Chapter 5. Business Plan[1]

> A system of finance which might prove a commercial success would not necessarily prove an economic success, but the system which promises to be an economic success must be based on commercial principles.—William R. Gourlay, 1906[2]

> To properly appreciate the great achievements of the microcredit movement, one has to be more skeptical of its self-image than is normally considered polite or respectful.—Pankaj Jain and Mick Moore, 2003[3]

Most microfinance is supplied by macro-organizations. In 2007, six microfinance institutions (MFIs) had more than one million current borrowers: the big three of Bangladesh; fast-rising SKS and Spandana in India; and BRI in Indonesia. These six accounted for 45 percent of all microcredit borrowers worldwide in 2007, according to data from the Washington, DC–based Microfinance Information Exchange (MIX), and the 74 MFIs above 100,000 accounted for fully 79 percent. (MFIs voluntarily supply their data to the MIX. See Table 1.) To cut the data another way, the "average microcredit client" in the 2007 sample was served by an MFI with 2.5 million borrowers, a national market share of 26 percent, 11,200 employees, $800 million in assets, and operating profits at 15 percent of revenue.[4] And torrid growth has made 2007 a long time ago statistically speaking: at least two MFIs each in India and Mexico have since joined the million-borrower club.[5][update]

The operations that dominate microfinance today did not exist 30-odd years ago, and so must have arrived at their current position through rapid growth. Though many today take charitable grants or capital at lower prices than are available to conventional organizations of similar risk, the MFIs are large enough that subsidies are a modest fraction of overall costs. In other words, the providers of most microfinance are successful businesses. They have found ways to control costs, build volume, keep repayment

[1] This chapter is based on Roodman and Qureshi (2006).
[2] Gourlay (1906), 216–17.
[3] Jain and Moore (2003), 29.
[4] Author's calculations, based on MIX (2008). Non-profit MFIs reinvest any earnings in their operations or pass them back to funders.
[5] Web sites of Bandhan, Share Microfin, Compartamos, and Financiera Independencia, viewed December 19, 2008.

rates high, and prevent internal fraud, all while operating in countries with weak infrastructure and low education levels.

Table 1. Characteristics of microfinance institutions (MFIs) by size, 2007

	MFIs		Borrowers		Staff members/	Assets/ MFI	Profit (% of
MFI size	Number	Share of total	Number	Share of total	MFI	(million $)	revenue)
< 100 borrowers	21	3%	1,384	0.002%	6	0.5	−140%
100–1,000	99	12%	45,819	0.08%	15	2	+1%
1,000–10,000	311	37%	1,329,028	2.4%	52	6	−15%
10,000–100,000	326	39%	10,327,990	18%	260	33	+7%
100,000–1 million	68	8%	19,275,710	35%	1,558	223	+20%
> 1 million	6	1%	24,861,569	45%	20,310	1,497	+17%
All	831	100%	55,841,500	100%	402	45	+10%

The 91% of MFIs with fewer than 100,000 borrowers had 21% of clients and an average profit of 5% of revenue.

The 9% of MFIs above 100,000 borrowers had 79% of clients and average profit of 18%.

Note: Sample includes all MFIs that provided relevant data to the MIX and for which microfinance represents at least 90% of operations. The Vietnam Bank for Social Policies is excluded as atypically, substantially subsidized. Profit margins averaged accross MFIs weighting by number of borrowers.

Source: Author's calculations, based on MIX (2008).

The main task of this book is to impose an outsider's question on microfinance: What is its social bottom line? How much does it help poor people? But before tackling the question directly, it is useful to take microfinance organizations more on their own terms, to observe them the way Darwin did finches, looking for links between how they operate and whether they survive. Most MFI leaders, staffers, and investors no doubt care deeply about the ultimate impact on borrowers and communities. But viewing MFIs more crassly—as practical solutions to challenging business problems—turns out to give an interesting, back-door entry into the question of impact. If the common emphasis on credit over savings, for example, can be explained as a matter of business practicality, that should seed judicious doubt that credit is what the poor most *need*.

The business problem for MFIs can be described as finding ways to keeps costs near or below revenues—but that generalization is vacuous and needs unpacking. The real challenges include building a large customer base to exploit economies of scale, retaining those customers, keeping loan repayment

rates high, and complying with regulations.[6] This chapter highlights some ways that MFIs meet such challenges, emphasizing credit, the service the movement itself has emphasized. The big picture that emerges is of an interaction between human ingenuity, chance, and evolutionary dynamics. Microfinance leaders have found a suite of techniques in product design and management that meet the business challenges they face. Most of these were consciously designed. Others were stumbled upon. And in any particular case, most were copied from another MFI. Regardless, because the techniques work, organizations using them have moved to the forefront of the microfinance movement through a process of "natural" selection. Thus business imperatives strongly shape the microfinance that most clients experience.

The dominance of credit

We have seen in previous chapters that a stand-alone savings account can substitute for credit in many uses—one case save or borrow for a sewing machine—and that poor people often prefer to save out of a healthy fear of debt. Insurance would seem to be a superior substitute for credit and savings in many situations. Just before my first son was born, I insured my life for $500,000. I could not have saved that sum in time for his birth, to have ready should I die young; nor would I want my wife to compensate for the loss of my income by slowly descend into debt. Ideally then, every one should have opportunities to save and insure along with opportunities to borrow. Yet, with some important exceptions, the microfinance movement has emphasized credit. The Microcredit Summit Campaign is working "to ensure that 175 million of the world's poorest families, especially the women of those families, access credit for self-employment and other financial and business services."[7] Muhammad Yunus has called access to credit a human right.[8]

Why has the microfinance movement favored credit? Principally out of practicality. Appropriately, regulators erect fewer barriers to lending than to collecting deposits and insurance premiums. A small

[6] On scale economies, see Gonzalez (2007), 39, which finds them up to 2,000 customers per MFI, though not beyond.
[7] Daley-Harris (2007), 33.
[8] Yunus (2008).

