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Microfinance, an opportunity not to be missed

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The impressive expansion of microfinance (we can no longer speak about microcredit only) has been based on two guiding principles in the industry: creating specialized microfinance providers, and creating sustainable (i.e. bankable) agencies. The first principle is based on the idea that microcredit and microfinance are, primarily, a way of doing finance that requires professional training in order to apply specialized expertise with regard to risk analysis and management for targeted population groups. The second principle is based on the idea that dependence on subsidies is a key obstacle that would hinder the unlimited growth microfinance institutions could experience, and would prevent them from serving thousands of millions of people that lack access to these services.

Likewise, these two principles, when taken to an extreme, have prompted part of the microcredit sector to increasingly detach themselves from development assistance policies, and become a commercial sector whose main objective is providing financial services to low income people in a sustainable way. We are witnessing, therefore, the implementation of two ideologies that have been present since the inception of the industry.

The first ideology sees microfinance as a financial tool for development. The ultimate goal is to foster the advancement of those that receive a microcredit (low income people that have traditionally been denied financial services) through access to this type of services and to include people that are still excluded.

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The second ideology sees microfinance as an expansion of the conventional financial sector, and hence its ultimate goal is creating microfinance providers that follow the same profitability and efficiency principles (maximize the return for shareholders). Both ideologies share the same objective of creating efficient and sustainable entities that provide financial services to low-income people. The fundamental difference lies on the ultimate mission of microfinance. Both positions face limitations when implemented.

The first ideology overestimates the benefits that access to microfinance services bring to the low-income populations. Undoubtedly, poverty is a multidimensional phenomenon and having access to capital in a timely manner (or to more secure savings mechanisms) could make a greater difference to the lives of poor individuals. However, it will not change structural elements in the environment that keep people in poverty. In the words of Professor González Vega, "a microcredit will not improve education levels in a household if there is no school in the community…"

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Microcredit will improve conditions so that people can take advantage of opportunities in their communities. Nevertheless, it will face serious limitations when creating new opportunities that did not exist before. Promoting microfinance that places too much emphasis on overestimated results could lead to disappointment. This is harmful and unfair for the industry as a whole, as it is indeed true that access to the right type of financial services can have significant impact. It should come as no surprise that such impact is not as broad and revolutionary as some of these providers attempt to convey, especially when dealing with such a complex phenomenon as the eradication of poverty.

The second ideology usually overestimates the impact of profitable microfinance providers. This group assumes, based on the laws of supply and demand that high levels of reimbursement, recruiting new clients and maintaining old ones (all this ensures the entities' profitability) are indicators of people's satisfaction and, therefore, of the benefits that access to financial services brings them. In addition to this, the more profitable the entities are, the more private capital they will attract, which would enable them to grow without constraints and serve a greater number of people that would otherwise be neglected. It is for this reason that high profitability and growth rates are considered indicators of a good service and are the best ways of maximizing microfinance's impact.

However, this does not always apply, especially if markets are imperfect as they typically are in poor communities. In places where there is no competition and where access to microcredit is limited and restricted to one entity, there can be poor populations that are provided a type of microcredit product that does not meet their financial needs, even if the entity is bankable. Furthermore, in areas with too much competition (where many microfinance providers compete for the same market niche without striving to really reach out to neglected populations) some providers may encourage over-indebtedness and exercise excessive pressure to renew their loans. This predicament imposes a culture of debt that does not assist the poor in any way. All this is done for the sake of creating profitable entities.

Promoting microfinance that places excessive emphasis on the fact that higher profitability makes a greater difference could ultimately result in disappointment also. Such is the case when the return does not, in turn, yield a real benefit for the population, and was obtained based on questionable ethical principles. This is unfair for those service providers that manage to maintain high profitability rates, achieving a positive impact on their clients, and are guided by untarnished ethical principles.

The fundamental challenge faced by both approaches is the lack of rigorous information that validates their statements and verifies the benefit or added value received by clients who have access to these services. Few providers can back up their social return with reliable information even though many of them should be able to. This places the industry as a whole in a tricky, but avoidable, situation as the false claims made by some providers, when questioned, could be used against all of them, causing great damage. The legitimacy problem, or reputational risk, is greater when some of the providers are funded by international donors, and socially responsible private investors. These investors seek a social return for their money which microfinance could provide. More transparency would help guide investors decisions regarding who to fund and why.

Some investors will believe that the commercial approach that seeks to maximize profitability will make a greater difference and hence they will decide to invest in those. Others will choose entities that promote savings and strive to serve the poorest people with appropriate services, and to address other non-financial needs of their clients. The key is that there is transparency and access to information so that investors can decide what return to expect from their investment.

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For this reason, microfinance providers have the opportunity to be accountable for their results in an objective manner. They can do it. Many international organizations (such as the Working Group on Social Development from CGAP and the Ford Foundation) are making efforts to define a set of social development indicators that will allow a comparison of the social mission stated by institutions with their real results. These indicators are meant to assess providers' social goals in an objective manner so that there is greater transparency in the industry. This way, service providers will be able to aspire to fulfill what they promise society they would.

These efforts will allow many entities to surprise their funders with revealing information about the social return of their management. They will not need to resort to overestimated benefits. They will be able to state accurately the poverty levels of their target population, the benefits derived from accessing their services, the ethical code that guides their operations…

Microfinance, given its social origin and its role in poverty eradication, has immense potential to become an example of a socially responsible financial industry. While many banks try to design socially responsible and financially inclusive policies, microfinance's advantage is that inclusion is precisely its main business. If financial service providers manage to demonstrate that they are socially responsible and that they are fulfilling a social objective, they will become a role model for the industry.