

Private Sector Microfinance

Alan Doran

Pro-poor microfinance institutions have their origins in NGO-managed not-for-profit programmes. As the microfinance 'industry' has grown and matured, the private sector has become increasingly active in marketing financial products and services to poor people in developing countries, demonstrating that the sector can be commercially sustainable. As well as in-country initiatives to deliver financial services to poor people, microfinance increasingly has an international dimension, such as enabling the transfer of remittances, linking capital markets to microfinance initiatives, and supporting ethical financial consumerism in wealthy countries. The author reviews these trends, and concludes that the expansion of private sector microfinance should broadly be welcomed by anti-poverty campaigners. The entry of commercial actors can result in increased competition, reduced costs, more sustainable services, and greater coverage of financial services for poor people. However, completely commercial services may be unsuitable for the most vulnerable poor, a sub-sector where careful, tailored programming continues to be essential.

This background paper was written as a contribution to the development of *From Poverty to Power: How Active Citizens and Effective States Can Change the World*, Oxfam International 2008. It is published in order to share widely the results of commissioned research and programme experience. The views it expresses are those of the author and do not necessarily reflect those of Oxfam International or its affiliate organisations.

1. Introduction to microfinance

What is meant by microcredit and microfinance?

Microcredit refers to programmes, originally and in many cases still donor or NGO sponsored, that primarily provide credit in tiny¹ amounts for self-employment but also other financial and business services (including savings and technical assistance) to very poor persons, mainly women.

Microfinance is the broader term, more commonly used today. It reflects the fact that thousands of microfinance institutions (MFIs) of varying institutional structure, degree of independence, and funding sources, including those partially or completely commercial in approach and ownership, now exist. These deliver an increasingly wide range of retail financial services to the poor. As well as credit and savings products, money transfers and insurance are being offered by more and more MFIs.

Within microfinance, savings products are increasingly being emphasised. In many cases, the availability of well-designed, safe and accessible savings products for the poorest is as important, if not more important, in poverty reduction than microcredit.

There is increasing overlap and interaction between the formal financial sector, that is, banks and other for-profit private-sector financial companies, and microfinance.

What is the history, growth and scale of microfinance ?

Microcredit began in the early 1970s in Latin America with experimental programmes by NGOs like Opportunity International, and in Bangladesh in 1974 with the Grameen (village) banking programme. It experienced rapid growth and international diffusion driven by specialist and non-specialist NGOs. In 1997, a high-profile Microcredit Summit was held in Washington, addressed by Hillary Clinton. This launched a campaign to expand microcredit to reach 100 million of the poorest families in the world by the end of 2005, and a global monitoring and reporting system for MFIs.

At the end of 1997, 618 MFIs reported² that they served 13.5 million borrowers, of whom 7.6 million were classified as among the poorest, defined as those in the lower half of those living below their country's poverty line, or below \$1 per day.

By the end of 2004, the reported figures³ had risen to 3,164 MFIs, serving 92.3 million borrowers of whom 66.6 million were among the poorest when they took out their first loan. Of these poorest clients 83.5 per cent were women. Assuming 5 persons per family, some 333 million family members would be affected. The overall growth rate over that 7-year period was 36.1 per cent per year, though growth between end-2003 and end-2004 was 21.6 per cent.

MFIs vary enormously in size. The 52 largest institutions and networks, each of which has over 100,000 clients, account for 84 per cent of the poorest clients. At the other end of the scale there are 2,321 MFIs with less than 2,500 clients.

Among the global population of MFIs (estimated at 10,000 plus) there are those that have made the transition from solely NGO-funded programmes to self-sustaining independent financial institutions, with a variety of domestic and international funding sources. A few of these have become purely for-profit operations, though most still have some reliance on soft capital sources for their equity. These include donors and socially responsible investment funds. Sources of funds for on-lending to

¹ Credit is typically \$100 or less for the first loan, but can graduate to larger amounts on successful repayment.

² Source: Microcredit Summit Campaign (2005), Report.

³ Because of the huge scale of activity and voluntary compliance, the reported figures are not comprehensive. Many smaller MFIs do not report, or have ceased reporting data. In particular some large government programmes in China and Thailand are not submitting data.

borrowers include commercial bank loans, sometimes supported by donor guarantees, and for those licensed to take them, savings deposits. A few MFIs have been set-up from the beginning as commercial operations.

As the microfinance 'industry' has matured; examples of MFIs with sustained records of high profitability and no subsidy have emerged within many markets. This, together with the new interest among big corporate entities in marketing products and services designed for poor people in developing countries ('bottom of the pyramid strategies'⁴) is making the private finance and investment sector reassess microfinance. Rather than a worthy charitable activity, it is seen more and more as a commercial opportunity. The increasing investment of private capital and availability of bank lending are two of the drivers for the continued expansion of microfinance.

How does penetration of microfinance to the poorest vary across regions?

As shown in the table, penetration of microfinance among poor families worldwide varies greatly, with Asia far in advance of other regions.

