Microfinance – Commercial or Social?

by Tom Sanderson

Recent criticism of the high interest rates and loan shark methods in some areas of microfinance lead Tom Sanderson to explain the wide and growing range of microfinance services, and to suggest a suitable balance of social and commercial goals. He then looks at the biblical texts on the taking of interest, thrift and indebtedness, and makes some suggestions about helping poor people with related problems such as insurance and indeed savings. He concludes with an outline of the particular features and advantages of Christian microfinance.

It has featured in a BBC edition of Newsnight, articles in the *Financial Times* and *The Economist* – microfinance has been in the limelight in recent months, not for its success but rather its failures.

Three significant events have occurred in a short space of time:

First, there has been a crisis in Andhra Pradesh in India where it is claimed that microfinance firms have caused clients to commit suicide in the face of mounting debts.[1]

Second, the head of the Grameen bank in Bangladesh, Professor Muhammad Yunus, Nobel prize winner and 'father' of microfinance, has faced corruption allegations and been forced to step down as chairman of the bank.[2]

Third, a Danish TV journalist (Tom Heinemann) and a UK academic (Milford Bateman) have gone public with a documentary[3] and a book[4], both challenging the claims that microfinance alleviates poverty. In fact they suggest the exact opposite – that microfinance enslaves people to debt, multiplying uneconomic micro-businesses and thwarting growth and job creation in larger businesses.

So why this change of fortune in a sector that was once heralded as the best development intervention known to equip, empower and improve living standards amongst the poor? And how, as Christians, should we interpret and respond to these events?

Many meanings of Microfinance

It is important to recognise that the Grameen Bank style of microfinance is now just one approach in a maturing and diverse industry. NGO programmes of the Grameen type used to dominate the microfinance space; they were known for their pro-poor design, a focus on women, rural outreach and group-based methodology. Interest charged on the loans was intended to defray some or all of the operational costs and to provide a much more affordable alternative to the local money lender.

But the interest rates charged, usually in the range of 1-3% per month on a short-term loan, quickly attracted investment finance into the sector. Financiers recognised that if enough loans can be disbursed, then the interest recovered can more than compensate the costs of the operation. Lo and behold - the sector bred profit-making microfinance companies and there was an inflow of investment capital in search of high returns. There was and is talk that microfinance can deliver a double bottom line: both a financial and a social return. This created an unusual asset class that suited socially responsible investors leading to more finance being attracted into the sector.

At the grassroots end of microfinance, savings cooperatives and rotating savings clubs have long been customary means of self-help. Members form 'trust groups' and pool their savings – either for disbursement in a 'merry-go-round' kind of sequence, or for occasional borrowing and repayments within the groups. Some of these traditional mechanisms have been modified to provide more flexible services, including so-called village banks. Based on the accumulated savings of the communities themselves, such mechanisms have not relied upon external finance or been subject to the same commercial testing.

Micro-insurance is also an emerging sub-sector in the developing world, with specialist providers designing credit-life policies, serious accident, crop and weather insurance products – made affordable by pooling risks in group-based policies.

So whenever there is a discussion of microfinance, it is vital to understand clearly what segment of this dynamic sector is being referred to: the NGO sector, the commercial sector; savings schemes, credit ones; internal or external capital or insurance. The shorthand of micro-credit; micro-savings and micro-insurance can help to disaggregate what is now a multi-faceted industry, but even within such terms there is now a wide spectrum of models and practice: some good and some bad.

The Double Bottom Line

Is it really possible for micro-credit schemes to deliver both social and financial goals? I would argue strongly in the affirmative, but acknowledge that it is certainly not an easy task. To deliver two goals, you have to be committed to both, consistently and, over the medium to longer term, in balance. In terms of the social objective, the local Board and staff of the microfinance organisation have to be committed to reaching the poor and continuing to do so, without drifting towards serving more middle-class clients with ever larger loans. In terms of the commercial objective, the local Board and staff have to target and continue to obtain operational sustainability. This will mean very tight control of costs, control of defaulters, reasonable interest rates and a constant hunt for cheap loan capital.

The two are clearly in tension and that is why both the Board and staff have to develop systems for measuring performance according to both social and financial criteria. In fact, it is also a key role for donors and socially motivated investors to do the same, to ask the right questions and to monitor and feedback on progress. Things can so easily slip towards either a social security-style charity model, where micro-credit programmes need

Village Bank in Pueblo Nuevo, Región Brunca, Costa Rica unending subsidies, loan recovery is weakly enforced and programmes remain sub-scale, or towards a commercial banking-style operation where interest rates are high, clients are encouraged to take more and bigger loans, and are then chased for repayments – as is the case in Andhra Pradesh.