NGO ought not, and in most places cannot, easily become a bank or insurance firm, entrusted with other people's money. And consumers generally view matters the same way, hesitating to save and insure with light-weight start-ups. In addition, for lenders, the regularity and uniformity of loan repayment schedules speeds transactions at weekly meetings, and may also increase total financial flow. Credit imposes discipline and routine, which encourages clients to repay more regularly than they might save.

A final factor in favor of credit programs is that they are more attractive objects of investment for many public and private donors. Ironically, the greater need of credit programs for outside capital may make it easier to attract it from government donors, who often feel incentives to disburse larger amounts with less staff time. With the same effort, a big donor could place $100 million in a lending program or $10 million in a savings program. Then there are the "optics" of credit: whether you are a member of parliament able to move millions or a rich-country citizen with $100 to spare, it is more appealing to lend to a baker in Afghanistan, as *New York Times* columnist Nicholas Kristof did through kiva.org, than to invest that money purely in the unglamorous training, equipment, and reserves needed to start a bank.[9] In a sense, credit makes the intermediating institution disappear in the minds of donors, so that clients alone fill the visual field. Overall, the path of least financial resistance for many microfinance institutions is to borrow in bulk to finance small loans. Malcolm Harper, the long-time chairman of the Indian MFI BASIX, has reflected that as a source of capital, "client savings are not cheap, in spite of the low interest rates we pay, because the mobilisation and transaction costs are high. It is much cheaper to take bulk loans from the national or global financial system. It is more profitable to put poor people into debt than it is to take care of their savings."[10]

Still, several microfinance leaders have broken against the dominance of credit over savings. BRI and Grameen both hold millions of voluntary savings accounts. These two are arguably exception-

[9] Kristof (2007).
[10] DevFinance online discussion group, August 20, 2009, http://ow.ly/ykLI.

al: BRI originated as a rare government financial program run on businesses principles, and Grameen obtained its banking license through personal connections with a dictator. But there is also reason to think that as more MFIs mature, more will win the confidence of regulators and clients to take savings too. Bolivia's BancoSol, a historical path-breaker in Latin America, saw savings accounts surpass loans in number in 2006.[11]

The business perspective also helps us understand why despite the evident value of insurance to poor people whose lives are full of uncertainty, microinsurance remains a fledgling thirty years after microcredit took off. An insurance policy can be thought of as a savings account with one change; while both entail repeated small pay-ins and an occasional large pay-out, an insurance pay-out occurs after some pre-specified but unlikely event such as a death. Thus insurance raises the same providential concerns for regulators as savings banks: regulators must assure that policy holders' money is being held responsibly. And it raises additional business challenges. For one, regulators also need to make sure that what insurers charge and what they promise are roughly in balance, so that the insurers neither grossly overcharge, accumulating large surpluses, nor undercharge, rendering them unable to compensate clients in moments of need.

Then there are the classic economic problems of insurance. One of these is "adverse selection," that the people who are most likely to need the insurance, yet hide this fact, are the ones most likely to buy it. In defense against the invisibly ill, for example, health insurers in the United States usually price individual policies exorbitantly. The standard solution to adverse selection is to deliver insurance through groups that are formed on the basis of criteria other those that are the basis for insurance. In selling group health policies to large companies, for example, American insurers charge less because they worry less that the employees as a group are more illness-prone than the general population. The other classic problem is "moral hazard": insurance insulates people from some consequences of their own ac-

[11] [Mix Market web site, viewed December 30, 2008.]

tions, which can make them reckless or wasteful. Why irrigate the fields if the insurer takes the hit for parched crops? Why not get that medically useless kidney ultrasound if it costs the patient nothing and profits the doctor? Co-payments (an example of "co-insurance") aim to minimize this problem by sharing costs between the insurer and the insured. Then there are problems of distrust, denial, misunderstanding, and administrative complexity. Distrust: Unless the insurer has a rock-solid reputation, potential customers may view *it* as a risk. Denial: In general, human beings try not to think too much about the bad things that could happen to them, or at least underestimate the risks, and so under-invest in insurance. Misunderstanding: Insurance can strike people new to it as strange. Why purchase a policy that probably won't pay out a penny in any given year when you could keep the money for yourself and save it for an overly rainy day? Poor people can be taught the logic of insurance—but perhaps at cost that is prohibitive relative to the small sums involved. Finally, administrative complexity. Whatever event triggers insurance payments must be cheap to observe. Checking that a drug was medically necessary and actually dispensed, or that rice paddy far from the nearest paved road really was flooded, can be expensive--worthwhile for a claim of $1,000 but perhaps not for one of $100. Small wonder then that only three percent of people in the 100 poorest countries have formal life, health, or property insurance.[12]

Facing this complex of challenges, those hoping to bring the great benefits of insurance to more people have worked along several lines of development. The first is that would-be insurers have looked to solidarity groups and village banks to serve as the analog of employers in the United States health insurance, as assemblages of people brought together to borrow and save—not adversely selected to run up insurance costs. Second, they have emphasized insurance against death and disability. As Daniel Defoe wrote in 1697, these conditions are easy to observe and hard to fake.[13] And they are relatively free of moral hazard, since no insurance policy covers the human costs of loss of life and limb.

[12] Roth, McCord, and Liber (2007).
[13] Defoe (1697).

These two considerations, along with the low additional cost of adding on the product, explain why credit life insurance—insurance packaged with a microloan—is the most common form of microinsurance to date. An alternative and intriguing basis for insurance as we saw in chapter 4 is regional rainfall, which can be observed more cheaply than individual farmers' fields.

A taxonomy of microcredit

We saw in chapter 4 that three types of microcredit have become globally popular: village banking, which is most akin to the old cooperatives; solidarity groups, which are more formally regimented; and individual lending, which is closest to traditional banking. The telling in chapter 4 emphasized the organic way in which these methodologies arose. But it is worth keeping in mind that many other methods were probably tried and found wanting, and so their stories are not told. That the three dominant methods have survived suggests that they are more than accidents of history, that an order underlies the historical happenstances.

