HOW TO MAKE A LASTING MICROFINANCE INSTITUTION:

A RECIPE FOR SUCCESS

By

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Abstract

2005 was designated as the "Year of Microcredit" by the United Nations Economic and Social Council. Microcredit was seen as a breakthrough in facilitating financial access for those from all backgrounds. Microcredit is a smaller division of microfinance, which describes financial services, such as loans, savings, insurance, and fund transfers to entrepreneurs, small businesses, and individuals who lack access to traditional banking services. Many see microfinance and microcredit as synonymous; however, microfinance is broader because it provides a collection of financial services, not just credit or loans. The author put together a guide by compiling previous studies that detail the successes of microfinance institutions across the globe. This guide will be instrumental to any organization curious about microfinance institutions or those looking to enter the industry. While looking through published research on microfinance, many studies highlighted one specific point about microfinance institutions. However, not one recent literature review summarized all of the important points of interest drawn across a multitude of studies.

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Introduction

2005 was designated as the "Year of Microcredit" by the United Nations Economic and Social Council. Microcredit was seen as a breakthrough in facilitating financial access for those from all backgrounds. This was important to the United Nations, as financial inclusion is often seen as a key to solving poverty around the globe. As of 2011, there were 2.401 billion people who were unbanked or did not have any type of account at a financial institution. The majority of these people were in developing countries, where nearly 60% of people are unbanked.[1] Microfinance institutions work to provide financial services to those in developing and developed countries who are excluded from traditional banking services. This presents a major breakthrough in financial inclusion, as there previously was no large network that allowed those who are unbanked to have easy access to banking services.

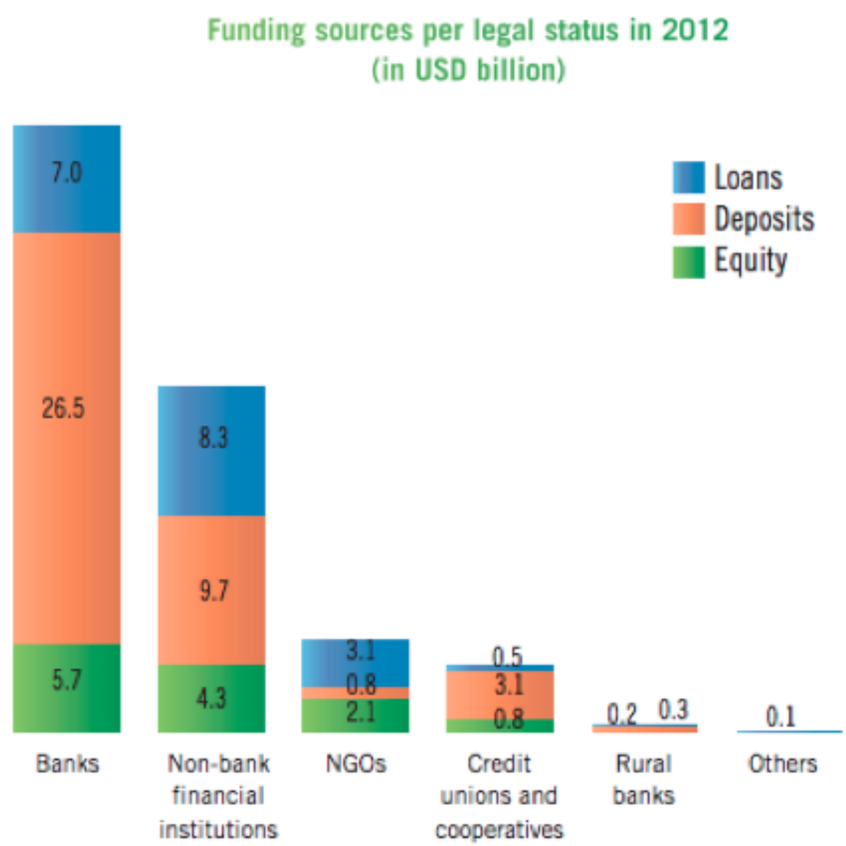
Microfinance is defined as "a general term to describe financial services, such as loans, savings, insurance and fund transfers to entrepreneurs, small businesses and individuals who lack access to traditional banking services".[2] Many see microfinance and microcredit as synonymous, however microfinance is broader because it involves a collection of financial services, not just credit or loans.[3] Although microfinance has transformed since it was first started in the early 1970s, its core mission has stayed the same: financial inclusion. Traditional banks commonly excluded those of lower means for fear they would not pay back the loan. These lower income individuals have also been excluded because they were not seen as profitable for the bank, whose central mission is to turn a profit to money for shareholders. There are five broad categories of exclusion from financial markets: self-exclusion, access exclusion, political and social exclusion, condition exclusion, and marketing exclusion. Microfinance was created with the purpose of helping people get out of poverty, which in turn promotes financial inclusion.