Table 1

Region	Asia	Africa and Middle East	Latin America & Caribbean	Europe and NIS
Number of poorest families (million)	157.8	61.5	12.1	3.5
MFI outreach Number of families	59.9	5.2	1.4	.06
% coverage	38	8.5	11.6	1.7

Source: adapted from Figure 2, p26. *State of the Microcredit Summit Campaign Report 2005*. Note: Poorest families defined as those living under \$1 per day adjusted for PPP

What is a typical borrower profile among the poorest clients?

The predominance of women borrowers has been a continuing feature of the microfinance industry. The role models winning global awards at high profile ceremonies at the end of the UN's 2005 Year of Microcredit were low-income women, in some cases illiterate, successfully starting businesses with loans of under \$100, in poor regions of countries such as Sierra Leone and Afghanistan.

The main categories of microfinance clients are female heads of households, pensioners, displaced persons, retrenched workers, small farmers, and micro-entrepreneurs. Locations include urban and rural areas, but penetration of rural areas, where most of the poorest live, is more difficult.

On the whole women tend to be poorer than men, and therefore to prefer smaller loan sizes. In many cultures, women have less access to collateral, such as title deeds to land, which also makes it more difficult for them to secure larger loans.

How did microfinance reach poor borrowers?

One of the innovations of microfinance, and a key reason why the poorest groups - and women especially - were able to take advantage of it, was the solidarity lending system. Under this system, would-be borrowers form groups (usually between three and six people), within which each member agrees to guarantee the loans of the others. If any one individual member defaults on his or her loan, the other members of the group are required to cover the shortfall.

⁴ Prahalad, C.K.(2005) *The Fortune at the Bottom of the Pyramid: Eradicating Poverty Through Profits*, USA: Wharton School Publishing

As the microfinance industry has expanded and developed to cover a wider range of borrowers and circumstances within the poor and vulnerable non-poor segments of populations, individual loans and those requiring informal or formal collateral have become relatively more common. Group lending is nevertheless still a major channel for credit.

Does the microfinance industry require subsidies?

Less and less is the answer to this question. The reason is that the industry has become increasingly sustainable, as the ability of poor borrowers consistently to repay loans at rates that cover costs has become apparent, and a wide range of suppliers has entered the market.

As the microfinance industry has developed, the weight of policy opinion has turned against subsidised interest rates, which were common in older NGO microcredit programmes. The evidence is that few benefit from subsidised credit, and it tends not to flow to those who need it most. At the same time, the low or negative margins over costs jeopardise the sustainability and growth potential of MFIs. It appears that in most circumstances even poor customers are willing and able to pay a cost-covering interest rate.

In exceptionally disadvantaged areas (such as those with low population density and widely scattered villages, far from economic centres, etc.) temporary subsidies may be warranted, but the policy guidance is that the subsidy should be directed to the operational costs of the MFI rather than the interest rate.

What determines the right interest rate?

The prevailing wisdom is that interest rates should be charged so that they cover all costs to secure the long-term sustainability of MFIs (assuming they are efficient) and thus ensure that the service is continuously provided. Long-term sustainability according to many authorities⁵ implies that rates should cover all administrative costs, loan losses, the cost of capital including inflation, and an allowance for increasing the equity of the MFI, so that its volume of operations can expand.

This does not mean that all high interest charges by MFIs are justifiable. Sometimes MFIs, especially ones that are funded by donors, are not aggressive enough in containing transaction costs. The result is that they pass on unnecessarily high transaction costs to their borrowers. Sustainability should be pursued by cutting costs as much as possible, not just by raising interest rates to whatever the market will bear. Competition among suppliers of financial services will assist the downward pressure on costs.

What are the main challenges to the microfinance industry?

CGAP⁶ estimates that despite the enormous expansion of the industry, as many as 3 billion people still do not have access to financial services. So the major challenges are to continue and if possible to accelerate the scaling up of microfinance industry, to reach increasingly poorer and remote people especially in rural areas, and to lower costs, taking better advantage of new electronic technologies such as smart cards, mobile phones, PDAs and ATMs, for both providers and consumers of financial services⁷.

Another challenge is working out the best ways to ensure that poor and vulnerable consumers do not fall prey to predatory lenders and other unscrupulous practices, from which the industry is not

⁵ See for example CGAP (2003) Direct Training Module on Interest Rates, April.

⁶ CGAP, the Consultative Group to Assist the Poor, is a consortium of 31 public and private development agencies working together to expand access to financial services for the poor in developing countries.

⁷ See for example, the latest major review of the microfinance industry in Helms, B. (2006) *Access for All*, CGAP.

immune. Consumer education, the regulatory framework, and healthy competition are all elements of the solution.

In what ways do banks directly interact with microfinance?

The main channel for banks' involvement continues to be providing loanable funds to independently owned MFIs. More recently, some banks have developed their own MFI operations either through subsidiaries or working with local partners.

