ADB FINANCE FOR THE POOR
A Quarterly Newsletter of the Focal Point for Microfinance
September 2005 • Volume 6 Number 3

IN THIS ISSUE

Flexible Financial Services for the Poor: Experience of *Safe*Save, Bangladesh *1*

Selected Publications on Microfinance *6*

Financing Microfinance Trends and Thoughts for the Future *7*

Book Review *The Economics of Microfinance* *11*

BARRIERS TO LEARNING

It is what we think we know already that often prevents us from learning

Claude Bernard, French physiologist

Source: *Harvard Business Review*, July–August 2004, p. 81

Flexible Financial Services for the Poor:

Experience of *Safe*Save, Bangladesh

BY MARK STAEHLE
Technical Advisor, *Safe*Save, Bangladesh

If you are very poor, you have few assets and spend most of what you earn on food and fuel.[1] When you need more than these essentials, you may go without, or you may liquidate what little assets you have (perhaps at an inopportune price), draw down whatever savings you have, or may borrow against future earnings. While the very poor are generally believed to be unable to borrow in volumes that financial institutions might find interesting, research by Stuart Rutherford and others demonstrates that even the very poor are active borrowers—and not only from high-interest moneylenders.[2] Much of that borrowing comes through reciprocal lending and borrowing relationships with other poor people and is taken free of interest, but it is most certainly a form of household financial management through borrowing—as is taking household goods or food on credit from a shop, taking salary in advance from an employer, getting behind on rent, retailing items on loan from a middleman, or participating in a rotating or accumulating savings club.[3] The poor have very dynamic financial lives: a fact that should be of interest to microfinance institutions (MFIs) seeking to work with the very poor. However, Rutherford found that MFIs in Dhaka held only 21% of the study population's total financial debt.

The poor have very dynamic financial lives

*Safe*Save was founded in 1996 by Stuart Rutherford, a microfinance enthusiast, and Rabeya Islam, a Dhaka housewife with years of experience of running savings-and-loan clubs among her poor neighbors. The premise is that very poor people would not only use, but also pay a sufficient price for a microfinance service that

- is nearby and ***convenient***, in the way that neighbors, family, employers, moneylenders and shopkeepers are;
- provides a ***frequent*** opportunity to transact as amounts are small, and a very

The quarterly newsletter of the **Focal Point for Microfinance** at ADB aims to provide information on microfinance. Articles in the newsletter, however, do not necessarily reflect official ADB views. Articles may be reprinted with proper acknowledgement of the source. Please address any inquiries, comments, and suggestions concerning the newsletter or its content to the Focal Point for Microfinance; Governance, Finance, and Trade Division; South Asia Department. Asian Development Bank, 6 ADB Avenue, Mandaluyong City, 1550 Metro Manila, Philippines. Tel +63 2 632 6931 • Fax +63 2 636 2337 • E-mail: nfernando@adb.org. *In this publication, $ refers to US dollar.*

When collectors call, their clients are offered an opportunity to save or repay any amount they wish

poor household's cash flow is large in relation to its small assets;

- is ***flexible***, allowing a choice between using savings, credit, or a combination of both, to match small, frequent "pay-ins" with larger, less frequent "pay-outs"; and
- above all, is ***reliable***.

In 1997, *Safe*Save was registered as a cooperative with 15 members. At the end of June 2005, it had 20 shareholding members. *Safe*Save's clients are people in Dhaka's slum communities, typically earning their living as day laborers, rickshaw pullers, shopkeepers, garment workers, low-level government employees, and other low-income or "catch-as-catch-can" pursuits. *Safe*Save is still relatively very small, with only 10,000 clients (four MFIs in Bangladesh have more than two million clients), a loan portfolio of $330,000, and a savings portfolio of $249,000.[4] *Safe*Save is, however, operationally sustainable. Return on equity, including grant capital of $158,000, was 6.3% for the financial year ending 30 June 2005—roughly the rate of inflation in Bangladesh.

*Safe*Save accomplishes largely its sustainability through cost control, a key component of which is hiring low-profile local people as staff. Most of the field workers (called collectors, and are all women) were born in the slums where they work, and have only a primary school education. Their average monthly take home pay of about $60 is twice the per-capita gross domestic product in Bangladesh; the best performing collectors earn two-thirds of what a branch manager (all of whom have university degrees) makes. *Safe*Save's success depends primarily on the collectors, the front line of contact with clients.

*Safe*Save's collectors visit an average of 180 clients door-to-door at their home or work place, 282 days per year. There are no groups or meetings, and clients only need to visit the branch to open an account, take loans, or make big withdrawals. When collectors call, their clients are offered an opportunity to save or repay any amount they wish, starting at $.02, and to withdraw up to $8 on the spot. Larger amounts can be had at the branch office, which is typically within one-half kilometer of the client's home, within a maximum waiting time of 10 minutes.