Although microfinance originally started as an idea for developing countries, known as international microfinance, it has slowly moved into developed countries, which we will call domestic microfinance. As corporate social responsibility (CSR) rose in the 1990s, banking institutions in industrialized nations found a natural association between CSR and microfinance.[4] By utilizing microfinance, these banks were able to show tangible efforts they were making to include everyone in the financial system.

While looking through published research on microfinance, I noticed that there were many studies highlighting one specific point about microfinance institutions (MFIs). However, there was not one recent literature review that summarized many important points of interest across a multitude of studies. I believe this paper will be helpful for those wanting to study what makes an MFI successful. Although not every success factor is relevant for every country or situation, it is worthwhile to see what works where and why. Existing MFIs, companies looking to enter the market, support organizations, and investors will find this information helpful in pursuing their various activities.

The beginning of modern microfinance as we see it today starts with Muhammad Yunus and the Grameen Bank. The Grameen Bank started as a lending group in 1976, but did not actually gain the status being a bank until seven years later. It began with an innovative idea that had not been seen before in the financial industry: loans without the need for collateral. The loans could not be used for trivial items, but rather were considered investments that could improve one's wealth permanently. Group members, who were originally all women, would put earnings together into a pool and each week one member would be awarded the earnings to use for her idea, whether that be a new business or the next level of education. Although this model quickly changed with the addition of many new members, the idea of no collateral did not. The Grameen Bank has lent to 8.93 borrowers as of December 2017, 97 percent of whom are women, who are typically excluded from the financial system as they are not the head of the household.[5] As the Grameen Bank began to receive international attention, more MFIs appeared all over the world, leading the United Nations to declare 2005 as the "Year of Microfinance".

Entities providing microfinance are called microfinance institutions. These institutions can take many forms; the main distinction between MFIs is whether or not it exists with the purpose of producing a profit. As seen below, banks, which are for-profit, provide a large amount of funding for microfinance, including loans, deposits, and equity. However, non-profits provide a larger amount of microcredit, or loans. The graph below highlights the fact that non-bank financial institutions and NGOs, both non-profit organizations, provide a larger amount of loans than banks, a for-profit organization, do. Banks, however, do provide more services overall due to their structure and the amount of resources they can afford as a for-profit organization.



Source: Microfinance Barometer 2014 by Convergences

This paper focuses on the success factors of MFIs and how they achieved that success. Success can be seen as being two-fold: social performance and financial performance. Although social performance seems prominent in an industry where there is not a large profit to be made, financial performance is needed for institutions to stay up and running. This has allowed MFIs to pursue a double bottom line wherein both social and financial performance is measured as satisfactory. Financial performance is not defined by one metric, but many; examples include portfolio risk, operating expense percentage, cost per borrower, size of loan, and profitability.[6] Social performance may differ by specific institution, similar to corporate social responsibility; however, it is generally built around pursuing a social mission. In microfinance this is often defined by the following metrics: reach, diversity of clients, serving poor clients or women, and the lessening of poverty.[7]

The following factors were found to have an impact on at least one type of MFI: legal status of MFI, location of MFI, capital structure, macroeconomics factors, type of borrower client, and management. Although some factors, such as location, are only relevant some of the time, they reveal a large effect when studied. This paper will not only explore the background of microfinance and its growth, but also create a roadmap to a successful MFI.