In the latter activity, banks are frequently assisted by specialised microfinance NGOs such as Accion, based in Boston, USA. In some cases the NGO is a joint venture partner with the bank in the MFI.

A recent example of the large impact that bank funding of loans can have on microfinance comes from India. Just two years after launching the operation, ICICI, India's second-largest private bank⁸, has close to 1.5m customers that qualify as extremely poor, and an associated loan portfolio of \$265million. It works through 53 small MFIs; ICICI lends at 9.5-11 per cent, a bit more than it charges its corporate clients, and the MFIs re-lend the money at 16-30 per cent. The first 5-12 per cent of loan losses are chargeable to the MFIs' equity to ensure sound lending. Returns are good and ICICI wants to expand the scheme.⁹

Initially, commercial banks would only lend to MFIs with some form of external guarantee cover. Specialised NGOs such as Accion were able to provide this, and often arranged a progressive reduction in the guarantee cover as the bank's confidence in the MFI increased. MFIs vary enormously in their financial and management strength. While some can borrow unaided, most still require some form of guarantee, now provided by a wide range of socially responsible or donor-linked international financial institutions.

An example of direct bank involvement in MFI operations is Real Microcredito in Brazil. ABN Amro bought Banco Real in 1998, acquiring a network of 2350 branch offices. In 2001, the bank asked Accion to help it set up a for-profit microlending subsidiary. With ownership split 80/20 between Banco ABN Amro Real and Accion, Real Microcredito began operations in 2002, and by June 2005 had just under 6,000 active clients with an average loan balance of \$519.

Another route, also favoured by Accion, is the service company model, where a non-financial subsidiary is created for the origination and administration of microloans. This has a number of advantages over an MFI subsidiary including regulatory simplicity, and an absence of incompatible institutional cultures between the microfinance and conventional operations within a single bank group.

What is the relationship between migrant worker remittance flows and microfinance?

The families making and receiving remittances are best thought of as transnational. Their needs for financial services are transnational as well as local, at both ends. The opportunity for both banks and MFIs to use the servicing of remittance flows as a platform to add new customer groups has been recognised. The opportunity is sometimes described as an integration of the remittance and microfinance business segments.

Remittance flows from emigrants' earnings in developed countries back to their families are now a very large component of international flows, and exceed amounts both of foreign direct investment

⁸ Founded as a development finance institution in 1955, with joint funding from the World Bank and the Indian Government, the bank was set up in 1994, and privatisation took place in 1999-2000.

⁹ Source: The Economist (2005) 'The Hidden Wealth of the Poor' Supplement Microfinance Survey, 3 November.

and multilateral aid flows. Estimates of total remittance flows range widely, from \$125 billion to \$225 billion for 2003, partly because there are no standard definitions. Specialised money transfer companies and informal means such as family members carrying cash have been more important conduits for remittance flows than the banking system so far.

The leading recipient countries are India, Mexico and Pakistan, while the main source countries are the US and Saudi Arabia. A proportion of the remittance flow (estimated at 10–15 per cent) feeds into investment in education, housing or small businesses, rather than into immediate consumption.

Many of the senders, as well as recipients, of remittances do not have bank accounts. Only a minority of those that do, use them to handle remittances. Charges levied are high at both ends, particularly where cash is used several times in the transaction chain. Banks are increasingly recognising the size of the business opportunity to provide a cheaper and more useful service, and the added benefit of an entry route into microfinance through accounts offered to recipients. A constraint on bank penetration, apart from trust issues, is the desire for some emigrants and their families at home to remain invisible to the tax and other authorities.

Examples of the recent pro-active stance of some banks towards the remittance market include Bank of America, which announced in September 2005 that all its account holders would be able to send remittances to Mexico without charge; the money can be retrieved at other banks and payment agencies. HSBC in May 2005 announced a joint venture with Opportunity International that allows money to be sent to the Philippines via the internet and retrieved from local ATMs. In America, HSBC has just launched a scheme under which anyone with a minimum account balance of \$1,500, or willing to pay \$8 a month, can transmit money to HSBC's affiliates abroad without charge. To start with, this may not be profitable for the bank, but HSBC believes that much of the money could be channelled into savings accounts from which other services might follow.¹⁰

Another linkage between remittances and microfinance is through recipient borrowing capacity. In Ecuador, the privately owned Banco Solidario, a social-mission bank, concentrating on microenterprise and the self-employed, is providing automatic local credit approval to families with members who have immigrated to Spain.

Are there examples of new for-profit international microfinance banks?

Starting new for-profit MFIs from scratch may be easier and more effective than converting not-for-profits into commercial operations. This is supported by the example (the only one so far) of Procredit, a multinational microfinance bank with 7,500 employees, \$2 billion in assets, and an investment grade rating, allowing it to raise money in the German bond market. Founded as recently as 1996, backed by investment from the International Finance Corporation (IFC), the commercial arm of the World Bank, Procredit has set up banks in 15 countries and taken over banks in 4 others. Its founder had previously worked for various development agencies on conversions of NGO based MFIs to financial institutions, which in many cases required overcoming great institutional and cultural obstacles to change. Procredit is working in the Congo, showing that banking is a commercial opportunity in what most would say is very difficult territory indeed. It does, however, accept subsidies from development agencies in new territories for the first two or three years of operation.