And indeed one does. The microcredit methods that have been deployed large-scale can be seen as arrayed along a spectrum. At one end, loans are smaller, more costly to provide relative to loan size, and are only made practical by shifting certain burdens onto borrowers. At the other end, loans are larger, more expensive for the MFI to administer, yet cheaper as a percentage of the amount lent and more convenient for the customer. Within the world of micro-banking, as in banking in general, richer people, who transact in larger quantities, get higher-quality services while the poorest get the.opposite

We can discern this continuum in statistics on loan sizes and expenses of MFIs broken out by lending method. The first dollar-denominated column of Table 2, which is based on data from MFIs reporting to the *MicroBanking Bulletin* (*MBB*) for 2007, shows that village banking and solidarity group loans are much smaller than individual ones. A strict reading also says that village banks make somewhat larger loans than solidarity lenders. However, all but a core of dedicated poverty-focused solidarity

lenders have moved into the mixed individual-solidarity category (making individual loans too), so those in the "solidarity" category are unrepresentative. The typical loan size for solidarity lending is probably between those listed for solidarity lenders and mixed ones, and above that for village banking, as is the case in an analysis by Robert Cull, Asli Demirgüç-Kunt, and Jonathan Morduch of a smaller data set.[14] The next column of the table, in percentages of national GDP/capita, also suggests that village banking reaches at least as deep into the ranks of the poor.

And the table confirms that lenders' expenses go down with loan size, but not as fast, so that they go *up* relative to loan size. For example, individual lenders incurred $149 in costs per loan, which is the highest in the table—but the lowest relative to the much bigger loans they made. In general, such expenses can be divided into three categories. The first two vary little across lenders: financial (interest on money borrowed to fuel lending) and default (which appears in accounting through loan loss set-asides). The last, largest, and most variable is operating costs, which include everything from rent to wages. Village banking has the highest operating costs relative to the (small) amounts lent—the median (50th percentile) value among reporting MFIs being 18.9 percent of assets, a financial sum dominated by the value of outstanding loans. The figure for solidarity lenders is around 16 percent, and that for individual lenders is 11.2 percent. But the "operating expenses/loan" column in the table confirms that group lenders spend the least per loan. The final column shows that they achieve this economy in part by generating more loans per employee: some 250 each, compared to 176 for individual lending.

[14] Cull, Demirgüç-Kunt, and Morduch (2007), F115.

Table 2. Characteristics of microfinance institutions reporting to the *MicroBanking Bulletin*, end-2007 (medians)

Lender type	Number of MFIs in sample	Credit/borrower $	Credit/borrower % of GDP/capita	Expenses (% of assets) Financial	Loan loss	Operat-ing	Total[1]	Operating expenses/ loan ($)	Loans/ loan officer
Individual	277	1,444	62.5	6.9	1.5	11.2	21.5	149	176
Mixed individual-solidarity	440	423	38.5	6.4	1.4	15.6	24.5	108	220
Solidarity	79	132	16.1	7.1	1.3	16.6	26.6	23	260
Village Banking	94	186	15.8	6.9	1.4	18.9	27.4	61	278

Individual lenders make bigger loans, at higher cost per loan but lower cost per $ lent

Group lenders are opposite

[1]Previous columns do not sum to totals because median totals differ from total medians.
Note: "Assets" includes, and is typically dominated by, the outstanding loans to clients. Financial expenses include interest and fees in obtaining funds to on-lend. Loan loss provision is set-asides to cover costs of client defaults.
Source: MIX (2008).

Group lending methods achieve these high volumes in particular ways. Recall that in classic solidarity group lending, borrowers group together in sets of three to seven, most commonly five. Usually the pattern of disbursements and repayments is regimented. In the traditional Grameen model, payments begin immediately after disbursement, are due weekly, and are constant over the life of the loan (though interest payments at the end may be larger). Entry into the regimen is staggered within a group: first two borrowers take their loans and begin to repay, then two more, then the fifth. After a borrower pays off one loan, she becomes eligible for a larger one if all group members are in good standing. Typically, eight solidarity groups are federated into a larger unit that the Grameen Bank calls the "center," which gathers with the Grameen worker to transact all business.

Village banks bring together a dozen people or so, give them a single loan, then delegate authority to them for on-lending to individual members. Members elect officers to conduct the village bank's affairs. Usually, loan sizes are allowed to differ among individual members. But all loans generally carry the same repayment and interest rate terms, and borrowers are generally offered a loan ladder, a sequence of three to five loan cycles with a maximum amount for each cycle. For example, as of 2004, Mexico's Compartamos offered a three-step loan ladder for its village banking product, with the first

loan at most $150 and the third at most $1,400. Because village banks are larger than solidarity groups, village banking more frequently faces the tension of expanding spreads in loan size within the group, which can make a poor woman responsible for a richer peer's larger loans. To protect the poorest, most village banking MFIs try to keep the maximum-to-minimum-loan ratio below ten.[15]

A microcredit officer's daily labor—what generates most of those operating costs—consists in the abstract of a few tasks: *underwriting* (approving) new loans, *monitoring* use and repayment of borrowed funds, and *enforcing* repayment. MFIs lending to individuals handle these jobs directly. But group lending shifts much of the responsibility onto borrowers. Yoked together by joint liability, clients choose peers they deem reliable (helping with underwriting), keep close tabs on their activities (monitoring), and pressure them to keep up on debt service (enforcement). The delegation is most complete in village banking, since the MFI just makes a loan to the group. The delegation of responsibility makes group lending cheaper per loan, which advances the frontier of practicality in making smaller loans to poorer people.