Clients aged 16 years or older, who have lived in the branch working area for one year or more, are *guaranteed* the right to borrow if they simply follow the rules of *Safe*Save's savings and loan product. Loans are issued one at a time, within one working day of a client's request, with a value up to their credit limit, or three times their savings balance, whichever is less. There is no schedule for loans (loans can be taken for less than the credit limit); and borrowing is not required (one in five account holders never borrow at all). There is no fixed-term and no fixed repayment schedule for loans. Loans are taken for an unlimited duration, and only the interest payment, generally of 3% of the outstanding loan balance, is due each month.[5] The clients who choose to repay quickly will earn increases to their credit limits—increases are given for each month that a client repays at least 10% of the original loan amount, provided that interests were never late for that loan. Clients with loan may also withdraw savings, as long as the balance does not dip below one-third of the outstanding loan amount.

Box 1: A POTENTIAL *SAFE*SAVE CLIENT

Sultana and her family of seven squat in an abandoned school building. Their per capita income is only $0.32 per day, but they have a very dynamic financial life.

- Every day, $0.04 goes to a local savings club.
- A "mud bank" (piggy bank) gets occasional coins.
- The household has 7 interest-free loans from neighbors ($1 to $65).
- The household has given two interest-bearing loans to neighbors ($15 and $30).
- They hold shop credit from six shops ($1 to $15).
- Sultana is a "money guard," holding a balance of $15 in savings for neighbors.
- In the past, Sultana was a MFI member when her family was earning better.
- The family once paid into an insurance scheme, until the agent disappeared.

Source: Rutherford, Stuart. 2005. Research carried out for the ADB conference *"Expanding the Frontiers of Commercial Microfinance."* Manila.

Small transactions have been *Safe*Save's mainstay. The transaction volumes and amounts in December 2004 are given in the table.

*Safe*Save's 10,000 clients are making more than 100,000 transactions per month. The premise behind *Safe*Save is that someone like Sultana (see Box 1) is a valuable potential client—that she can and will pay sufficiently for loans from an MFI that sees her as a customer and serves her needs *conveniently, frequently, flexibly*, and *reliably*. The evidence to date is that demand from the very poor is strong, and that the very poor *can* pay sufficiently to sustain *Safe*Save's operations. This does not necessarily make *Safe*Save a "model" for microfinance, but it suggests that a variety of MFIs, including credit unions and building societies, can reach the very poor by viewing them as clients who can and will pay for a good financial service, and then by creating products and systems that are appropriate to the very poor in the context within which these MFIs work.

LOAN PORTFOLIO QUALITY

*Safe*Save loans are generally small—of the 537 loans issued in June this year, 452 were issued for $100 or less. *Safe*Save's long-term loan loss rate is estimated at less than 3%, taking into consideration both write-offs and the estimation of bad debt that has not yet been written off.[6] It has so far proven unnecessary to place clients into groups, or to take any form of physical assets as collateral, as the relationship between the collector and the client has been sufficient to secure small loans. When *Safe*Save ran into overdue loan problems there was generally a high incidence of *one household arranging to take multiple loans at once*, defeating the rules which award credit limit increases to strong repayers. In the past, other factors contributed to bad debt:

- product designs giving overly large first loans;
- lack of performance incentives for collectors in early years (prior to 2003);
- loans disbursed without face-to-face contact between borrower and branch manager;
- weak internal controls leading to delays in responding to collector dishonesty;
- product features which made loans unattractive, like loan ceilings or linking loan terms to contract savings plans; and
- loan refinancing behavior—clients' use of a successive loan to cancel amounts due from a previous loan.

TRANSACTION VOLUMES FOR 10,000 CLIENTS (June 2005)

Transaction transactions	Total number of per collector	Number of transactions per client	Number of transactions transaction ($)	Average amount of each ($)	Total amount of all transactions ($)
Deposits	50,737	846	5.10	0.35	17,651
Loan repayments	25,995	433	2.60	1.32	34,268
Loan interest payments	16,667	278	1.70	0.67	11,148
Withdrawals	1,656	28	0.20	8.08	13,387
Loans	537	9	0.05	71.92	38,621

In extreme cases, loans become very old and eventually uncollectible

These problems have been resolved during 2001–2005. One particularly fruitful change has been the introduction of an incentive pay system for collectors in January 2003. All collectors receive a stable basic pay amount averaging about $40, which varies slightly with seniority. They also receive 5% of the revenue they generate, regardless of performance, adding around $10 and making revenue collection mutually beneficial for both *Safe*Save and the collector (particularly important given that many collectors work with their neighbors). However, the real performance incentive is a quarterly bonus based on client numbers and portfolio quality. That bonus ranges from a low of $8 per quarter for collectors with 120 active clients and 90% of their loans on time, to a high of $62 per quarter for collectors with 200 active clients and 96% of their loans on time (on time means that no monthly interests are overdue). The element of performance-based incentives, which may add 50% or more to a collector's income, has been responsible for improved financial performance.