Definitions

The following terms are relevant and defined for the purpose of this paper:

Developed Countries: The economy is fully developed in this country, which is defined by as a GDP per capita of $25,000 or more. In addition to the GDP per capita requirement, the country must be highly industrialized, maintain stable birth/death rates, women are working at relatively similar levels, and they use a disproportionate amount of some resource. The Human Development Index (HDI) is also often used to confirm a developed country. The HDI qualifies life expectancy, educational attainment, and income into a number between 0 and 1, where 1 is the most ideal.[8]

Developing Countries: If a country does not meet the requirements of a developed country, then it is said to be a developing country.[8]

Financial Inclusion: “individuals and businesses have access to useful and affordable financial products and services that meet their needs – transactions, payments, savings, credit and insurance – delivered in a responsible and sustainable way.”[9]

Microcredit: refers to small loans, often given to those excluded from traditional loan systems. The size of loans varies from those in developed countries given by established banking institutions, and typically range from 100 to 1000 dollars.[10]

Microfinance: “a general term to describe financial services, such as loans, savings, insurance and fund transfers to entrepreneurs, small businesses and individuals who lack access to traditional banking services”.[11]

Microfinance Institutions (MFIs): An organization involved in microfinance or microcredit.

Microlending: The process through which an individual, not a bank, loans a small amount to another person. This often occurs through the facilitation of a third party that finds entrepreneurs worthy of the money who will reliably pay it back. These third parties allow for nearly anyone to become involved in microcredit.

History of Microfinance

Microfinance started as an idea without a name. Although microfinance was introduced to the modern world by means of the Grameen Bank, there were institutions in place before. In fact, some MFIs existed in developed countries, before they did in developing countries. MFIs have had different focuses throughout their existence as organizations, but they always provided microcredit. Many of their initial focuses were on the welfare of people, as they worked to temporarily alleviate the issues people were facing due to poverty. After the realization this did not permanently change the lives of many, MFIs switched their focus to poverty mitigation, as they worked on changing the conditions causing poverty. However, as MFIs fully develop, they set their sights on larger scale economic development, helping not only individuals, but the whole groups of people.[12]

Below is a brief timeline explaining key events that lead to the expansion of the microfinance industry.

1961: ACCION International, a non-profit financial services organization, is founded with an initial investment of $90,000 in Venezuela. This is seen as the beginning of MFIs.[13]

1971: Another organization, Opportunity International, is founded in Indonesia and Columbia where they begin to lend to small entrepreneurs. This begins microfinance in Southeast Asia.[13]

1972: BRAC (Bangladesh Rural Advancement Committee) is founded in Bangladesh to help refugees. This MFI was later go on to be one of the biggest in the world.[14]

1974: Shorebank is founded in Chicago. It is a community development bank with the purpose of stimulating the economy and helping those with lower incomes. This is one of the first instances of microfinance in the United States.[13]

1976: Economist Muhammad Yunus finds $27, which he uses to fund the loans of 42 families.[13]

1983: Muhammad Yunus creates the Grameen Bank, based on the group lending model he originally started. The Grameen Bank will become one of the most popular models for microfinance and will globalize it.[13]

Early 1990s: The term microfinance rises in popularity over microcredit.[15]

1992: ACCION assists in founding BancoSol, which provides non-profit microfinance services in Bolivia; a place previously untouched by microfinance.[13]

1997: The National Microfinance Bank in Tanzania (NMB) is founded, bringing microfinance to Africa.

In Germany, Deutsche Bank starts an initiative for microfinance to create the trend of social investing.

In the United States, the Grameen Foundation is founded. This year highlights the globalization of microfinance.[13]

1998: PlaNet Finance (now known as Positive Planet) is founded in France. They work to use the power of the internet to support NGOs.[16]

2005: The United Nations names 2005 the year of microcredit.

Citi Microfinance is created by Citi Bank in London, New York, India, and Columbia.[13]

Kiva is founded in San Francisco to help connect lenders to loaners to in hope of decreasing poverty. The American public becomes more aware of the power of microfinance due to organizations like Kiva.[17]

2006: There are now over 3,000 MFIs helping 106 million people around the world, as reported by the Microfinance Summit Campaign Report.[13]

Muhammad Yunus is given the Nobel Peace Prize for establishing credit as a human right.[13]
Barclays enters the microfinance world by creating Ghanaian Microfinance, further expanding the partnership where developed countries use microfinance as means to improve their CSR.[13]