How are international commercial banks changing their view of microfinance?

Among international commercial banks the provision of financial services to the poor is moving gradually from a traditional Corporate Social Responsibility (CSR) function to being part of the business model.

¹⁰ Source: Easton, T. (2005) 'The Hidden Wealth of the Poor', The Economist Supplement, November.

Citigroup is one of the leaders of this trend. In 2004 it appointed a senior executive, Robert Annibale, as its first global director of microfinance, responsible for commercial relationships with microfinance institutions, on a multi-business and multi-product basis, providing financing and product partnerships. He reports directly to the global head of consumer banking. He remains on the board of The Citigroup Foundation, which has been active in providing soft investment monies for microfinance.

Citigroup has already established relationships with MFIs in 20 countries and expects this number to grow quickly to 30. It is, for example, providing life insurance policies through its Mexican subsidiary, Banamex, which are sold by MFIs to their customers. It has made a strong entry into the emigrant remittance market, which is correctly seen as intrinsically linked to microfinance (see above). For its wealthy clients, it has created guarantee funds that allow them to put up collateral in America for credit extended in poor countries. Annibale's public profile is quite high, and other banks are clearly watching Citibank's lead.

Citigroup has also applied its investment banking power to microfinance. It led the financing in August 2004 of a \$44m 5-year bond issue for Compartamos, the leading MFI in Mexico, and indeed the largest in Latin America, with some 300,000 borrowers, mainly rural women. The bond was supported by a partial IFC guarantee, thus achieving investment grade rating in Mexico, and attracting domestic investors such as mutual and pension funds. The extra capital will allow Compartamos to approximately double its portfolio.

Are there links between western capital markets and microfinance?

Deutsche Bank is applying its expertise in structured bond finance in a project designed to change the perception of capital market bond investors about the risks and returns in microfinance. Its Commercial Microfinance Facility capitalised at \$50 million will invest in microfinance in Africa, South Asia and Latin America, through flexible lending to local commercial banks working with MFIs. The lending will include many different risk-sharing instruments including subordinated debt and guarantees.

The thinking behind it is that only if pro-poor financial products can demonstrate that they can achieve attractive and secure returns for investors will they be able to harness the enormous resources of the capital markets and thus operate on a sufficient scale to penetrate the huge numbers of 'unbanked' poor.

This commercial project was launched in June 2004, and follows on from the Microcredit Development facility, a much smaller \$2.65 million non-profit fund, which attracted largely philanthropic investors not seeking a return. The new facility has a structure that does provide investors with a high degree of loss protection, but the plan is that the follow-on bond issues will be able to reduce this in the light of experience.

Another capital market link to microfinance is through Socially Responsible Investment (SRI) indices and sustainability ratings. Some SRI indices and rating processes for publicly quoted companies are beginning to include the provision of pro-poor products, which for financial institutions frequently include microfinance, because a criterion for judging the company can be included in the SRI category or given a high sustainability rating.

2. How can the finance sector respond to Oxfam's vision for the anti-poverty role of the private sector in general?

Oxfam's preferred vision¹¹ is that the private sector (on all scales of business operation) will no longer be part of the problem ('do no harm' principle) but instead will be part of the solution. It is looking to encourage proactive corporate social leadership rather than reactive risk avoidance policy.

Global financial houses are generally better than domestic at the sustainability agenda, according to one ratings agency spokesperson¹². This is presumably because (a) they have more reputational risk in sensitive western markets from their operations everywhere, (b) they have joined international public commitments such as the Finance Initiative of UNEP,¹³ and (c) they have more advanced ideas about long-term shareholder value being linked to the sustainability agenda.

There is more work to be done, however, by pro-poor advocates in demonstrating the positive value of sustainability for investor appraisal of financial houses. Three aspects of a sustainable business approach need to be linked. These are first: appropriate marketing, directly or indirectly through intermediaries, of pro-poor financial products and services; secondly: the adoption of the sustainability agenda...considered as enabling economic development (not just quantitative 'growth') to take place with less environmental and social damage; and thirdly, the desired result, 'quality' earnings from stable long-term sources with steady growth, which investors value.

A second aspect of the private sector context is pro-poor consumer marketing by banks in developed countries. The market for retail financial services (banking, credit cards, insurance, savings) in the North is huge and competitive. Socially responsible suppliers are making headway (e.g. Triodos, Co-operative Bank, Shore Bank, Charity linked credit cards) but are still a miniscule element in the market. Mainstream banks, in the UK at least, with big brands, have not so far used a pro-poor stance as part of their retail marketing, except for one-off sponsorship campaigns.

