the field of microfinance determined by the combination 'beneficiaries-services', each of which is relevant for specific categories of intermediaries. It is underlined that as the level of 'bankability' of beneficiaries increases the package of services which accompanies a microfinance programme is progressively more structured. In the same way, the involvement of microfinance financial intermediaries is increasingly supported by the intervention of other financial intermediaries.

In particular, MFFIs focus their activity on the 'poorest of the poor', the 'poor', and the 'unregistered', limiting the financial services offered to credit, insurance cover, and technical assistance, and only in a few cases to forced savings from beneficiaries. Conversely, formal MFBs find their most natural

BENEFICIARIES INSTITUTIONS	POOREST AND POOR	UNREGISTERED	DISADVANTAGED	MARGINALIZED
MICROFINANCE FINANCIAL INTERMEDIARIES	→	→		
MICROFINANCE BANKS	→	→		
MICROFINANCE-ORIENTED BANKS			→	→
MICROFINANCE-SENSITIVE BANKS			→	→
SERVICES	<ul style="list-style-type: none"> <li>• CREDITS</li> <li>• TECHNICAL SERVICES</li> </ul>	<ul style="list-style-type: none"> <li>• CREDITS</li> <li>• INSURANCE</li> <li>• TECHNICAL SERVICES</li> </ul>	<ul style="list-style-type: none"> <li>• CREDITS</li> <li>• INSURANCE</li> <li>• SAVINGS</li> <li>• TECHNICAL SERVICES</li> </ul>	<ul style="list-style-type: none"> <li>• CREDITS</li> <li>• INSURANCE</li> <li>• SAVINGS</li> <li>• OTHER F.S.</li> <li>• TECHNICAL SERVICES</li> </ul>

Figure 6.2 A taxonomy for a modern microfinance

targets, in 'disadvantaged' and 'marginalized' beneficiaries, and are involved in programmes with more structured products and more complex and consolidated financial structures.

It is useful to consider, however, that in recent microfinance experience it is possible to identify a trend which highlights operating models which are not easily classifiable. In particular, we are witnessing a crossover movement which is seeing a greater involvement of MFBs in programmes destined for 'the poorest of the poor', the 'poor', and the 'unregistered', and a parallel involvement of NGOs and other microfinance financial intermediaries in programmes aimed towards 'disadvantaged' or 'marginalized' beneficiaries. In fact, for microfinance-oriented banks and microfinance-sensitive banks in particular, the need to find new and more efficient ways of channelling and managing funds creates space for intervention even in programmes which are less structured, aimed at the poorest and the unregistered. At the same time, the efficacy of more structured programmes is increased by the contribution of microfinance financial intermediaries which contribute their local knowledge, important for improving relations between the intermediary and the beneficiary, as well as technical and operative expertise which is useful in the planning and monitoring of the project.

For the future, it is possible to foresee that microfinance programmes will be increasingly characterized by the presence of investors that are not linked to one actor, but rather represent a pool of mixed institutions which may see the presence of informal, semi-formal, and formal financial intermediaries at the same time.

### **6.3 Sustainability and outreach: can banks make ethical profit from microfinance?**

The entry of banks and private investors into the microfinance market, as well as the increasing scarcity of public funds, has brought the dichotomy between sustainability and outreach to the attention of donors and practitioners in recent years. In microfinance, sustainability is understood, firstly, as the ability of MFIs to repeat loans over time (*substantial financial sustainability*), regardless of how the financial stability of the project or institution is achieved.

*Substantial financial sustainability* (Figure 6.3) describes the ability to cover the costs necessary for the start-up and management of the microfinance activity, whether through the profits from services offered, in particular financial ones, or through grants and soft loans. In a stricter sense, therefore, to be financially sustainable, a project or institution must receive a flow of donations and profits, from interest and commission, that cover operating costs, inflation costs, costs related to the portfolio devaluation, financial costs, a risk premium, and the return on capital brought by project investors or MFI shareholders.