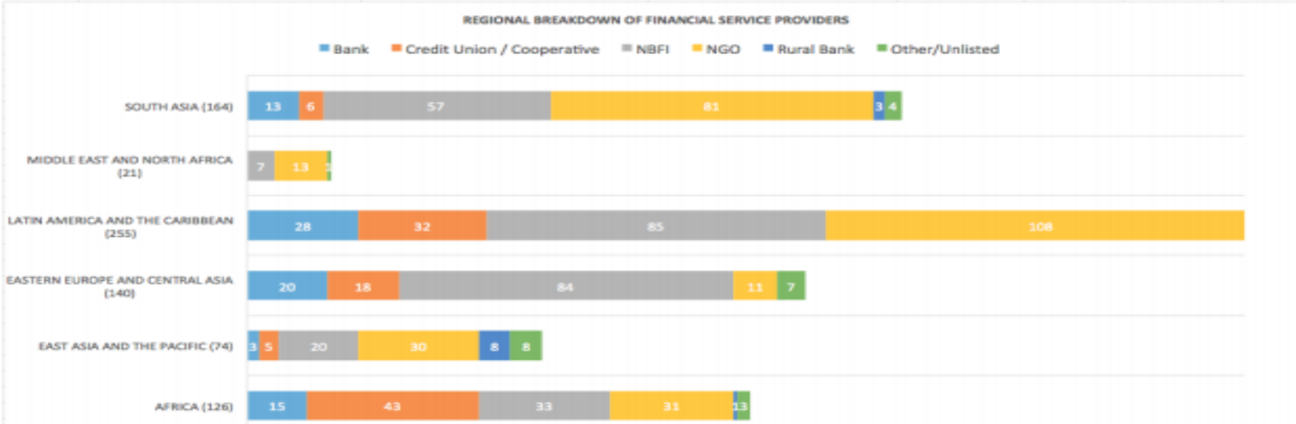
2016: BRAC, a microfinance NGO, is named the number one and largest NGO in the world.[14]

Types of Microfinance Institutions

Broadly, there are two different types of MFIs: for-profit and non-profit. For-profit MFIs typically focus more on maximizing profit and shareholder wealth rather than on creating value for the client. This means that for-profit MFIs are controlled by their shareholders, with a one share, one vote rule. Non-profits are distinctly different, as there is a lack of control because decisions are left up to the judgment of a manager. Non-profits do not have shareholders; however, they do typically have a board of directors that watch over the organization to ensure its well being.[18] These board members are not usually very involved because they do not have any financial stake in the organization.[19]

When looking at organizations that are classified as non-profit, the most common is a Non-Governmental Organization (NGO). NGOs are neither the public sector or the private sector; they serve as an independent third sector. Due to the lack of ties to these other sectors, they are seen as more humane and sympathetic than typical organizations.[20] Non-profit MFIs place more emphasis on social performance than for-profit MFIs.

The graph below shows the regional distribution of MFIs as of August 2016:



*NBFI=Non-bank financial institution, where some are for-profit and some are not

Source: Where Good Intentions Meet Good Business Practice by MIX

Lifecycles

Most MFIs go through a life cycle, as they may change their goals, organization status, and funding sources over time. They start as NGOs, where their funding comes from grants and the purpose of the organization is focused on social values. As the MFI becomes more established, private debt capital becomes more readily available and MFIs start to think more about profitability. Finally, as an MFI reaches stability, they make the transition into for-profit by taking advantage of equity financing. Although this model is typical, other surrounding macroeconomic factors may affect funding resources and thereby, an MFI’s transition.

Rating Agencies

Although there are 13 rating agencies, most studies reference the Microfinance Information Exchange (MIX). MIX was founded in 2002 in the United States and was created for the purpose of enhancing the microfinance industry through the promotion of transparency.[21] The MIX uses what they call diamond ratings, which refers to levels of data shared. The following is taken directly from the MIX website:

1. | Level 1 | General information
2. | Level 2 | Level 1 and outreach data (at minimum, data for two consecutive years)
3. | Level 3 | Levels 1-2 and financial data (at minimum, data for two consecutive years)
4. | Level 4 | Levels 1-3 and audited financial statements (at minimum, audited financial statements including auditor's opinion and notes for at least two consecutive years)
5. | Level 5 | Levels 1-4 and rating or other due diligence report (at minimum, ratings/evaluation, due diligence and other benchmarking assessment reports or studies for one of the two years reported)