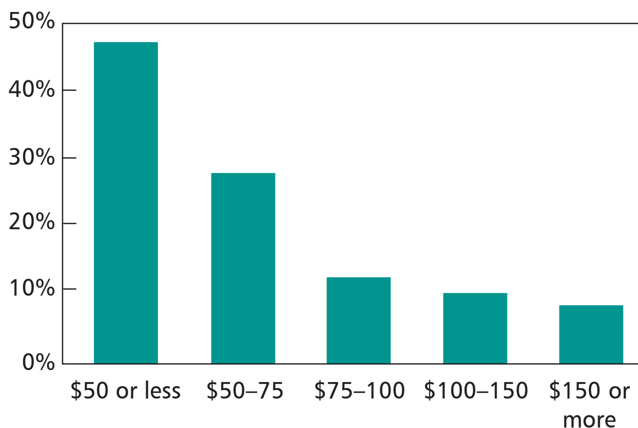
In extreme cases, loans become very old and eventually uncollectible, even if the client remains in the working area.

This can be the result if the client habitually pays interest, without making progress in repaying principal. However, it may also be the result of genuine hardship in the household, such as abandonment or drug addiction. These loans are generally pursued patiently without further interest, but are not written off, if the client is in the area.

In April 2005, *Safe*Save began introducing a new policy which limits loans to one per household, rather than one loan per eligible account. This change will reduce profitability, but it is seen as necessary for the long-run health of the loan portfolio. The policy will prevent clients from circumventing credit limits by arranging loans through multiple accounts.

In Bangladesh, overlapping among MFIs and the potential for over indebtedness of MFI clients are concerns.[7] Regardless of where one stands on this debate, *Safe*Save does not appear to be affected. Instead, *Safe*Save, like moneylenders, provides a service which is complementary to mainstream microcredit, which has less convenient terms.

DISTRIBUTION OF LOAN SIZES (June 2005)



TECHNOLOGY

*Safe*Save has always used a database to track account records, but in 2002 it also began experimenting with the use of handheld computers or personal digital assistants (PDAs) for field-level transactions. The system is proving not only beneficial to internal control, but also cost-effective and popular with staff and clients. The major wins so far are the following:

- an account error rate of less than 0.1%—at least a 10x improvement on paper-based systems;
- the ability to provide branch managers with a PDA containing the account balances and transaction details for all clients, to facilitate random checking;
- the ability to assign the assistant manager to the management of both the MIS and cash, without losing "dual control," allowing the branch manager to spend more time in the field;[8] and
- the ability to ensure that product rules are followed, and that collectors' procedures are disciplined, by using the palmtop device to control transactions.

Clients are pleased with the technology, which gives them confidence and adds to *Safe*Save's reputation for reliability. The PDAs, the oldest of which are now more than 2 years in operation, cost about $120 each. While direct costs are higher than paper-based systems, indirect benefits more than make up for the expense, and *Safe*Save is expanding the use of the system at its own cost. About 3,500 clients are presently served by the system. More information on this can be found in a series of briefing notes to *MicroSave*, available on *Safe*Save's website (www.safesave.org).

OUTREACH

*Safe*Save does not selectively target the poor and very poor households. Instead, products and systems are designed to satisfy the poor and very poor, and the service is then offered to all households in the branch area. An ongoing study will determine whether *Safe*Save's clients are poorer than the clients of other MFIs, whose groups may "screen out" vulnerable clients, and whether *Safe*Save's clients are more or less poorer than the average inhabitant of the branch areas. The results of the study should be available on *Safe*Save's website later in the year. Initial findings indicate that *Safe*Save's clients match the broad demographic profile of the branch working areas, indicating that it is able to extend its service not only to better-off slum households, but also to the poorest households in the working area.[9]

PLANS

*Safe*Save plans to double its client base to about 20,000 in the next 3 years. That expansion will not be funded by grants; *Safe*Save will instead seek one or more commercial bank loans to finance the expansion. Growth, however, will be controlled partly because it has to ensure that the emphasis remains on systems (quality over quantity), but primarily because Bangladesh does not yet have an adequate legal identity for profit-seeking MFIs to intermediate deposits. As *Safe*Save does not intermediate between clients, expansion requires larger amounts of external capital than would otherwise be needed.[10] Licensed intermediation would give rise to a host of new