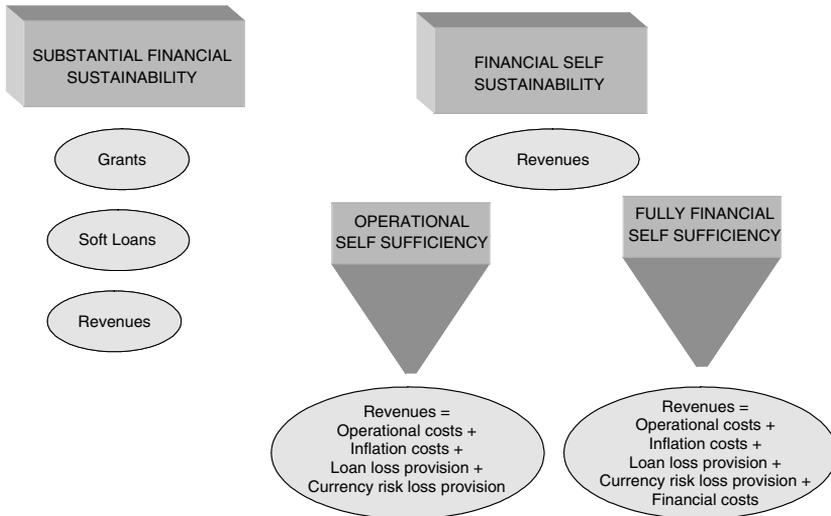


Figure 6.3 Different levels of microfinance sustainability

*Financial self-sustainability* should not be confused with substantial financial sustainability. When we refer to substantial financial sustainability, grants and subsidized funds are also included among the items which contribute to cover costs and to stabilize the income of a MFI; whereas, with financial self-sustainability, grants and soft loans are not considered in assessing the independent ability of the institution to cover costs. With regard to financial self-sustainability, it is necessary to further distinguish between *operational self-sufficiency* (where the operating income covers operating costs, the cost of inflation, loan loss provisions and currency risk loss provisions) and *fully financial self-sufficiency* (where the operating income is enough to cover not only operating costs, inflation costs and provisions, but also the financing costs which include debt costs and adjusted cost of capital).

Analysing sustainability is important for any type of business or economic activity undertaken. However, in microfinance and for MFIs especially, it represents a crucial element for two reasons. Firstly, MFIs work with marginalized clientele, who are not accepted in the formal financial system as they are considered too risky and not profitable enough. Therefore, it would be logical to assume that the institutions which decide to work with such clientele have greater problems in covering costs with an adequate profit flow in the medium to long term.

Secondly, the operating costs necessary for the screening of trustworthy individuals and small business and the monitoring of those borrowers are such that when compared to the profit made from a single client, they could

show little advantage in working for such small amounts. However, a project or an institution may be substantially financially sustainable, in that it is able to attract a constant flow of subsidized funds over time which significantly reduce financial costs and allow the profits to cover residual costs, but not financially self-sustainable since, due to the lack of subsidies, and therefore funded at market costs, it would be unable to achieve profit stability.

It follows that, in analysing sustainability and in distinguishing between substantial sustainability and self-sustainability, a central role is played by subsidies, from which, in different ways, the vast majority of microfinance programmes and MFIs have benefited. In fact, although the goal of leaving aside the donors' funds has been considered by many as an essential step in order to make microfinance a stable instrument to sustain the poorest people, as well as those financially excluded, there are few cases of microfinance institutions or programmes which, in some form, have never received subsidies and are in a condition of economic stability. The search for a balance between costs and profits in the running of MFIs brings us back to the debate in the literature about the precise nature of microfinance. Thus, it is important to examine more closely the type of aims and benefits that should inspire microfinance programmes, and which are addressed towards *outreach*.