The two dominant forms of group lending share a feature whose role in the efficient operation of MFIs is rarely explained: compulsory public meetings every one or two weeks. As the Grameen Bank gained fame in the late 1980s, economists, led by future Nobelist Joseph Stiglitz, latched onto the five-member solidarity group as a structure of theoretical interest. They modeled how joint liability solves "information problems" for the lender, that is, reducing the effort groups lenders make to know their clients.[16] The focus on the group of five misses the fact that the true locus of peer pressure in solidarity lending is the large meeting of several dozen participants, not unlike in village banks—so much so that social pressure, rather than formal joint liability, appears to be the real glue of group lending. The pressure does not bear down solely in the privacy of people's homes as they negotiate the formation and

[15] Westley (2004), 29–31.
[16] E.g., Stiglitz (1990) and Ghatak (1999).

conduct of their groups of five. Rather, its real application is glaringly public. “It is staff pressure that triggers peer pressure,” reports Imran Matin, who is now a Deputy Executive Director at BRAC.[17] A woman who shows up for a meeting unable to pay risks bringing shame on herself and her family—not to mention the ire of other women inconvenienced by this disruption of the meeting’s routines. The presiding MFI loan officer may hector her, delay new loans to her peers that day, or otherwise force the group to sit for extra hours until *someone* makes a side-deal to cover the unfortunate woman’s payment.[18]

Nor are village banks free of such pressures: Pro Mujer “does not end its village bank meetings until all loan delinquencies are cleared up,” wrote Glenn Westley of the Inter-American Development Bank in 2004. “Village bank members are expected to extend a loan to any member with a payment shortfall. Many program dropouts complain of these long meetings and of coming to hate meetings.”[19] Stuart Rutherford calls this pressure “meeting-day joint liability.” “The pressure falls especially strongly—and especially effectively—on members who are known to have cash, or the prospect of cash, that day. Thus, members due to get a loan disbursed that day, or members who have brought large [savings] deposits…often feel themselves morally obliged to lend short-term to members with repayment difficulties. This can cause resentment.”[20] The practice described earlier of staggering the loan cycles of clients within solidarity groups, assures that there is often someone close to getting a new loan.

The public nature of large-group meetings and the resulting play of honor and shame thus matter more for timely repayment than formal joint liability, a fact which rigorous research has confirmed. In an experiment run with the Green Bank of Caraga in the Philippines, economists Xavier Giné and Dean Karlan found that after borrowers in randomly chosen, ongoing solidarity groups were notified that joint

[17] Matin (1997b), 266.
[18] See Jain (1996), 83, and Matin (1997a), 456, on the Grameen case; Montgomery (1996), 296–97, on BRAC; Rutherford (2009), 135, on ASA.
[19] Westley (2004), 22.
[20] Rutherford (2004), 30. Also see Matin (1997a), 456–57.

liability had been dropped, repayment rates and other indicators of portfolio health showed no change in the following three years—except that centers without formal joint liability attracted more new clients.[21] The preeminence of meeting-based peer pressure explains why the globe-leading Bangladeshi microfinance giants have gradually dropped formal joint liability, but not public meetings. The Association for Social Advancement (ASA) officially switched to individual liability in 1995. Grameen Bank followed suit around 2001, going so far as to assert that it had *never* held members jointly liable.[22]

In sum, group lending is public banking for the poor, in contrast with private banking for the rich. The poor like the peer pressure of group lending no more than the rich would. As Malcolm Harper writes, accentuating the negative: "Group-based microfinance delivery systems are temporary low-quality expedients, like shared toilets, primary school classes of 60 children, or clinics without doctors. These are the best that can be provided at the present time for some people in some places, but they are recognized as fundamentally unsatisfactory."[23] The bottom line in the bargaining between lenders and borrowers over who does the tough work of underwriting, monitoring, and enforcing loans is that individual lending is unattractive for lenders at the low end of the income scale as too expensive, while group lending is unattractive to borrowers at the high end as too burdensome. As a result, village and solidarity banking serve the poorest while individual lending goes to the less poor. This pattern is of course universal in service businesses: the less you are willing or able to pay, the less you are catered to.

Additional adaptations

An evolutionary perspective helps explain not only the dominance of credit and the three-way typology within it. Like the fronds of a fern, the finer details of microfinance practice are also honed by selection. This section details examples, all of which shape the microfinance experience for poor people and thus connect to the question of how microfinance affects their lives. The business imperative can explain why

[21] Giné and Karlan (2008).
[22] Rutherford (2008), 21.
[23] Harper (2007a), 36.

group credit has focused on women, why microfinance has thrived in dense places such as the deltas of Bangladesh and the cities of Latin America while struggling in Africa, why the very poorest do not partake of microcredit, and why it is rarely used for farming. It might seem crass to impose this Darwinian perspective on an activity meant to help the poor—to suggest, for instance, that group credit favors women for the narrow commercial reason that it helps MFIs operate cheaply. But just as in natural selection, the processes that generate variation and prune it can be entirely separate. Those who have invented or copied the idea lending to women may have done so out of the most selfless of motives. But their approach would not have come to the fore if it did not make business sense.

Frequent transactions and short loan terms

Borrowers use microcredit for everything from weddings to school fees to business investment. Investment uses in particular range from substituting for high-interest supplier's credit, which can pay dividends in a single day—remember the stool-maker who inspired Muhammad Yunus (see chapter 1)—to buying calves that will not generate returns for months. Yet microloans almost always require frequent, regular payments that start immediately after disbursement. And they usually mature in six or twelve months. The ancient Athenian *eranos* groups appear to have required frequent payments, as did Jonathan Swift (see chapter 3).

Clearly the regular payments and short terms are pragmatic. Just as for 30-year home mortgages, allowing microcredit borrowers to defer too much repayment into the distant future would invite disaster. For group credit, meeting frequently also strengthens the social glue that helps assure repayment. (Peer pressure doesn't work if you rarely see your peers.)[24] But the demand for immediate repayment has profound consequences for who uses microcredit and how they use it. Two kinds of households can be relied upon to generate the demanded payment stream: those that intend to invest the loan in a high-

[24] Feigenberg, Field, and Pande (2009).

turnover business, which usually means high-volume retail; and those that already earn income from sources *other than* any investment project they intend to pursue with the new loan. Microcredit payment plans, however, are poorly matched to investments such as calves and crops whose returns may not come for months (and may be too low to cover the interest). Resourceful households can still put microcredit to such uses if they can tap steady, pre-existing income streams.[25] To this extent, though, microcredit lies beyond the reach of the poorest people, including many women without husbands.[26] In most households in the village researcher where Sanae Ito lived, men earned that steady income.[27] In fact, one of the most important investments the world's poorest people make is in the seeds, fertilizer, and labor needed to plant crops. So ill-suited is standard microcredit to crop-raising that the two generally do not intersect.[28]