There is the possibility of offering a service loosely analogous to British Airways' climate-change premium, which allows flyers to opt to achieve carbon neutrality on an air-ticket, or to electricity companies that allow green-renewable electricity to be 'bought' by customers paying a premium price. Global banks could allow their customers in the North to opt in, by paying premium charges, or by donating interest (as in Novib's arrangement with the ASN Bank in the Netherlands, where interest is received directly by Novib) to a range of pro-poor activities, which they could deliver directly to communities in the South. Banks would probably choose to match or partially match the donations. The pro-poor activities should be separated from the bank's commercial operations because introducing forms of subsidy for products and services will distort and confuse the local market. But helping to fund schools or hospitals from the contributions of better-off and far-away customers of a locally operating bank could be an attractive marketing proposition at both ends.

3. What is the future for microfinance as an anti-poverty tool?

How should microfinance itself be viewed by pro-poor advocates? This question is sometimes reduced to a stark choice: will development of microfinance be advanced most effectively by significant increases in donor funding or by a massive commercialisation of the industry? If this were a real choice, then Oxfam would need to develop a view. But the answer appears to be that both are necessary and those different parts of the market for microfinance services require different solutions. The key is that the two approaches should complement rather than undermine each other.

¹¹ See de Laaf, F. internal Novib note on the finance sector, quoting OI's mission policy and Novib's CSR project

¹² Ambrose, B. (2005) 'Banks must change tactics as CSR goalposts shift' *The Banker*, 7 March.

¹³ The Finance Initiative of the United Nations Environment Programme has developed from its origins in 1991, with 5 commercial banks, to encompass banking, insurance and other financial service companies, and now has 230 signatories. Its strap line is 'innovative financing for sustainability'.

Social-mission finance for the 'poorest of the poor', as supplied traditionally on soft terms by donor programmes does seem to have a diminishing role. The received wisdom that MFIs working in this market segment cannot be fully self-sustaining is being challenged by experience¹⁴. Certainly subsidies to final customers resulting in distorted or two-tier markets should be avoided. Even permanently supporting the operational costs of MFIs risks damaging the prospects of competing self-sustaining MFIs becoming established in the same region. Instead, donor funding should be channelled to the equity of commercially run MFIs, to backing guarantees extended to commercial banks lending to MFIs, and to the further build up of microfinance infrastructure, such as regulatory arrangements, information collection, professional education and training, and ratings systems.

CGAP avoids the term 'poorest of the poor' and instead classifies microfinance clients into four groups: vulnerable non-poor, moderate poor, extreme poor and destitute. Providing financial services for the last of these is not usually feasible even for donor-supported MFIs, though there are exceptional programmes that appear to succeed.

(SKS) (Swayam Krishi Sangam) Microfinance is a village banking operation in the Telangana region of Andhra Pradesh, one of the poorest regions of India. It is based on women's solidarity groups, and begins with compulsory savings products, but also provides non-subsidised microcredit (see Appendix for a fuller description). SKS is donor-supported but includes commercial banks as sources of loanable funds.

A different approach to the destitute is represented by Grameen Bank's interest-free microcredit system for urban beggars, called the Struggling Members programme. Two years from its introduction, 50,000 people are using it. It is designed not only to empower people on the margins of society economically but also to boost their morale and dignity. Grameen provides identity badges with its logo showing it is supporting the borrowers. Typical loan sizes are \$9 with a flexible repayment schedule. Unlike other Grameen Bank borrowers, struggling members do not have to join a solidarity group. The loans, which include credit lines with local shops allowing items to be bought for resale, have to be repaid from non-begging activities.

Yet another approach is BRAC's Income Generation for Vulnerable Group Development (IGVGD), also in Bangladesh. Here grants are used to jump-start microfinance, by making a strategic link between food-aid on the one hand and training, savings and credit, on the other.

On the whole, therefore, it seems preferable to take microfinance, as a mainstream activity, away from its traditional social-mission context in order to encourage the entry of large-scale commercial capital and 'healthy' competition. This should first increase access and then bring down the cost of finance for the poor. Oxfam may need to take a stance in this debate, which affects the private sector context.

A second question, which may present a more genuine choice, is whether microfinance should continue on its current path of institutional development. The goal of most MFIs is to become full-service banks serving their local markets with appropriate financial services much as developed country banks do. The microfinance infrastructure and policy framework is generally supportive of this aspiration. Other well-placed observers, however, have pointed out¹⁵ that this approach fails to treat poverty reduction holistically. Improved access to financial services cannot be effective in lifting people out of poverty without similarly improved access to health education and health services, and indeed to educational services in general. Raising income from \$0.50 to \$1.50 per day can be swiftly undone if basic knowledge about health topics such as child vaccination or HIV/Aids prevention is

¹⁴ The latest research as reported in the State of the Microcredit Summit Campaign Report 2005, gives details of financially sustainable institutions operating in the poorest sections of the population e.g. in Bangladesh. Three myths are identified and attacked: one —microfinance institutions cannot reach the poorest because they are too costly to identify and motivate; two—if an institution succeeds in reaching the very poor, it cannot become financially self-sufficient; three—an institution that somehow manages to reach the very poor and become financially self-sufficient will only be adding a debt burden to those families.