Although the literature offers various taxonomies of the values that express outreach, it is possible to define the concept in two partially opposing ways: *depth* and *breadth* (Figure 6.4). Depth represents the poverty level of the beneficiaries involved, whereas breadth concerns the number of clients reached. In the first case, in terms of overall benefit, outreach towards poorer beneficiaries is preferred in spite of the total number of potential customers. Assuming that in social welfare the community prioritizes the poorest individuals, the depth of a microfinance involvement is proportional to the net benefit that derives from the offer of financial services to those people. The basic idea is that, for the poorest individuals, the benefit of receiving a loan is greater than for people at a higher social level. On the

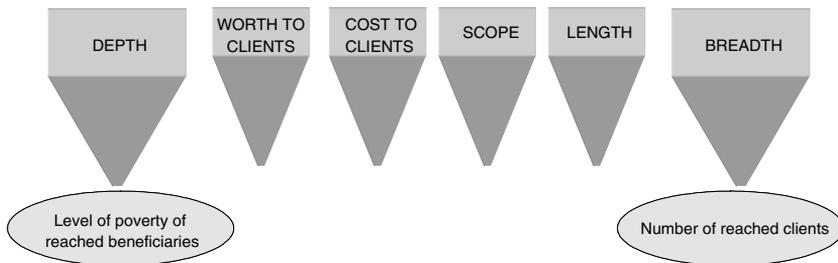


Figure 6.4 Dimensions of microfinance outreach

other hand, priority to breadth implies a preference towards a wider consideration of customers, although they are not all categorized as 'the poorest of the poor'. In a context in which the demand for financial services from the poorest and the financially excluded people is higher than the supply, the ability to reach a larger number of beneficiaries becomes a goal itself.

In the literature, other aspects of outreach are often mentioned, which, however, are referable to simple proxies of breadth and depth. An important initial indicator of the depth of the programme is the loan amount, since most financially excluded clients tend to ask for smaller loans. Furthermore, outreach can be considered as *worth to clients*, that is, an indication of the client's attitude towards paying for services, since these significantly meet their own financial needs. It indicates the maximum amount that the borrower would reach in order to obtain a loan. A poorer beneficiary obviously accepts to pay more. A greater *worth to clients* may correspond to greater depth.

The third variable of outreach consists in the *cost to clients* for the financial services achieved. This represents the cost of the loan for the debtor. It is the sum of direct cash payments for interest and fees, plus transaction costs. Generally, the cost to client is positively related to depth, because, in theory, greater depth implies riskier clients as well as fixed operating costs are shared by a smaller number of beneficiaries. The fourth proxy of outreach is *scope*, that is, the number of typologies of financial contracts supplied by MFIs.

The fifth profile of outreach regards the *length* of the microfinance programme. It represents the period of time during which microfinance services are offered. An indirect proxy of length is the obtainment of profits that guarantee the carrying out of the programmes, even without lasting donations. The underlying idea is that the offer of microfinance should not run out in a short space of time. Consequently, it is assumed that the offer is positively correlated to profits generated by MFIs. The greater the variety of the products and financial services that are offered, the greater is the length of operations and, presumably, the greater is the outreach. Scope and length, however, can be associated to programmes which prioritize depth as well as those that focus on breadth.

### **6.3.1 The microfinance dilemma: Sustainability versus outreach**

As stated in the previous paragraphs, sustainability represents the essential prerequisite for MFIs – especially for microfinance banks which by definition are profit-oriented – to continue to provide their services in the medium and long term, as any other firm. On the other hand, in cases of financial exclusion – in which the demand for financial services from disadvantaged individuals greatly exceeds the supply – an analysis concerning outreach is necessary in order to address the resources, which are by definition scarce,

towards financing productive micro-activities that are able to provide the highest return.

In the literature and among practitioners, sustainability and outreach have been deepened in order to verify the existence of a trade-off between the objectives of economic and financial equilibrium and the social goals. Considerations concerning a preference towards providing stronger support to depth goals rather than breadth goals are typical dilemmas in welfare economy, which are difficult to deal with without an exhaustive analysis of the context. Furthermore, it is common to find an orientation in the literature aiming to stress the need to carry out corner choices between sustainability objectives and outreach goals. Hence, this chapter avoids revisiting a historical debate regarding the priority to be assigned to different models of outreach and their compatibility with sustainability. Instead, it is more useful to examine the managerial aspects that allow one to find a better equilibrium between sustainability and outreach.