Women members of microfinance in Mancherial, Andhra Pradesh, India

In practice, there will be seasons and short bursts where it is good and proper to focus improvements on either the social goals or the financial ones. Indeed, some staff and Board members bring with them a tendency or affinity to drift towards one or the other. Teamwork is vital and the challenge for all stakeholders is to be clear, intentional and transparent about objectives and measurement criteria.

To illustrate the point, Five Talents – the microfinance initiative of the worldwide Anglican Communion – uses the following indicators to help navigate this area: (Note that some indicators are useful in both groups).

1. Indicators that help to maintain the *social* mission of microfinance programmes:

Average loan balance – this should be fairly stable around an agreed target. If the average loan values are rising over time, it can indicate that the average client is becoming more middle-class. This might be good for the individual clients concerned, but the programme may fail to serve the poorer clients that were the original focus.

Gender balance – a healthy proportion of both male and female clients. Programmes often start with a bias (intentional or self-selected) towards women which can easily drift towards a male clientele. This may miss the intended demographic beneficiaries.

Repayment rate and write-off rate – a 100% repayment rate may be good financially but might indicate rough justice for late payers. Alternatively, it might indicate that loans are only made to very safe businesses, failing to serve more risky clients. Rates around 85-95% could indicate good social performance.

2. Indicators that help to maintain the *commercial* viability of microfinance programmes:

Operational self-sustainability percentage – this should be at or around 100% in a mature programme, with gradual improvements towards 100% in a young programme.

Repayment rate and write-off rate – as above. If write-offs are zero that would be very good but potentially worrying. Equally, if write-offs are more than 20% per year it indicates irresponsible lending or poor practice.

Total Portfolio and number of clients – if these indicators are increasing then the programme is likely to be in good shape. If the community begins to show signs of saturation and penetration by micro-credit, then it may be time to consider scaling back and transferring resources to another more needy community.

There are important biblical issues to be addressed in discussing micro-finance. Others have considered these issues in much greater detail[5] but I would like to touch on two particular points below.

Thrift versus Indebtedness

The Bible extols thrift[6] as a virtue and debts[7] are seen as something to be cleared and avoided. On this simplified basis then savings-based programmes seem to fit the biblical paradigm more neatly than credit-based ones. But micro-credit, particularly when practicsd responsibly, should not be thought of as encouraging indebtedness. Rather, it enables people to take advantage of opportunities which come their way. The parable of the talents (Mt 25:14) – from which Five Talents derives its name – speaks of the imminent return of the Master and his expectation that the servants should make the most of the opportunities, using their initiative and always being ready to give account when he does return.

The Parable of the Talents

engraving by Otto Elliger
in Historie des Ouden en Nieuwen Testaments
by David Martin,1700.

Multiple lending, where a client takes out one loan to pay off another, is clearly bad practice. It's a lot easier to say that than to apply it on the ground where credit bureaux checks hardly exist and asymmetry of information prevails. We know from the huge personal debts amongst UK consumers that over-indebtedness is inter-related with many aspects of poverty, such as unemployment; family breakdown and addictions. The microfinance machine in developing nations must not fall into the same trap. Formal financial regulations need tightening and can play a part, but providers and financiers must take a responsible attitude. Tim Heinemann and Milford Bateman are right to emphasise the risks in this area.

Charging Interest

The Old Testament law prohibits charging interest to a fellow Jew (Ex 22:25; Lev 25:35) but seems to permit charging interest to a Gentile (Dt 23:19). Shakespeare's *The Merchant of Venice* graphically illustrates the 16th century outworkings of this: the cultural prejudices surrounding a money-lending Jew. But God's concern and protection for the poor is clearly spelt out in these scriptures. Elsewhere (Pr 28:8) it is the issue of exorbitant interest that is condemned. Other passages of course emphasise forgiveness (Lk 7:41) and generosity (Mt 5:42).

Amongst the Five Talents microfinance programmes, interest rates currently range from 1% to 3% per month on a flat rate basis over what is usually a 4-6 month loan. That means for a typical £50 loan the client has to pay back between £52 - £59[8], with the surplus £2-£9 being used to cover the operational costs of providing the service such as staff costs, record keeping, training and transport. Our consistent experience is that clients, once trained and explained, are almost always capable of repaying such a loan since the annual rate of return on their small investment is frequently well in excess of the 12-36% cost of capital.

Why is that the case you may ask? Our reflection is that micro-business opportunities in Africa and developing nations in general are severely constrained by capital shortages, and that a small injection of cash can generate a substantial return. Over time, with increasing competition and economies of scale, rates of return are likely to diminish. But we have observed, like many micro-financiers, that the untapped opportunities for micro-enterprise and trade are so widespread that microfinance can indeed have a significant impact on poverty alleviation at the household level. This is hard to prove statistically, as Heinemann and Milford have made clear, and it is now an active area of research in the sector.