Dynamic incentives

Almost all MFIs start small with new clients, lending less than the borrowers initially could use, observing their repayment, then rewarding promptness with larger loans, and so on in an expanding cycle. Group lenders in particular follow loan ladders that specify a maximum loan size for each loan cycle. This "progressive lending" creates what economists call "dynamic incentives" because what a client does today affects her options tomorrow. Lenders create dynamic incentives whenever they offer better loan terms down the road as a reward for on-time repayment today. They can be powerful. In an experiment in South Africa, Karlan and fellow economist Jonathan Zinman found that offering a borrower a lower interest rate on his next consumer loan had a huge impact on repayment of the current one.[29]

Progressive lending, like requiring frequent payments, is practical. By gingerly testing the waters with a new client, it winnows out risky customers before they can do much harm to an MFI's balance

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[25] Jain and Moore (2003), 15.
[26] Ito (1999), ch. 5.
[27] Ibid., 101.
[28] Harper (2007b).
[29] Karlan and Zinman (2008b).

sheet. But progressive lending also shapes the clients' experience of microcredit. For a borrower who is struggling to fully repay a loan, the last few weeks of the loan cycle, the period of the final installments, are the most stressful. Yet they are exactly when the new, larger loan looms close. This creates a powerful incentive for the borrower to go to a second lender—a family member, a peer borrower, another MFI, or a moneylender—for a bridge loan to be repaid as soon as the new, larger loan comes through from the primary MFI. Progressive lending can thus feed a cycle of debt, concealing, deferring, and exacerbating the ultimate confrontation with trouble. The risk is real; how often it strikes is unclear. Fortunately, the various other filtering mechanisms at work, such as frequent repayments and group liability, tend also to prevent repayment problems from spiraling out of control.

Forced savings

A common element in solidarity groups and village banking is compulsory or "forced" savings. Some forced savings are taken directly out of the loan amount before disbursal; as of 2003, for example, the Bolivian village banking MFI CRECER withheld 10–20 percent of a loan up front. FINCA Nicaraguan takes forced savings equal to 32 percent of the loan amount, but takes them incrementally, like loan payments, at successive group meetings.[30] Some MFIs allow clients to withdraw forced savings when they are done paying off the associated loan, others not till the client leaves the program altogether.

The practical effect of this rather odd combination of saving with borrowing is to accelerate loan repayment so that toward the end of a loan cycle, the MFI is actually in debt to its clients. It is yet another way that MFIs reduce the risk of costly defaults. Forced savings reduce MFI financial exposure should a village bank or a solidarity group center collapse. Throughout the 1990s, for example, Grameen members' savings at the Bank exceeded 40 percent of their borrowings from it.[31] And the threat of losing savings can deter default in the first place. Similarly, using forced savings to cover the missed pay-

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[30] Westley (2004), 49

[31] [Grameen Bank, "Historical Data Series in USD," grameen-info.org/index.php?option=com_content&task=view&id=177&Itemid=503, viewed September 24, 2008.]

ments of individual clients helps the MFI recover losses. And creating the possibility that one person's forced savings will cover another's missed payments amplifies meeting-day joint liability.

MFIs sometimes describe forced savings as a way to inculcate the habit of thrift. But the practical value, if not the motive, clearly has as much to do with constraining clients as it does with giving them access to more financial services. The habit and discipline of regular saving can also be taught by offering voluntary time deposit accounts (analogous to certificates of deposit), or commitment savings accounts (see chapter 2). These are far less common.

Credit life insurance

Some lenders require borrowers to buy credit life insurance, which covers their debt to the lender upon death. For instance, Grameen Koota, a solidarity group MFI in India, has members pay two percent of the loan amount in equal weekly installments into an "emergency fund" that is used to write off the outstanding loan balances if the borrower dies. The fund also pays 500 rupees ($11) to the family for funeral expenses if the deceased borrower had been with the MFI for less than one year, and twice that if longer.[32]

Credit insurance helps clients and MFIs both. It helps borrowers by reducing risk. In group settings, it protects members from having to choose between running after a deceased's grieving family or covering a loss themselves. For the MFIs, it lowers the risk from death of borrower. It also earns fee income at low administrative expense. In fact, Grameen Koota's two percent fee seems high when you consider that the break-even price of credit life insurance as a percentage of the loan balance, assuming no transaction costs, equals half the percentage of borrowers who can be expected to die during the loan repayment period. For example, if an MFI lends $100 each to 100 women and one (i.e., one percent) can be expected to die—on average, half-way though repayment—then the average loss would be about $50,

[32] M-CRIL (undated), 10.

or 0.5 percent of the $10,000 lent. A half-percent fee would cover insurance costs. Seen through this lens, the two percent fee on one-year loans implies an expected death rate of four percent per year, which seems unrealistically high—or is a hidden way to raise the effective interest rate.

Lending to women

The face of microfinance is usually a woman's. Some MFIs, like ProMujer in Peru and SKS in India, lend exclusively to women.[33] But while 99 percent of the borrowers of pure solidarity group lenders and 94 percent of those of village banks are female, going by medians from the 2007 *MBB* survey, only 50 percent of borrowers of the median individual lender are.[34] Why the gender gap between individual and group lenders? Perhaps group-oriented MFIs feel a stronger sense of mission to target women with their tiny loans. The oppression women suffer by virtue of their gender only compounds their economic poverty; and women are thought more likely to channel the support to their children. Meanwhile, the larger loans of individual lenders go more for enterprise investment than consumption smoothing, and men dominate in the sphere of commerce.