Box 2: SUMMARY OF PRODUCT FEATURES

- Clients may save and withdraw, in any amount they like, with some restrictions to maintain partial savings collateral when loans are present.
- To prevent rent-seeking, subjective loan decisions are not made by staff—clients are guaranteed loans according to published rules, and spot-checking helps to ensure that staff are not withholding loans.
- Loans are guaranteed within one working day of a client's request, provided that product rules are met.
- Physical collateral or third-party guarantees is not required; loan disbursements are publicly witnessed, but the witness is not financially responsible.
- Loans may be taken for any purpose.
- In general, loan fees are charged at the rate of 3% of the month-end declining balance.
- Repayment of loan principle is up to the client—there are no fixed schedules or maximum duration for the repayment of a loan.
- The client's credit limit rises with each loan, provided all interest has been paid on time, with the biggest increases going to clients who demonstrate an ability to make regular loan repayments each month.
- Loans are forgiven upon death; if the death can be verified, the savings balance is returned to a nominee.
- Clients pay service fees of $0.32 for account opening, $0.08 per month for the daily visit service, and $0.80 as a loan processing fee for each loan taken.
- The savings interest rate is 6% per year, if minimum balance is $16 or higher.
- Product rules are always delivered to the client in writing, with at least one month's written notice before any changes take effect.

opportunities to expand the line of savings products, offer more attractive rates for savings, and use the increased deposit base to fund faster expansion.[11,12]

CHALLENGES

*Safe*Save also faces a number of challenges. Two of its major challenges are the following:

- The lack of a licensing arrangement for profit-seeking MFIs prevents *Safe*Save from deposit intermediation, limits sources of commercial capital, and inhibits the development of a commercially-minded board of directors.
- Downward political pressure on interest rates may make it difficult for *Safe*Save to continue charging an effective loan interest rate of 36% and, therefore, maintain profitability. ■

[1] The concepts put forth in this article are attributed to Stuart Rutherford, whose research led to the founding of *Safe*Save in 1996.

[2] Rutherford, Stuart. *Money Talks: Conversations with Poor Households in Bangladesh about Managing Money.* Institute for Development Policy and Management Working Paper 45/2002. See www.man.ac.uk/idpm.

[3] In a rotating savings club, the equal periodic savings of all members go to one member in turn each period; whereas in an accumulating club, the fund builds up as members save, and is lent out according to need, on interest, to individual members.

[4] The exchange rate used in this articles is $1=Taka 63. All figures are given in dollar equivalents to simplify the figures for an international readership.

[5] In three of *Safe*Save's branches, the interest charge is 10% per 3-month period, with a 1% rebate for clients who pay the interest in full within the first month.

[6] The actual rate of write-off is less than 2%.

[7] Overlapping occurs as clients take loans from multiple MFIs at the same time.

[8] "Dual control" principals ensure that the person who enters transaction information does not manage the cash. In the case of branches with the hand-held computer system, transaction information cannot be changed by the assistant manager, so he or she can be both cashier and MIS manager.

[9] CGAP's Poverty Assessment Tool has been used in the research. Initial results indicate that about 25% of *Safe*Save's clients fall into the lowest quartile of relative poverty.

[10] *Safe*Save reserves about 30% of all deposits as a form of self-regulation.

[11] In 2004, *Safe*Save's seventh branch mobilized a deposit portfolio of one million taka in its first year of operation. The demand for savings products is strong, but the lack of opportunity to intermediate those deposits makes mobilizing them at high rates of interest uneconomic for *Safe*Save.

[12] For more information, see *Safe*Save's website (www.safesave.org) for regular updates. Inquiries may be directed to mail@safesave.org.

SELECTED PUBLICATIONS ON MICROFINANCE

BOOK

Armendariz de Aghion, Beatriz and Jonathan Morduch. 2005. *The Economics of Microfinance*. Cambridge, Massachusetts: The MIT Press.

JOURNAL ARTICLES

Anthony, Denise. 2005. *Cooperation in Microcredit Borrowing Groups: Identity, Sanctions, and Reciprocity in the Production of Collective Goods*. American Sociological Review, 70 (3): 496–515.

Arun, Thankom. 2005. *Regulating for Development: The Case of Microfinance*. Quarterly Review of Economics and Finance. 45 (2/3): 346–357.

Burgess, R., R. Pande, and G. Wong. 2005. *Banking For the Poor: Evidence from India*. Journal of the European Economic Association. 3 (2–3): 268–278.

Chamlee-Wright, Emily. 2005. *Fostering Sustainable Complexity in the Microfinance Industry: Which Way Forward?* Economic Affairs. 25 (2): 5–12.

Daru, P., C. Churchill, and E. Beemsterboer. 2005. *The Prevention of Debt Bondage with Microfinance-Led Services*. European Journal of Development Research. 17 (1): 132–154.

Hitchins, Rob, David Elliott, and Alan Gibson. 2005. *Making Business Service Markets Work for the Rural Poor—A Review of Experience*. Small Enterprise Development, 16 (2): 10–23.