¹⁵ See Daley-Harris, S. editor, (2006) State of the Microcredit Summit Campaign Report 2005, pages 11-13.

unavailable. The debate is whether microfinance should be sometimes integrated with other services. Microfinance outlets can be situated in health clinics, and MFIs can be access points to health and education programmes. There are already examples, from Haiti and El Salvador, of successful developments of this kind. If MFIs merely succeed in becoming conventional banks, the original innovative, even revolutionary, pro-poor momentum behind the microfinance concept will be lost.

4. Microfinance as a catalyst for change in commercial banking

Model 1: Failing banks can be rescued by reorientation to microfinance, especially if there is a need to provide transaction volume to generate profits to cover costs of a branch network.

The foremost example is Bank Rakyat Indonesia (BRI). By the 1970s it had become a badly run state bank with an impossible mandate, making heavy losses. It was supposed to help farmers to increase rice production, but the government reserved the right to approve borrowers and required BRI to pay more for its deposits than it received for its loans. There was no incentive for the bank to collect deposits, and no follow-up of borrowers who did not repay their loans. None of BRI's 3,600 lending units made money.

Facing disaster, in 1983 the bank embarked on a complete reorganisation in which it reversed every policy. It increased its loan rates by half and shifted its target client group from the well connected to poor people without any ties to government or financial companies. It actively marketed deposits and abolished minimum limits on accounts. Success followed rapidly. The BRI formula has since been emulated around the world.¹⁶

BRI now has 32 million depositors and 3 million borrowers, operating in 4,000 locations including the remotest areas. It achieved a successful partial privatisation in November 2003, and is one of the most profitable banks in the country.

Model 2: Adoption by a global commercial bank of a for-profit sustainability approach including microfinance, as a follow-up to an initial defensive reaction to a reputational attack by an environmental NGO.

ABN Amro, ranked 17th in the world banking league and 10th in Europe, has adopted sustainable development (SD), encapsulated by its triple bottom-line phrase 'people, planet and profits' as a high profile part of its public corporate identity, and claims it is an integral part of its business model.¹⁷ Based in the Netherlands, it operates in 51 countries, and has Brazil and the US as its other two home markets.

The use of the phrase SD indicates a deeper commitment than one of CSR. The sustainability department has been integrated within the risk management function. The bank has integrated environmental, social and ethical issues into its standard credit risk evaluation.

The bank traces its SD commitment through a learning curve from loss avoidance to value creation over a number of years. The transition from innocence began in 1999 with public protests led by a local NGO, the Dutch branch of FOE. The NGO enrolled Dutch customers of the bank in a petition to ask management to exert its influence on the activities of Freeport, a US mining company operating in Indonesia, partially financed by the bank, and with a poor record on environmental and social impacts. This was something of a wake-up call and began a process of positive response that included early and continuing dialogue with NGOs, including FOE. Building from the case specific issue

¹⁶ Based on Easton, T. (2005) 'The Hidden Wealth of the Poor' *The Economist* Supplement, 3 November.

¹⁷ Sources: (a) Interview with The Banker by Madeleine Jacobs, Head of Group Sustainable Development, ABN Amro Bank, May 2005 (b) Jacobs, M. (2004) 'Managing SD for Competitive Advantage', paper presented at World Council on Business Sustainable Development October, 2004, (c) ABN Amro (2004), Sustainability Report.

through to developing internal standards and policies on specific sectors, such as forestry, mining, oil and gas, and defence, the bank took a leading position in developing the Equator Principles, launched by IFC in 2002. The Equator Principles are a framework (non-mandatory) for financial institutions to manage environmental and social issues in project financing. Some 39 leading banks worldwide have adopted them, so far. The process of further elaborating the principles of SD and diffusing them throughout strategic and operational approaches continues.

SD includes a commitment to developing banking services for the poor. Microfinance, along with Socially Responsible Investment (SRI) products and green bank financing is identified in the range of 'sustainable products'.

ABN Amro says, 'the cooperation with NGOs has steepened our learning curve and has offered us new insights in business development such as microcredits.'

The reasons for taking SD so seriously are given as, first: the duty of responsible conduct given the power of financial institutions in society and that stakeholders are demanding transparency and accountability; secondly: that the practice of SD goes to core competencies of the bank, such as trust, sharing the mind set of the client, managing financial and reputational risk, and staff engagement and satisfaction; and thirdly: that it creates a setting for product and market opportunities. Long-term shareholder value will be enhanced by its adoption.

Questioned about the downside of their approach, one answer was that it 'may result in turning down seemingly profitable deals in the short run. Explaining the "contradiction" between short-term potential gains and long-term value creation is clearly one of the challenges.'

It is hoped that the benefits in terms of institutional investor perceptions of transparency, sustainability and governance are reflected in the share price. Already the bank finds itself at the top of the SRI indices.