But however deserving and appropriate women may be for microcredit, this is not the only reason they have gotten more of it. We saw in Chapter 4 that men actually dominated in Grameen's earliest years. As Yunus and his team refined the methodology, they shifted toward women. BRAC, the giant Bangladeshi NGO, moved on the same path as it entered microcredit.[35] After 13 months of field work in Bangladesh, anthropologist Aminur Rahman of the University of Manitoba concluded that the immediate reason for the move toward women was practical. For cultural reasons, women were more sensitive to the reputations of their families, perhaps precisely because of their relative lack of power. As a result, in rural Bangladesh, they repaid more reliably. One loan officer explained to him that, "In the field it is hard to work with male members. They do not come to meetings, they are arrogant, they argue

[33] MIX web site, viewed December 24, 2008.
[34] MIX (2008).
[35] Goetz and Sen Gupta (1995), 46.

with the bank workers and sometimes even threaten and scare the bank workers." Women, he was told, are more vulnerable and submissive, and less mobile, thus easier to track down if they do not pay.[36] The very attractiveness of the public meetings for women otherwise barred from public fora may give MFIs leverage too.[37] One woman put it to Rahman this way:

> When a woman fails to make her instalment on time, she experiences humiliation through verbal aggression from fellow members and bank workers in the loan center. Such humiliation of women in a public place gives males in the household and in the lineage a bad reputation (*durnam*). In an extreme case peers may take the defaulter to the bank office. For a man, if he is locked inside the bank building for several days it would mean almost nothing to other people in the village. But if this happens to a woman then it will bring *durnam* to her household, lineage and village. People in other villages will also gossip about it.[38]

None of this means that microfinance does not help women. That women are repaying year after year hints that they use the money responsibly and productively. That women have been gathering week after week to conduct business in group meetings is changing norms about women's use of public space in many countries. (The next two chapters explore these themes in depth.) But MFIs' preference for working with and through women strongly suggests that they do so in part because it helps them solve a business problem. Stuart Rutherford, perhaps the keenest observer of microfinance in Bangladesh, calls the reliability of women "a stroke of great good fortune" since targeting women appealed to Western funders.[39] "It is not a philosophical thing; it is very practical," says Carlos Labarthe, co-CEO of Compartamos, 98 percent of whose clients are female.[40] And as pointed out earlier, thanks to evolutionary selection, the business logic can operate even when MFI managers see themselves as targeting women for their own benefit..

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[36] Rahman (1999a).
[37] Goetz and Sen Gupta (1996).
[38] Rahman (1999a), 70.
[39] Rutherford (2009), 102.
[40] Bruck (2006); [Mix Market website]

Streamlining for mass production

An unfortunate side-effect of the frequent transactions mentioned above is that by imposing on the time of clients, MFIs also impose on the time of their employees. To control the high administrative burden, it is imperative for MFIs to streamline the passing of many bits of money from hand to hand at each meeting. Microfinance, in other words, must be mass-produced.

One way to do economize on staff time is to limit field officer travel. In urban slums where it is possible to stroll by hundreds of homes in an hour, field workers can go door to door; *Safe*Save reports that its officers visit up to 200 clients a day in Dhaka, the dense capital of Bangladesh.[41] Field workers for individual lenders in urban Latin America also typically spend much of their time visiting clients where they live and work. But in somewhat less-dense areas, most MFIs have the clients come partway to the loan officers, through group meetings. Thus, in addition to making banking a public event, the meetings facilitate mass production. "The main purpose and function of the groups and centers was to [enable] routine repetition of identical behavior by all…members, week after week, 52 times a year, which made it a 'cultural habit' for each individual member to follow Bank norms," wrote Jain of Grameen operations in the 1990s.[42] A group field worker can bicycle into a village, process a large number of transactions, and move on. In Bangladesh, workers follow regimented schedules, typically visiting two to three centers each morning to run weekly meetings.

Another way to keep transaction processing efficient is to limit the diversity of product offerings. This is one reason loans tend to have inflexible and uniform repayment schedules, and why associated products such as forced savings and credit life insurance tend to be formulaic too. It also explains why MFIs have found it difficult to offer transaction accounts (like checking accounts) which give the client control over the timing and size of transactions.

[41] SafeSave web site, safesave.org/people-staff.htm.
[42] Jain (1996), 83.

Vikram Akula founded SKS Microfinance in India after several years observing self-help groups and the Grameen Bank. He sees his company's edge as being in transactional efficiency. SKS makes sure all loan payments are multiples of 5 rupees, the smallest bill, and accepts no coins.[43] Loan officers enter meetings with pre-printed, computer-generated lists of expected transactions. Transactions are quickly logged into a computer database. The uniformity in process makes it easier for managers to monitor the data in order to detect irregularities and send in "SWAT teams" to handle them. Irregularities can signify trouble or innovation on the ground that should be learned from.[44] SKS holds no monopoly on these practices; the efficiency of Bangladesh's ASA won it the top spot on the *Forbes* 50 list of MFIs in 2007.[45]

Branch staffing at efficient MFIs tends to be tight and uniform, with an organizational structure tailored to the context and the services delivered. In Indonesia, the typical BRI branch has 4–10 workers under, at the most, five job titles: unit manager, credit officer (responsible for loans), teller (occupied primarily with taking deposits), and bookkeeper (likewise), and sometimes a guard. These simple, standardized units facilitate growth. Typically, MFIs grow fastest through horizontal expansion—opening branches in new territory—rather than vertical expansion—increasing penetration in current territory. Standardizing roles and limiting overall functions allows branches to reproduce like cells, growing for a while by expanding local coverage, then splitting in two after territory and clientele reach a certain size. Each new unit can be staffed with a combination of veterans taking up their accustomed roles and new hires to whom they pass on their experience. The decision to split requires relatively little involvement from those further up the organizational hierarchy.[46] Such reproductive rapidity is at work in of India today. Horizontal growth fueled by venture capital helped Share Microfin [double] from 1.0 million to

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[43] Bellman (2006).
[44] Vikram Akula, Chief Executive Officer, SKS Microfinance, Hyderabad, India, interview with author and Uzma Qureshi, April 16, 2006.
[45] Swibel (2007).
[46] Rhyne and Rotblatt (1994), 31–35, 111–12.