Johnson, Susan. 2005. *Gender Relations, Empowerment and Microcredit: Moving on from a Lost Decade*. European Journal of Development Research. 17 (2): 224–248.

Kaboski, J., and R. M. Townsend. 2005. *Policies and Impact: An Analysis of Village-Level Microfinance Institutions*. Journal of the European Economic Association. 3 (1): 1–50.

Manaktala, Shivani. 2005. *IDE (India)'s Market Creation Approach to Development*. Small Enterprise Development, 16 (2): 36–43.

(continued on p. 10)

Financing Microfinance
Trends and Thoughts for the Future

BY MARC DE SOUSA SHIELDS
Director Enterprise Solutions, New York
and BRADLEY KING
Financial Analyst, Enterprise Solutions, New York

What do Hong Kong property developers, Peruvian coffee producer cooperatives, and Ugandan investment groups have in common? Not much, except that all of them either have bought or once wanted to buy minority positions in microfinance institutions (MFIs).

This interest comes as no surprise to many who follow the impressive development of many MFIs whose returns on equity (ROE) continue to outperform most other local investment opportunities.

Despite such performance, most MFIs continue to need significant additional volumes of both portfolio funding and equity capital. While savings will and must supply the majority of funding, worldwide demand for debt capital alone will top an estimated $3 billion by 2009. Demand for new equity should, as a result, top $500 million.

GENERAL TRENDS

Microfinance is transforming from a donor-dominated sector to one responding to the needs and interests of private capital. The sector must do this if it is to reach a significant number of poor with key financial services.

This transition to private capital is well under way. Many MFIs are entirely or almost entirely funded by private capital. But the transition has been slow and difficult as many MFIs lack the management capacity to attract and absorb private capital. Best practice knowledge, improved regulatory regimes, and stronger sector associations, among other things, have had strong positive effects on the sector's capacity. While improvements vary by country and by institution, clearly many MFIs now have or will soon develop the capacity to profitably employ commercial capital.[1] Four relevant general trends have been observed.

- While savings fuel most MFI growth, strong demand exists for debt, which is not always available in the region at the volume or on the terms required.
- The majority of sector "risk-tolerant" capital (debt and equity) comes from noncommercial sources such as international financial institutions (IFIs), including the Asian Development Bank, or quasi-commercial capital suppliers, such as the Triodos Doen Foundation.
- A great portion of the available "risk-tolerant" capital goes to low-risk, mature, and profitable MFIs, denying higher-risk MFIs growth opportunities and possibly decreasing the overall development impact of such funding.
- MFIs demonstrate attractive ROEs, but private investors remain wary or unaware of MFIs, many of which reject private investors as unsuitable shareholders.

SAVING TRENDS

Savings is considered the most stable and inexpensive form of financing available to MFIs. Their collection, however, is fraught with challenges.

- Many countries do not have appropriate regulatory structures permitting MFIs to collect deposits.

Many MFIs are entirely or almost entirely funded by private capital. But the transition has been slow and difficult

- Many MFIs do not have the management expertise required to efficiently collect deposits.
- MFIs with cost-efficient savings programs often cross-subsidize many small demand account deposits from the poor with larger-term deposits from wealthier clients. These MFIs must compete in higher-income deposit markets which are often intensely competitive.

Despite these challenges, an increasing number of institutions worldwide are transforming into financial intermediaries. A survey of 61 regulated Latin American MFIs by the Inter-American Development Bank, for example, found savings comprised on average 65% of all funding. Many Asian MFIs have also increased their reliance on voluntary savings.

DEBT TRENDS

Although majority of microcredit loans are or will soon be funded by intermediated savings, debt from banks, investors, or noncommercial funding sources, remains important to the sector. Important trends are as follows.

- Strong worldwide demand for debt capital is estimated at $700 million in 2005 and $3.1 billion by 2009, mostly in local currency.
- Many large and profitable MFIs continue to take advantage of loans from IFIs and national development banks, which are often available on subsidized rates or and/on noncommercial terms (i.e., non-collateralized loans, payment grace periods, and very long amortizations) even though they are capable of accessing local commercial capital. The result is that a strong concentration of high-risk, subsidized capital is invested in many sustainable institutions that arguably do not need it.
- Some countries, particularly the very poor, generally speaking, have greater demand for debt.
- Most MFIs are not rated by market-recognized raters (e.g., Standard and Poors, Fitch), or they have not achieved ratings that attract market interest (e.g., institutional investors dealing with pension funds typically require an "A" rating or better).
- Lenders typically lack understanding of the microfinance sector, resulting in short-term, small loans with 100% (or more) guarantees. MFIs are often unable to fully use loan portfolios as security because of the complexity of using them as collateral.
- Commercial banks often require strong outside credit guarantees on loans to MFIs and face high-reserve costs for only partially collateralized or uncollateralized loans.
- Increased interest and ability to go to local bond markets or to securitize MFI portfolios in local and international markets have been observed.
- About 80% of fund investment is in hard currency; strong demand exists for funding denominated in local currency. There is a small movement among some suppliers (*see MFI Specialty Funds on p. 9*) to increase local currency denominated lending.