The Head of SD admitted that the upside is at this stage intangible, though clearly positive, and that the downside of NOT adopting a SD approach is immense risk.

Model 3: Responding entrepreneurially to political pressure on the banking sector to develop minimum standard microfinance products.

The first noteworthy aspect of this model is that the impetus to develop financial services for the poor can sometimes come from domestic political actions. This was the case when Mzansi bank accounts [basic low-cost accounts designed to bring in previously unbanked people into the banking system] in South Africa were launched¹⁸. But banks reacted differently to pressure from above.

The Mzansi entry-level bank account was the first result of the Financial Sector Charter of October 2003. The Charter was an initiative adopted by banks aimed at extending banking facilities to the poor, responding to pressure and broad-based discussions after the Financial Sector Summit of August 2002 held by the National Economic Development and Labour Council (NEDLAC). This has representatives from government, organised labour, organised business and organised community groups.

The second noteworthy aspect of the model is a reminder that true respect for the poor includes the recognition that they should be treated as a competitive market opportunity. The original proposal was to introduce a standard product across all banks. This drew strong opposition from the Minister of Finance, who thought it represented collusion and price-fixing. It also suggested a paternalistic rather than a commercial attitude to the market segment. The revised proposal made the prices, features and benefits previously specified into minimum standards for delivery of a Mzansi product.

¹⁸ This section is largely based on Tyobeka J. (2005) 'Reaching South Africa's Unbanked', *The Financial Regulator*, September.

Minimum standards include a ban on monthly administration fees, access to all banks' ATMs at same cost, and at least one free deposit per month. The banks would then be free to compete creatively to produce the best product.

The third aspect to note is how the revised proposal, moving the sector towards a pro-competitive approach, stimulated ABSA bank, subsequently taken over by Barclays, to rethink its Mzansi product. It decided, with the support of the CEO and group executive directors, to launch the product at a breakeven price, taking only variable costs (and not fixed costs) into account. This represented a departure from its standard pricing approach. The thinking behind it was strategic: the 'unbanked' population was seen as a new sub-segment for sustained profitability growth of the bank.

It was accepted that returns from the product might be slow in coming, could depend on some customers graduating up from entry-level and on the success of cross-selling other services. Free services on the Mzansi product that would normally be charged for included: failed ATM transactions due to insufficient funds, one free over the counter deposit plus four more free electronic deposits per month. Withdrawal fees were reduced to 55 per cent of the normal rate. ABSA's delivery and distribution has also been innovative, using mobile salespeople working with hand-held computer terminals that interface with its core systems. It has used a new smaller ATM, which breaks even on a lower transaction volume to penetrate rural areas, working in some cases with rural shopkeepers. Within six months of launch a cross-selling opportunity arose to sell modularised funeral policy plans to some Mzansi customers. ABSA has become the market leader in the previously 'unbanked' segment. Whether the product is profitable is not known as yet.

Other banks have also adopted innovative competitive and marketing approaches. One has a board game in financial literacy and banking for customers.

Another element driving the private sector in this situation is the public accountability 'stick' of the SA Banking Association's financial sector scorecard, which reports on the performance of individual banks against target numbers of Mzansi accounts and geographical reach. Brand reputations may suffer if performance is below expectations.

5. How can Oxfam take advantage of current trends in microfinance to move forward on the anti-poverty agenda?

In terms of the microfinance issue, the main trend is positive at the moment, if we agree that entry of domestic and international banks, as well as investors on capital markets, into banking for the poor, at unsubsidised prices, is to be supported.

Banks that have yet to join in the movement to engage in the development of pro-poor financial services are more susceptible now that the profitability of these activities is evident. There is already momentum within the sector given the position taken by some leading banks as reported on in this briefing paper.

However, additional leverage is possible given the widening and deepening of ethical consumerism. The commitment to have a direct engagement in financial services for the poor is potentially a clear criterion for choice of bank in developed countries. A refinement would be to include a fair trade version of this engagement, though work would need to be done to create a fair trade standard. It is not clear exactly how this would work, as lending and/or investment in microfinance are not directly analogous to trade in food or clothing.

An additional lever, possibly as important as the two above, is investor pressure, both conventional and SRI. The emerging evidence is that leading MFIs compare favourably with commercial banks in

terms of growth and return on assets in many difficult markets worldwide.¹⁹ In part this is because commercial banks are often subject to old-fashioned protectionist systems of regulation. Investors may well conclude that microfinance may be a better route for international banks to gain exposure in these markets than by investing in conventional commercial banks.

A harmful aspect of the trend would be the diminution of well-designed non-emergency grant programmes bringing the destitute within reach of financial services, or of savings services, on the spurious grounds that in all locations and circumstances everyone can be a microcredit borrower at market rates. This is emphatically not the case nor the view held by most microfinance professionals. The idea that microfinance, and in particular microcredit rather than savings services, is a poverty panacea has to be countered. What is needed is a nuanced position which avoids harmful subsidies on the one hand, while recognising on the other that it is crucial that clients have the capacity to repay loans on the terms offered, so that they benefit from credit and are not pushed into debt problems.