[two million] clients in 2008, and its competitor SKS to expand from 1.6 million to [5.x] million. In short order, Indian MFIs will become the largest microcreditors in the world, measuring by number of clients.[47]

The drive to streamline limits what non-financial services can be bundled with microfinance (see chapter 4). Anything more than a modest dose of teaching in basic subjects such as handwashing or birth spacing will double the personnel cost—a new trainer to accompany each credit officer—or at least force the solo officer to spend more time with each group and visit fewer each day. This is why most MFIs that bundle health and education with finance, notably the affiliates of Pro Mujer and Freedom from Hunger, tightly delimit the topics their officers teach. Going beyond such limits requires additional, dedicated funding, such as BRAC receives.

Meeting the customer

Most people in rich countries relate to their banks impersonally. They pull cash out of ATM's, apply for credit cards online, mail checks to their power companies. Though there is much excitement about the potential for mobile phones to bring the same automated convenience to the poor, so far microfinance has happened mostly face to face, and for reasons that will not be easily overcome, at least for *credit*. In poor countries, workers are cheap compared to computers (and MFI's implicitly put little value on customers' time too). The primacy of public peer pressure in group lending and the need for onsite inspection of businesses in individual lending—in other words, the very informality that characterizes microfinance—make human interaction the substrate for finance.

From the lender's perspective, going to the customer helps build relationships, acquire information, speed transactions, and enforce compliance with loan terms. Given the lack of public documentation of assets and income, and general lack of credit histories, officers of individual lenders especially

[47] Figures based on fiscal years beginning April 1. [Get 3/31/09 figures from SKS and Share web sites.]

have to assess repayment capacity through indirect means: they can observe the lifestyles of clients, talk to neighbors about character and integrity, and visit business premises to ascertain repayment capacity. Even information regarding the drinking and gambling habits of clients can furnish clues about their default risk. Individual-loan officers of BANEX in Nicaragua drop by borrowing businesses unexpectedly at the end of the day to check if the cash in the register is consistent with the business revenue estimate submitted in the credit application. Knowing that the financial statements in loan applications never include the salary of the owner, they estimate the "shadow salary" by looking for evidence of the borrowers' household spending, be it the presence of a new motorcycle or the size of a home.[48] A loan officer demanding action on a late repayment in front of family, neighbors, or business associates, or publicly hauling out items pledged as collateral, is bound to exert social pressure on borrowers even in urban neighborhoods where social bonds are weaker than in tight village communities.

A major business challenge in doing microfinance, then, is bringing the banker and the banked together efficiently. Poor people cannot afford to travel long distances to meet their bankers. Public transportation can be expensive, as can missing a day of work. And the poor's lack of knowledge of the formal financial system can deter them from starting with microfinance in the first place. A loan officer who comes to the village or neighborhood and transacts in public reduces the transaction costs for the borrower even as he demonstrates to neighbors that financial services are within their reach too. Meeting the customer is cheap in cities and dense rural areas, but a serious challenge in sparse regions, as in much of Africa. This is one reason that microfinance has succeeded much more in populous Asian countries and the *favelas* of Latin America than in rural Africa. Microfinance's ecological niche tends to be restricted to where people live close together. And it is another reason that most of the developing world's farmers, who tend to be the poorest of the poor, are generally left out of microfinance. In India,

[48] Gabriel Solorzano, President, FINDESA (now BANEX), Nicaragua, interview with author and Uzma Qureshi, April 27, 2006.

according to the World Bank, where the government has worked hard to extend banking to the poor, 55 percent of smallholder farmers have a savings account and only 31 percent have a laon from a formal financial institution. "Access is even lower in Africa, where fewer than 1 percent of farmers in Zambia and 2 percent of the rural population in Nigeria have access to credit from formal institutions."[49]

Competition and change

It is recognized in rich industrial countries that an organization's capacity for change is essential to its success, even survival. The context in which organizations operate is constantly evolving, so organizations must change too. Thus while financial realities do constantly push MFIs to impose rigidly on their clients, especially on the poorest ones, MFIs are *not* simply converging to some static ideal of mass production. Mobile phones are often pointed to as a potentially disruptive technology in microfinance. In Kenya, the mobile phone company Safaricom has succeeded spectacularly in giving poor people a new way to transfer money long distance, and even save, by buying airtime now and using it much later.[50] To date, however, another force has kept most leading MFIs on their toes: competition. Faced with the need to retain clientele, MFIs have proved adept at studying their customers' needs and responding. Though making financial markets certainly can be to competitive and free, the textbook verity that competition can empower the consumer still holds much truth for microfinance.

One sign of the benefits is the tendency of interest rates to fall in competitive microcredit markets. Because most MFIs' profits are small relative to operating costs, or non-existent, their rates cannot fall for long without a constant search for ways to produce the same service more efficiently. A study of three countries by David Porteous of the consulting firm Bankable Frontier found that in two, rates charged by MFIs had fallen and were likely to do so more. Arguably the best indicator of pricing in the