For the purpose of proving success factors, I have only included studies that use level 4 (4 diamond) rated MFIs and above. These MFIs are audited externally and because of that are seen as trustworthy.[22]

Success Factors

The following chapter will discuss success factors that affect MFIs. As mentioned earlier, there are potential trade-offs and synergies when considering financial performance versus social performance. Although MFIs' missions are socially focused, they often struggle to become financially independent. This leads to the double bottom line that MFIs often tout, but rarely successfully achieve. Significant trade-offs have been identified by the industry leader on microfinance information: MIX. The following outcomes were discovered in 2008 after a study of 208 MFIs was completed.[6]

- Efficiency trade-offs were found when MFIs targeted the poor, and when MFIs trained their staff regarding social performance and social responsibility
- Staff productivity synergies were found when MFIs trained their staff on social performance and social responsibility
- Both efficiency and productivity synergies were found when client retention was high

These trade-off and synergy findings are extremely important for any MFI to consider. MFIs pursue a double bottom line of social and financial performance, however one should not hinder the other. Although a MFI cannot ignore neither financial performance nor social performance, they can choose to focus on specific factors within one category to best serve their clients.

The following list details the financial and social factors I will consider: good management, percentage loaned rural, percentage loaned women, growth, legal status, surrounding corruption, culture, and social trust. Studies used model MFI success as a dependent variable.

<u>Good Management</u>

Good management is critical to the success of many institutions, and that has been found to be true in research on MFIs. Well-trained employees feel more dedication to their MFI and institutions have incentive systems in place are more likely to be successful. Satisfactory pay for managers will specifically increase social performance in that office. This was found to be true after a literature review of 33 quantitative, exploratory success factor studies was completed.

In addition to well-trained managers and staff, the commitment of upper management has also been found to be a significant of success. According to Harrarska, having managers who have prior leadership experience positively correlates with financial and social performance.[23]

In a case study of one MFI, Bank Rakyat Indonesia, many of these factors were found to lead to success. The authors visited 57 village locations, 9 branch locations, and the company headquarters to collect data. This study found similar success factors relative to the whole industry. Well-trained and committed staff, where staff complete three types of training programs, positively link to success.

They also found the link between success and incentive systems, although they attribute this to both staff and clients. The specific incentive systems in place for employees at BRI is commission bonuses based on the performance of the village location in which they work.[24]

A study completed in 2005 confirms that incentive systems and pay increase the performance of their office. It was found that managers who are adequately paid reach more borrowers than those who felt underpaid.[25]

<u>Percentage Loaned Rural</u>

Percent rural, or the percentage of clients that an MFI loans to that live in rural areas, is negatively related to financial performance to a significant degree. In a study of 373 MFIs, specific financial factors were found to negatively associated including “default, interest rates, the interest markup, and costs per dollar loaned” (114). That means that as percent rural increases, these specific factors decrease. This means that rural clients are good lenders, but do not contribute much to the financial success of MFIs. They have low default and interest rates, which means they are reliable loaners, and because of this they contribute to the social mission, but not much to financial performance.[26]

The interquartile range for percent rural in this study was 29 percent. MFIs that operate in a rural landscape must operate on a very different scale than those in urban landscapes. One theory for these differences due to operating landscape is the increase of social cohesion in rural landscapes. This means that members of a rural society are more likely to unite with one another in order to survive and succeed.[27] Therefore, members of a rural society have greater repayment discipline and lower interest rates because their fellow residents are more likely to help them then in an urban setting.

Percentage Loaned Women

In a 2012 study of 378 MFIs, it was found that 70 percent of MFI customers were women, and 47 percent of MFIs target women specifically. Women have a better repayment performance than men; however, their typical loan size is smaller. Studies have shown that women are more risk averse than men regarding financial decisions.[28] This makes women better credit risks for MFIs as they are much less likely to default. MFIs that have a higher percentage of borrowers that are female have an overall lower portfolio risk and a lower write-off rate. This makes these MFIs more attractive to investors as they have higher stability and less need for funding.[29]

However, due to their small loan size, they are sometimes less profitable than men.[29] But, it has been found that women are more likely than men to invest their income to improve the welfare of their families. This means that a dollar loaned to a woman has a greater social impact than a dollar loaned to a man.[28] One key example of an MFI that loaned to women was the early start of the Grameen Bank. They started with a group-lending approach that included women entrepreneurs, and the accountability that the women held each other to helped the Grameen Bank create the success it has today.