The dimensions of outreach must be taken into account by those who intend to put together a microfinance programme, but should be evaluated in the context of single programmes or the medium- and long-term strategies of MFIs. According to MFIs' codes of conduct, the different aspects of outreach can have different relevance, by increasing, falling, or even being cancelled.

Pricing policies adopted by MFIs, and in particular by microfinance banks, show the dichotomy between sustainability and outreach. When, for example, an institution decides to improve sustainability, by raising clients' commissions, there is the risk of not reaching all potential beneficiaries with the service; consequently, the value of breadth goes down, whereas the value of depth increases. In this case, the cost to the user increases because the increase in operational costs is transferred to the customers. When a MFI decides to keep the cost to user low, this means a decrease in operating margins and consequently in length – and ultimately in sustainability.

If an MFI, including microfinance banks, fixes high interest rates to cover operating and funding costs, both depth and breadth risk being affected. In this case, applying interest rates higher than the market ones can be justified by the fact that, for financed individuals, the financial costs are totally compensated by the benefits deriving from access to the credit. If, instead, a MFI, in trying to keep interest rates on credit low for outreach purposes, cannot achieve full sustainability, it is likely to create some distorting effects. In fact, firstly, the offer of financial services, especially microcredits, at lower interest rates than the market, distorts competition between those financed by MFIs who take this approach and the micro-enterprises which are financed in market conditions. Moreover, the fact of not achieving full sustainability leads some MFIs over time, and in particular microfinance oriented banks and microfinance sensitive banks, to leave the market, which can cause

serious problems for clients who had deposited savings with them but also for the micro-enterprises that lose their prevalent source of funding.

However, it is useful to underline how for some categories of beneficiaries the dichotomy between sustainability and outreach is less important. In fact, non-bankable individuals who are able to create products and services that can be placed on the market, are able to obtain margins for which the difference between the cost of funding, available at market rates, and the higher one actually obtained from the MFIs, does not have a significant effect. In this way, supposing that the microcredit beneficiary – being a small producer by definition and therefore unable to shift the supply curve as a price-taker – has the productive capability to achieve significant margins, he will be able to pay higher interest rates during the period in which he will continue to be considered unbankable, and at the same time he will remain in economic equilibrium. If, however, the spread between the market rate and that applied by MFIs could jeopardize the profitability, and therefore the sustainability of the funded micro-enterprises, it is unadvisable to proceed with the funding both in the interest of the beneficiary and also of the MFI.

#### **6.4 Policies for improving sustainability: a lesson for banks and traditional MFIs**

In analysing sustainability in managerial terms, the balance between revenues and costs in offering microfinance services can be seen as a matter of analysis and improvement of the performance over time. From this perspective, it results in being a crucial issue, especially for profit-oriented banks entering the microfinance market. Thus, here we present three key variables that, among others, can determine the success of a microfinance programme run by traditional MFIs as well as banks.

##### **6.4.1 Portfolio management**

With regard to profits, the main source of income in microfinance, and in some cases the only one, is the interest from the loans portfolio and related commission. For this reason, it is vital for MFIs' stability that they maintain a high-quality credit portfolio and adequate credit risk management in order to minimize loan losses. It has often been verified that the average quality of MFIs' loan portfolios are, in many cases, higher than that of formal financial intermediaries working in the same operational context. These elements, besides shattering the myth that less wealthy borrowers are not good clients, highlights a more effective incentive system to repay, a better credit selection process and a subsequent improved monitoring by microfinance banks and institutions, compared to traditional intermediaries, which should be better recognized.