> Some of the best-managed MFIs are issuing tradable debt

Many suppliers of debt to MFIs now believe that lending to the best-managed 200 MFIs is relatively easy to do. This is true to some extent as many specialized MFI funds and some banks have developed increasingly efficient means to assess credit and sector risk. Some of the best-managed MFIs are issuing tradable debt, such as bonds or certificates of deposits. These instruments tend to be longer term (average 2.5 years) and lower cost than bank loans. Through a combination of savings deposits, bonds, and certificates of deposit, MiBanco in Peru, for example, has lowered its financing costs by over 50% in less than a year.

It is worth noting that many national development banks, apex institutions, and international finance institutions continue to lend funds well below market rates, distorting debt capital markets for MFIs. This makes it difficult for commercial or commercially-minded investors, such as specialized MFIs funds, to sustain their operations.

EQUITY TRENDS

Equity is important because what drives owners, drives institutions, and hence the sector. MFIs are often owned by NGOs, which is a strength and a weakness. NGOs are generally concerned with the poverty mission of microfinance. This is a strength. But many NGOs also fear private capital for the diluting effect it may have on its mission or *raison d'être*.

MFI FUND INFORMATION

- 70% of all funding is invested in 114 regulated MFIs.
- 85% of private equity is found in the same, large MFIs.
- ProCredit banks represent 3% of funding recipients and receive 34% of funding and 60% of all equity.
- Latin American and Eastern European receive 88% of investment.
- Loans sizes range from $5,000 to $2.5 million.
- The average loan size is about $300,000.
- Loan terms range from 1 to 7 years with an average of 18 months.
- MFIs seldom have attractive dividends histories.
- Majority shareholders, such as nongovernment organizations, are often unwilling to maximize profits.
- MFI shares have poor liquidity, making exits difficult, and are worrying to investors.
- MFI share valuation and contracting problems.
- MFI owners and/or managers are unaccustomed to the rigors of selling shares or are unwilling to cede control to any outsiders.

At the same time, many MFIs have commercially competitive ROEs that are dismissed, overlooked, or unnoticed by poorly informed private investors. This is compounded by domestic investors' preference for controlling stakes of the companies they invest in and, conversely, by NGO owners who are rarely willing to sell more than minority stakes. These and other factors outlined below add to the challenge of establishing stronger linkages between private capital and microfinance.

Buying or selling MFI shares is a complicated, risk-filled endeavor for buyer and seller alike. The result is that there is very little equity capital available to MFIs, despite an increasing number of transformations and more MFIs in need of such capital.

MFI SPECIALTY FUNDS

About 45 private funds are dedicated to MFIs (excluding national apex funds).[2] These funds control about $400 million to $550 million, with assets held mostly in debt (75%), though some in equity (15%) and guarantees (10%). In the coming years, funds will annually disburse about $80 million to $100 million. The following are some trends.

- Due to the typical investment preconditions of profitability and/or being regulated, public and private fund equity and debt capital are generally concentrated in large, mature MFIs (*see box*).[3]
- The number of funds operating commercially (i.e., that charge commercial rates) is growing. Only one, Blue Orchard, is fully commercial (i.e., funded by commercial investors and charging commercial rates).
- About 90% of financing comes from IFIs, the balance coming from donors and social investors (most taking below market rates of return or requiring some form of public sector guarantee before investing).
- IFIs often offer well below market prices for MFI debt, making it difficult for commercially-oriented funds to compete.
- IFIs are often poor owners and do not provide the kind of oversight of their investments that is essential for good governance and profit maximization.
- Over 80% of funding is in hard currency; demand for locally denominated funding is strong. Some funds, like OikoCredit and the Triodos Doen Foundation, are increasing their local currency loans and using hedging techniques to reduce exposure to currency fluctuations.

While specialty funds will supply less than 5% of all funds to the sector by 2009, they remain important for a number of reasons.

First, they supply debt on terms longer than most conventional private sector suppliers. Many do not require collateral guarantees and offer relatively fast, uncomplicated service. Blue Orchard, for example, has offered loan terms of up to 7 years.

Second, the funds bring a wealth of experience to the sector. Many funds such as ShoreCap, for example, bring many years of microfinance experience and bank ownership to their investee companies. The value added by this experience accumulates not

The funds bring a wealth of experience to the sector

only at the operational level, but also, more importantly, at the governance level where ShoreBank (manager of ShoreCap) can apply its past experience as a small bank.