Growth

Growth is defined as annual growth in real GDP per capita in the surrounding country in which the MFI operates. This allows us to view MFIs in the broader macroeconomic context. Growth in a country increases an MFIs ability to cover costs and operate self-sufficiently. Growth is also negatively correlated with default, which contributes to increased financial performance. One additional percentage point of growth decreases the cost per borrower by $7 in a given country. So, with lower default and cost per borrower rates, increased growth in a country allows for more stable and attractive MFIs.[26] Although growth is an important factor to consider, it must be noted that this information is based off of one study.

Legal Status

A study published in 2010 shows that legal status of a MFI significantly affects financial and social performance; but no effect on overall profitability. However, a previous study published in 1998 offers the opposite opinion (Campion). I will disregard this however, as the data for the most recent study was taken 2001-2006, after the first study was published. For-profit MFIs were found to be more socially efficient than non-profit MFIs, as they have higher outreach indicators.

Private microfinance companies (microfinance banks and other non-banking financial institutions that are for-profit) have better portfolio quality than NGOs.[30]

Surrounding Corruption

Lower corruption in a country is positively related to faster extensive growth of an MFI. Corruption interferes with start-up growth and acts as an obstacle.[26] This impact is measured by the Worldwide Governance Indicators (WGI), which measures the extent to which public power is used for private tasks.[31]

Culture

Countries experienced lower financial performance if their culture influences the citizens to plan for the future and prioritize avoiding uncertainty. If countries had highly assertive cultures, where individuals of that country are confrontational and aggressive with others, then they tended to have better financial performance. Countries that promote stability and certainty in their cultures are less attractive environments for MFIs due to the strong impact on financial performance.

In addition, if a country has low gender equality, it is much less likely an MFI will reach out to women. However, the effect of not lending to women on MFI financial performance is not significantly large, as they are not always more profitable than men.[32]

Social Trust

Social trust is can be defined as having faith in people and believing they are honest.[33] It was found that MFIs target women borrowers when countries have low social trust. This is because social networks exist between women when economical social trust does not exist. This highlights the importance of diversity of gender in finance.[34] Social trust is constantly changing in countries depending on the government situation in their specific country. Often times developed countries, especially Nordic countries, have the highest social trust. However, for an MFI wishing to locate in a developing country, it may be helpful to consider if social trust is on the rise or the decline.[35]

Conclusion

Although this guide shows many success factors that contribute to MFIs, there is still much quantitative research to be done. The factors explored in this paper are summarized in the table below with green indicating a positive correlation, red indicating a negative correlation, grey indicating no findings, and a mixed red and green indicating that it is dependent on the independent variable and how it is measured. Good Management, Percentage Loaned Women, Growth of Real GDP and Legal Status all have a positive correlation with financial performance. Percentage Loaned Rural and High Country Corruption both have a negative correlation with financial performance. One case, Culture, has a negative and positive correlation with both financial and social performance depending on different characteristics of the specific country. All other success factors correlated positively with social performance except for those with no findings.

	Good Management	% Loaned Rural	% Loaned Women	Growth of Real GDP	Legal Status	High Country Corruption	Culture	Low Social Trust
Financial Performance	↑	↓	↑	↑	↑	↓	↑↓	—
Social Performance	↑	↑	↑	—	↑	—	↑↓	↑

Key			
	Positive Correlation	No Findings	Negative Correlation

Further research will need to be done to truly to be able to use a guide to build a successful MFI from the ground up. This guide could be helpful to a new MFI as they decide a country or environment to start in. As seen in this thesis, macroeconomic factors affect the success of an MFI, and as these factors are out of control, they are important to consider only for a new MFI. Existing MFIs can only change small factors, but they maybe be able to identify the root cause of problems with these results.

Future research topics could include the following: more exploration of macroeconomic factors, such as the unemployment rate or the surrounding political field, microeconomic factors, such as competition, cultural factors, such as Hofstede’s cultural dimensions, internal factors, such as organizational culture and marketing efforts.

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