As far as the selection process is concerned, the elements that seem to affect the quality of the portfolio the most can be identified in the proximity and

deep acquaintance between the MFIs' credit officers and the funded borrowers, in the use of specific technicalities conceived for microfinance – such as peer monitoring, dynamic incentives, and so on – and in the decision to lend to customers who have technical and operating skills but lack of funds. Instead, the quality of monitoring on the financed borrowers significantly depends on the ability and reliability of the credit officers, on the existence of at least two levels of control and, more generally, on the analysis and standardization of processes, which even smaller MFIs must somehow formalize. Furthermore, monitoring is made more efficient and timely by technological development, which allows MFIs to process a significant amount of data in less time and at a lower cost, like traditional intermediaries. The considerations made above do not rule out the possibility that MFIs should further improve credit management and operational procedures. Thus, the contribution that banks entering the microfinance market and other financial intermediaries can offer to traditional MFIs may have a great importance: the use of risk measurement and management models used by banks and the outsourcing of some phases of the production process may, in fact, be the key to a more efficient management. In this regard, there is a number of downscaling commercial banks that are starting to operate with financially excluded segments by using more simplified methodologies compared to those used with retail customers, but only with those clients previously selected by MFIs' partners.

#### **6.4.2 Pricing policy**

Interest rate policies are one of the most disputed topics in microfinance. In defining interest rates and commissions, banks and traditional MFIs cannot neglect the need to cover the costs of funding, the operational costs to be spread on each loan, the devaluation of purchasing power of currency due to inflation, loan losses and currency loss provisions, and a risk premium to remunerate for business risk.

In addition, the process of fixing interest rates must also consider a further four factors. First, microfinance banks and institutions must consider the pricing policies adopted by other intermediaries, formal and non-formal, operating in the same context, in order to avoid offering products too far from market conditions, and thus risking lack of demand. Second, like practices in use in traditional intermediaries, interest rate policies should reflect the higher or lower recovery rate implicit in the different technical lending products, considering the existence of collateral or other factors that may determine a pre-emption right for MFIs in case of default of the borrower. Furthermore, the fixing of interest rates cannot avoid considerations regarding triggering adverse selection and moral hazard processes, where interest rate levels are considered too high by the borrowers. Finally, the experience of many microfinance programmes carried out at particularly favourable interest rates have shown how such programmes attract different individuals

from the original beneficiaries to apply for a loan; this leads to very modest performance levels for MFIs.

Therefore, in order to achieve pricing which meets sustainability objectives, MFIs must consider both internal management variables and external market variables. However, it is also true that a greater efficiency in the credit process and in the measuring of credit risk by MFIs could contribute to reduce, other conditions being constant, the cost to users without compromising sustainability. Also in this case, collaboration with banks and other financial intermediaries could help traditional MFIs in such strategic activities.

### **6.4.3 Efficiency**

On the cost front, the situation seems equally critical, since it is affected by the contexts in which the different banks and traditional MFIs decide to work. As far as financial costs are concerned, the vast majority of traditional MFIs, as previously mentioned, are highly dependent on external funds, in the form of subsidies and soft loans. These funds have very low or no costs but are somehow unstable and uncertain over time, depending on donors' evaluations, on which MFIs have no influence. Therefore, obtaining subsidies is not necessarily a negative factor in itself; it is actually useful for sustainability. What is worrying is the unpredictability of these subsidies. Thus, the efficiency of a traditional MFI should not be measured so much on a lower dependence on grants and loans, as on the capability to keep these funding sources stable over time. This capability represents an intangible asset for MFIs that allows for a lower cost to the user and facilitates the goal of sustainability. Moreover, given that most of the MFIs that are not self-sustainable receive external subsidies, a deeper analysis of the optimization of subsidies is necessary. In this regard, it is believed that subsidies should mainly be finalized to finance the start-up phases of MFIs, bridging the gap between revenues, which at the start-up stage are usually not enough, and costs. Vice versa, if subsidies were used by banks and MFIs to keep the intermediation costs low, the effect of this policy would be to distort allocation processes, to alter market competition, and probably to worsen the portfolio quality in the long run.