Finally, the triple bottom line—people, profit, and planet—of management technology transfers is beginning to take place. Tridos Bank, manager of the Triodos funds, has recently introduced the Global Reporting Initiative concept on a pilot basis to six of its investee companies (*see www.gri.org*). Taking such move will help attract the interest of social investors worldwide who control more than $3 trillion, many of whom are looking to developing countries to provide higher returns than those found in their anemic home markets.

A WORD FOR THE FUTURE

The future face of microfinance will be that of private sector investors, if the sector is to serve billions of poor the world over. Trends toward private ownership are not only coming from within, but also increasingly from without, as well-financed commercial banks and finance companies enter the market.

Ensuring that the assets so painstakingly built up by NGOs and that public funding remain dedicated to their poverty reduction mission will take two determined efforts. First, individual institutions have to grow—organically or via mergers and acquisitions—to become large, profitable institutions whose core market is intractably providing financial services to low-income households.

Enlarging the concept of social responsibility to the "Triple Bottom Line" concept is critical to preserve its current mission and to realize its true potential as an agent for development, and in the process, encourage its private capital and clients to be the same. ■

[1] The focus here is not on the many thousands of tiny programs scattered around the world, but rather on the 200–300 smaller MFIs that typically have 1,000–3,000 clients, a good deal of operating experience, and a basis for strong potential growth.

[2] National apex funds are usually owned or controlled directly by national or regional governments. They operate independently or are managed by national or regional development banks.

[3] Public investors are those which are directly or indirectly controlled by a public financial institution. Private funds vary in ownership structure from those controlled by foundations or nongovernment organizations to those owned by commercial private sector interests.

SELECTED PUBLICATIONS ON MICROFINANCE (continued from p. 6)

Megicks, P., A. Mishra, and J. Lean. 2005. *Enhancing Microfinance Outreach Through Market-Oriented New Service Development in Indian Regional Rural Banks*. International Journal of Bank Marketing. 23 (1): 107–125.

Naponen, Helzi. 2005. *The Internal Learning System—Assessing Impact while Addressing Participant Learning Needs*. Journal of International Development. 17 (2): 195–209.

Miehlbradt, Alexandra. 2005. *Making Market Assessment More Useful—Ten Lessons from Experience*. Small Enterprise Development, 16 (2): 24–35.

Sethna, Armin. 2005. *Embedded Services—The Case of Materials Suppliers and MSEs in South Africa's Construction Sector*. Small Enterprise Development, 16 (2): 44–54.

Sisodia, N.S., M.B. N. Rao, V. Leedladhar, M.P. Vasimalai, R. Reddy, B. Mohan, R. Srinivasan, and M.S. Sriram. 2005. *Rural Finance in Contemporary Times: Interface with Microfinance. Vikalpa*: the Journal for Decision Makers. 30 (2): 81–112.

OTHER PUBLICATIONS

ACCION International. 2005. *Poverty Outreach Findings and Analysis: BancoSol, Bolivia. InSights No. 13*. ACCION International: Boston, MA.

ACCION International: Council of Microfinance Equity Funds. 2005. *The Practice of Corporate Governance in Shareholder–Owned Microfinance Institutions-Consensus Statement of the Council of Microfinance Equity Funds*. ACCION International: Boston, MA.

Consultative Group to Assist the Poor (CGAP). 2005. *Building Capacity for Retail Microfinance. Donor Brief No. 24*. Washington, DC and Paris: CGAP.

CGAP. 2005. *Due Diligence Guidelines for the Review of Microcredit Loan Portfolios. Technical Tools*. Washington, DC and Paris: CGAP.

CGAP. 2005. *Protecting Microfinance Borrowers*. *Focus Note No. 27*. Washington, DC and Paris: CGAP.

BOOK REVIEW

The Economics of Microfinance

by Armendariz de Aghion Beatriz and Jonathan Morduch

The Massachusetts Institute of Technology Press, Cambridge, Massachusetts

Reviewed by **NIMAL A. FERNANDO**
Principal Microfinance Specialist
Asian Development Bank

Literature on the microfinance industry has been increasing in recent years. However, except for a few articles in reputed journals such as the *World Development*, *Journal of Economic Literature*, and *Journal of Development Economics*, the literature has not established a strong link between theory and practice, thus leaving a significant gap in knowledge in an array of major issues in microfinance development.

This book, which provides a comprehensive survey of microfinance, is a pioneering effort to fill this knowledge gap. The authors clearly explain the rationale for the book: "There is a great deal already written on microfinance, both by practitioners and academic economists, but the two literatures have for the most part grown up separately and arguments have seldom been put into serious conversation with each other. Both literatures contain valuable insights, and both have their limits; one of our aims in this book is to bridge conversations, to synthesize and juxtapose, and to identify what we know and what we need to know" (*p. x*). The authors hope to achieve their aim not only by discussing the innovations that have created the microfinance movement but also by addressing and clarifying "the puzzles, debates, and assumptions that guide conversations but that are too often overlooked" (*p. 3*).