To illustrate the high rates of return, one of the Five Talents clients in South Sudan travels a day's journey on his bicycle to spend his loan on three crates of Coca-Cola. On cycling back to his village he can sell the individual bottles for twice as much as he paid. And he can sell them all within a week, easily paying back his loan and the interest, with a large profit for his family and for re-investment purposes. Such an enterprise is bound to attract competitors and margins will be squeezed, but for the entrepreneurs who see and seize the opportunities first, there are good business prospects to be enjoyed.

Another straightforward business is trading agricultural produce, like Salome who lives in Tanzania and uses her loan to buy 50kg sacks of beans at harvest time when the price is low. She stores them at home for a couple of months and when the market price rises she starts selling the beans in small quantities, making a handsome profit on each transaction. Her business has gone from strength to strength – diversifying into household goods with the same principle, buying products at wholesale price in bulk and selling small quantities at retail. Her children are the ultimate beneficiaries, well fed and able to complete their schooling, with much better life chances than their Mum.

It's not all about Business

Microfinance has tended to focus on business and loans for business purposes. However, life is much more complex than just business and the microfinance sector has broadened to encompass the need for financial inclusion (access to relevant financial services including savings and insurance) as one of the most significant challenges for the poor. It is now widely understood that people, and poor people especially, need financial services for:

1. Investment opportunities – to take advantage of arising opportunities
2. Consumption smoothing – to reduce vulnerabilities caused by irregular incomes and expenditures
3. Life cycle events – planning for expenses associated with birth, baptisms, education fees, wedding, retirement and death.
4. Emergencies – coping with health shocks, household, climate and economic shocks.

Microfinance cannot solve all the challenges, but programmes need to be clear if they are addressing one or a number of these areas and design suitable products accordingly. Clients often need training to make the most of the products and the opportunities. Commercial microfinance has tended to skimp on the provision of business training, seeing it as

Salome at the receipt of custom

Basic Business Training near Ndera, Rwanda, Africa

an expensive luxury that worsens the bottom line. However, socially motivated microfinance tends to see it the other way, as a vital component in holistic development that will enhance the portfolio and improve clients' resilience to shocks.

What does Christian Microfinance look like?

My passion is that Christian microfinance be professionally delivered with the 'heart of a pastor and the mind of a banker'. That is not to say that pastors do not have minds, nor bankers hearts (!), but simply that Christian microfinance should aim to achieve a balance both of excellent financial performance and demonstrable social impact. Christian microfinance should follow industry best practices to protect clients, know your customer, control indebtedness, and so on. But we should also actively promote a culture of savings, teach and encourage business planning, accountability and record-keeping. In doing so, we can help to transform people's lives fundamentally from - at times - despair to creative hope, dignity and a sense of unlocking God's promise and the God-given talents for each and every individual.

At Five Talents we are especially linked with the worldwide Anglican Church as our main community entry point and delivery partner. Sometimes this has had an adverse affect when clients have quoted the Lord's prayer 'forgive us our debts', hoping for leniency in their loan terms! But generally the church affiliation has provided a very credible basis on which to deliver microfinance services, since people of all faiths recognise the church as a trusted local institution that will be permanently present in the community, with high ethics, good accountability and a non-corruption culture. All of the Five Talents programmes have a very strong emphasis on business training and savings. In cases where clients cannot repay their loans we have clear procedures for re-scheduling, drawing down savings or genuine debt forgiveness. I feel it is a tremendous privilege and opportunity to help reach remote needy communities with a practical outworking of the Good News in this way. It's by no means perfect, but we are on the journey, making what we believe is a sustainable and cost-effective impact – and certainly that is what Salome and thousands like her testify.

1 http://www.bbc.co.uk/news/world-south-asia-11997571.

2 http://www.bbc.co.uk/news/world-south-asia-12734472.

3 Tom Heinemann, *Caught in Micro Debt*, 2010.

4 Milford Bateman, *Why Microfinance Doesn't Work*, Zed Books, 2010.

5 Peter Heslam, *Transforming Capitalism: Entrepreneurship and the Renewal of Thrift* Grove Ethics no. 156, 2010.

Paul Mills, *Investing as a Christian: Reaping where you have not Sown*, Jubilee Centre, Cambridge Papers, 1996.

6 On thrift see Prov 21:20 and the example of Joseph in Gen 41:48.

7 On debt, see Rom 13:8 and Ps 37:21.

8 For a £50 loan bearing 1% monthly flat-rate interest charge, the monthly interest is 50p. This makes the total interest charge over 4 months equal to £2. At 3% flat-rate interest per month, the monthly interest on a £50 loan is £1.50, such that over 6 months the total interest charge would be £9.

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