In the same way, the capacity to differentiate sources of funding should be evaluated. Many MFIs, with the aim of reducing their dependence on external funds, have for a long time extended their activity in collecting savings from the public. From this perspective, microfinance banks have a greater advantage compared to traditional MFIs. In fact, experience has shown in practice how even the poorest individuals have a savings capability, often not held in monetary form. Such savings, if reintroduced in the financial system, could usefully contribute to funding investment projects. The collection of deposits, however, is not always permitted by prudential regulations to all typologies of MFIs, and, nevertheless, it exposes the depositor

to the risks deriving from the misuse of funds by MFIs in excessively risky business, triggering agency problems. Finally, the reduction of funding costs can also be achieved through recourse to types of collection related to ethical finance, not as yet exploited much by MFIs, with particular reference to the collection of Ethical Investment Funds and Ethical Pension Funds.

The second variable that affects the efficiency of MFIs, including microfinance banks, and their capability to exist is their ability to keep operational costs low. Managing numerous microloans as well as the high-frequency repayment of loan instalments entails a significantly high level of operational costs, mainly due to personnel costs. The main effort of the most sustainable MFIs, therefore, is focused once again on the standardization of procedures, without transforming the universally acknowledged strong points of microfinance, such as close contact and deep mutual acquaintance between institutions and beneficiaries. Even in this sphere, interaction with banks and other financial intermediaries can be the key to success.

The factors discussed do not cover the full panorama of policies towards improving sustainability. The solutions offered by the market for sustainable outreach are many and varied. As such, the microfinance market must look more trustingly towards the traditional financial systems. The expansion of a network between the non-profit sector and the profit sector could help the search for other alternative solutions, which are able to exploit all the processes and products of financial innovation that are available in more developed financial markets.

On the other hand, so far the policies to expand sustainability described here are actually implemented by a very small number of formal MFIs. The creation of a structured network, and a greater collaboration between traditional MFIs and banks willing to enter the microfinance market would allow semi-formal and formal institutions to improve their own operations and to enhance their operating and management standards.

## 6.5 Conclusion

In recent years the microfinance market has experienced many important changes. The beneficiaries of support are no longer only poor people in developing countries. The offer of products includes other financial services and technical assistance, as well as microcredit. Together with donors and non-profit institutions, microfinance institutions, banks and other traditional financial intermediaries are present on the market. Therefore, modern microfinance offers more alternatives compared to the past experience of microcredit as it: targets a wider potential number of beneficiaries; tailors interventions to the effective needs and characteristics of clients and in selected intervention areas; allows for more structured financial and technical assistance.

In the face of growing financial sophistication, greater transparency and more efficient management system, microfinance risks losing its real nature

of immediacy and ethicality which mark its origins. The search for a balance between the sustainability objectives of microfinance institutions and the pursuit of social aims represents a big trade-off in microfinance. This contrast is inspired by two different theoretical approaches, on the basis of which microfinance is seen either as a method of diversifying the offer of financial services to financially excluded individuals, or as an instrument to support the development of the poorest sectors of the population.

The discussion between supporters of sustainability and defenders of outreach seems best represented by a scheme in which some MFIs focus on the social mission, while others, mainly microfinance banks, put the economic mission first. This means that the first type of institutions must somehow be subsidized, whereas the second can progress towards self-sufficiency. The analysis of the determining factors of sustainability and outreach has shown that there are operating and managerial policies which can bring together these apparently conflicting objectives. Traditional policies can be aided by more innovative solutions when microfinance operators form profitable collaborations with banks and other financial intermediaries. An integrated network for microfinance, which is now experienced in several countries, represents the most advanced and tangible way towards sustainable outreach.

Encouraging the development of microfinance, today, means especially to find operational and managerial models able to yield balanced cooperation between the non-profit system and the traditional financial system. The practitioners and the institutions of microfinance have to benefit from the expertise of banks and financial intermediaries to achieve a higher level of efficiency in resource management. Financial intermediaries can regain, with microfinance experience, proximity to local territories and customer care. Together, the non-profit system and the traditional financial system must collaborate to achieve the highest level of ethicality of financial intermediation for microfinance, compatible with the objectives of sustainability and performance.

### Note

1. Although the chapter has been jointly written by both authors, paragraph 2 is attributed to Mario La Torre, and paragraphs 3 and 4 to Gianfranco Vento.

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