The book consists of 10 chapters. Each chapter deals with a topic receiving diverse views among policy makers, practitioners, and researchers, and challenges many conventional assumptions of microfinance. All chapters present different views and analysis of issues in a manner that is easy to grasp. Although the authors use mathematics to clarify arguments, as they claim, the main points articulated in the book "can be understood without the math" (*p. x*). Each chapter ends with a well-written summary and conclusions and a list of challenging exercises for students in economics.

The introductory chapter on rethinking banking provides an excellent foundation for discussions in subsequent chapters. This chapter raises a range of major issues such as why conventional banks have neglected serving the poor, whether poor borrowers can pay high interest rates, whether the poorest are best served by loans or by better ways to save, whether subsidies have a useful role to play, whether providing microcredit without training and other complements is enough, and which aspects of lending mechanisms have driven successful performances. The simple figures used in the chapter to explain marginal returns to capital for poor and non-poor households greatly clarify the controversial issue of whether poor households can pay high interest rates.

The authors challenge many conventional assumptions of microfinance

Chapter 2 addresses an often raised question: why intervene in credit markets? The chapter discusses interest rates in informal credit markets and the problems faced by commercial banks that hope to lend to low-income households. The authors use primarily the basic analytical concepts of adverse selection and moral hazard. Reiterating

earlier issues raised by other scholars such as Joseph Stiglitz, the chapter points out the potential problems of increasing interest rates on credit too high. According to the authors, "the challenge for microfinance is to couple smart interest rate policies with new ways of doing business to ensure good incentives for customers" (*p. 52*).

The remaining chapters focus on rotating savings and credit associations and credit cooperatives (chapter 3), group lending (chapter 4), other lending methodologies (chapter 5), savings and insurance (chapter 6), gender (chapter 7), issues in measuring impact of microfinance (chapter 8), subsidies and sustainability (chapter 9), and issues related to performance of microfinance institutions (MFIs) (chapter 10).

The chapter on savings and insurance emphasizes the importance of these services for poor households and provides significant insights on how to deal with issues related to developing these services. The chapter also highlights the relevant lessons from experience with microcredit for micro-savings and microinsurance development. More importantly, the chapter questions the common assumption that borrowing constraints are far more serious than savings constraints, based on theoretical grounds and empirical evidence.

The authors thoroughly discuss gender aspects of microfinance in chapter 7 despite their modest claim that the discussion just scratches the surface. This chapter deals with questions such as why women have become the major category of clients in microfinance, whether women are better customers, and whether microfinance affects the empowerment of women. They argue that microfinance can have a potentially significant positive gender impact, although depending on the design and intent of the programs. However, they conclude with an open question on whether incorporating such outcomes into programs will lead to trade-offs with other goals.

Chapter 8 on measuring impacts brings together a wide range of issues relating to the subject and emphasizes inherent difficulties in impact evaluation of microfinance. However, the authors do not totally discard impact evaluations. Instead, they conclude that "for analytical purposes, having one very reliable evaluation is more valuable than having one hundred flawed evaluations" (*p. 222*).

Chapter 9 deals with yet another interesting subject: subsidy and sustainability. The authors have put together the conventional and controversial issues surrounding subsidies. They discuss how subsidies in principle can be designed to play a meaningful role in microfinance, without undermining the integrity of the institution. Their arguments supporting smart subsidies deserve the serious attention of funding agencies because it is not always possible to serve very poor clients while achieving full financial self-sufficiency. They point out correctly that while some MFIs such as the Association for Social Advancement (ASA) in Bangladesh "have found ways to achieve full financial self-sufficiency while serving the very poor clients" (*p. 251*), it does not necessarily mean that it can be done always and in any country.

The authors have put together the conventional and controversial issues surrounding subsidies

The final chapter deals with factors that influence the performance and impact of MFIs. The authors show how the design of incentive schemes, ownership structure, and organizational forms can be used to improve institutional performance and impact. This is based on empirical evidence from well-known MFIs such as the Bank Rakyat Indonesia's Unit Desa system, ASA, and Prodem private financial fund. The authors also tackle problems that these approaches are likely to create and thus provide a balanced rather than a biased discussion of issues.

In summary, this book makes a valuable contribution to the existing body of knowledge on microfinance development. The authors have used their extensive field experience to integrate theory with practice and have been brave enough to question many conventional assumptions to encourage fresh thinking and research. Despite the academic-oriented title, the book offers a great deal of insights on microfinance development for a wide range of readers—from practitioners and policy makers to those working in development agencies. The book is highly recommended. ■