6. Critical issues and questions for the role and impact of the private sector

Will competitive forces keep the poor from being exploited by the new for-profit entrants into the finance market?

Better with more competition than without, so Oxfam should perhaps be encouraging more banks, small, large domestic and international to see the poor as a profitable market segment, in which innovative and energetic business approaches can win through.

This does not mean that co-operative and not-for-profits are excluded but the overriding need to increase the scale of service provision may argue for these to be run on commercial principles at least sufficient to attract outside lenders to boost loanable funds.

How can microfinance be further scaled-up by getting more commercial banks directly involved, in addition to partnering MFIs?

There are a number of different ways through which commercial banks can enter the microfinance market, particularly the microcredit market. Specialised microfinance NGOs have distilled their experience of what works well in different circumstances. Promoting further co-operation between commercial banks and these NGOs with many years of experience in microfinance, and exploring the full range of flexible alternatives, is a clear way forward.

Should Oxfam be arguing for more subsidised capital to be made available for microfinance?

The answer to this is yes, but only if capital is deployed in ways that encourage, rather than discourage, commercially driven capital to come into the sector. That means helping to set up new MFIs designed to be self-sustaining, supporting the regulatory, information and training infrastructure of microfinance, avoiding subsidising either interest rates, or the operational costs of MFIs apart from on a strictly temporary and exceptional basis.

Appendix

SKS Microfinance

A rapidly growing MFI is SKS Microfinance, (SKS stands for Swayam Krishi Sangam meaning agricultural self-help groups), a village (Grameen) bank replica oriented to women borrowers, using a lending system based on 5 person groups, with groups combined into collectives – *sangams* (40 people maximum) – for each village.

¹⁹ See for example Littlefield, E. and M. Holtmann (2005) 'Microfinanciers overtake their commercial peers', *The Banker*, 4 July.

It currently operates in one of the poorest parts of India, the Telangana region of Andhra Pradesh. The region is part of the drought-prone, semi-arid Deccan plateau. SKS selected the region for start-up activities because more than half its people live in abject poverty. It is plagued by high rates of hunger, illiteracy, disease and bonded labour, and the vast majority of poor are landless labourers or marginal farmers who draw their livelihood from subsistence agriculture. Their plight is worsened by frequent drought, severe deforestation, and soil erosion. SKS hopes to reach 300,000 families in the region by 2008. SKS began in 1998, with local and international donor finance and by September 2005, had 126,000 borrowers, and a portfolio of \$13 million.

Partners providing funds for on lending to borrowers include major domestic banks, such as ICICI, HDFC and UTI, and international banks such as ABN Amro and Citibank.

Long-term goals include expansion towards two more of India's poorest districts, in the neighbouring states, Maharashtra and Karnataka. SKS provides loans for income-generating activities in an attempt to break the vicious cycle of 'low income, low savings, low investment,' into an expanding system of 'low income, investment credit, more income, increased credit, and more income.' These loans carry a 15 per cent flat interest rate along with one per cent upfront fee and must be repaid in 50 weekly instalments. As well as the small compulsory savings system that is part of the lending mechanism, it has introduced voluntary savings products and is planning to market insurance services.

References

- Ambrose, B. 'Banks must change tactics as CSR goalposts shift', (2005) *The Banker*, 7 March.
- Donor Information Resource Center at Consultative Group to Assist the Poor (CGAP) (2003) 'Making Sense of Microcredit Interest Rates, Direct Training Module', April.
- de Laaf, F. (2005) 'internal Novib note on the finance sector'
- Helms, B. (2006) 'Access for All', CGAP
- Littlefield E. and M. Holtmann (2005) 'Microfinanciers overtake their commercial peers', *The Banker*, 4 July.
- Daley-Harris, S., editor. (2006) 'State of the Microcredit Summit Campaign Report 2005', Microcredit Summit Campaign.
- Prahalad, C.K.(2005) *The Fortune at the Bottom of the Pyramid: Eradicating Poverty Through Profits*, USA: Wharton School Publishing.
- Easton, T. (2005) 'The Hidden Wealth of the Poor', *The Economist*, Supplement: 3 November
- Tyobeka, J. (2005) 'Reaching South Africa's Unbanked' *The Financial Regulator*, September.

© Oxfam International June 2008

This paper was written by Alan Doran in March 2006. It is one of a series written to inform the development of the Oxfam International publication *From Poverty to Power: How Active Citizens and Effective States Can Change the World*, Oxfam International 2008.

Alan Doran works in the Private Sector Advocacy Team at Oxfam GB.

The paper may be used free of charge for the purposes of education and research, provided that the source is acknowledged in full. The copyright holder requests that all such use be registered with them for impact assessment purposes. For copying in other circumstances, or for re-use in other publications, or for translation or adaptation, permission must be secured. Email publish@oxfam.org.uk

For further information on the issues raised in this paper, please email enquiries@oxfam.org.uk