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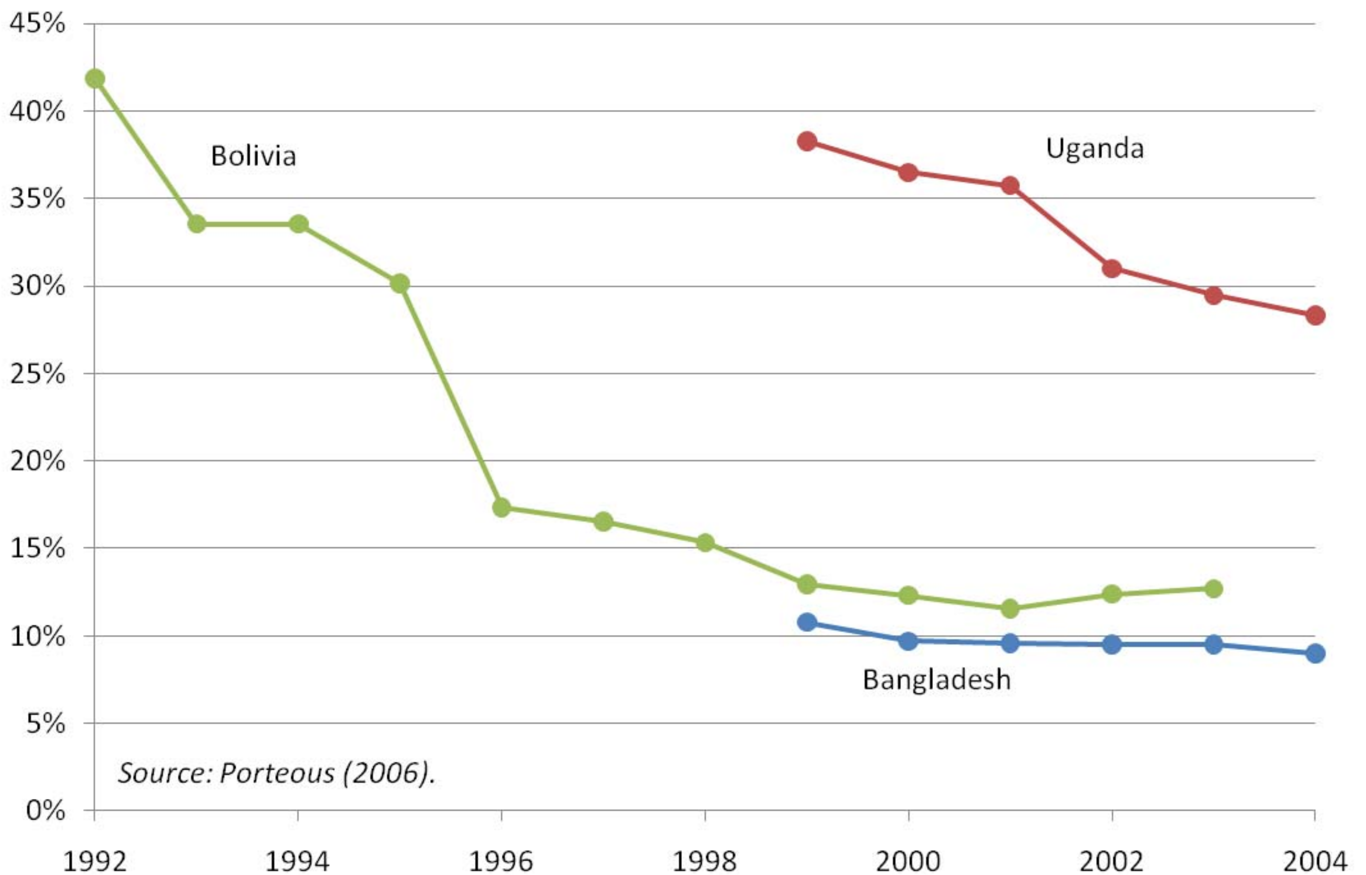
[49] World Bank, "World Bank Group Establishes Agriculture Finance Support Facility," press release, June 8, 2009, go.worldbank.org/IE6AUCO000. Another factor behind low outreach in Africa may be the high ratio between the wages of the relatively skilled people needed to work as microfinance as officers and the small loans that the continent's poor farmers can handle. See Roodman and Queshi (2006).

[50] Morawczynski and Pickens (2009).

study is the excess of the average MFI rate over standard commercial bank rates, since this removes fluctuations in the national interest rate environment. This difference fell ten percentage points in Uganda between 1999 and 2004, and 29 points in Bolivia between 1992 and 2003. (See Figure 1.)[51]

Figure 1. Difference between microcredit and commercial bank interest rates in three countries with competitive microcredit markets



Rates appear to have fallen slightly in Bangladesh too in 1999–2004—but not enough to firmly distinguish any drop from random noise in the data. With rates barely 10 points above standard commercial bank levels in 1999, the margin had less room to fall anyway.

A more direct examination of events reveals that competitive pressure has been alive in Bangladesh too in the early 2000's, animating major change at Grameen in particular. The Bank had started to

[51] Porteous (2006).

run aground in the late 1990s. Attendance at meetings was declining and defaults were rising. Many Grameen villages, it seems, had fallen into the what BRAC's Imran Matin called the "unzipped state" in which default spread contagiously as women asked, "Why should I repay if she did not?"[52] But a liberal definition of "overdue" muffled the loan losses in Grameen's published statistics.[53] Terrible floods in 1998 dealt a further blow to the finances of Grameen's clients and the bank itself (and provided a face-saving way to write off the bad loans). In November 2001, weeks before he was abducted by terrorists in Karachi, reporter Daniel Pearl exposed the troubles in the *Wall Street Journal*, which tarnished Grameen's international reputation.[54]

In fact, Grameen was by then well on its way to implementing a suite of reforms dubbed "Grameen II," which clearly responded to the disgruntlement of its members and would soon resuscitate the organization in extraordinary fashion.[55] In a letter to American friend, Yunus reflected that the difficulties were a blessing in disguise: "Our repayment problem was temporary but has been very educational. In a way I am happy that it hit us. That gave us the opportunity to build it in a way which makes it stronger than ever."[56] Under the new rules, joint liability was formally dropped, though the public meetings and the informal collective pressure for repayment remain.[57] Members were no longer required to borrow. Those who borrow are still required to save, but the savings go not into a group account but two personal accounts, one of which can be withdrawn from immediately. Loans can be "topped up" so that, for example, a woman who has repaid $50 of a $100 loan can borrow back that $50 instead of waiting until she has fully repaid the loan before getting capital back out of the Bank. A wider variety of savings products was offered, including a commitment-savings "Grameen Pension Scheme" that pays a substan-

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[52] Matin (1997a).
[53] Rutherford (2006), 4, 9.
[54] Pearl and Phillips (2001).
[55] Dowla and Barua (1996), ch. 3.
[56] Muhammad Yunus, letter to Sam Daley-Harris ("Friend"), August 21, 2001, bit.ly/bkciOh.
[57] Rutherford (2006), 17.

tial 12 percent interest per year. So far, Grameen's loan officers appear to be handling the complexity, thanks in part to computerization. And the Bank has boomed. "Grameen took 27 years to reach 2.5 million members," wrote Rutherford, the leading chronicler of the episode, "and then doubled that number in the three years following the full establishment of Grameen II."[58]

The success of Grameen II, like falling interest rates, offers hope that as the microfinance business matures in more countries and competition heats up, MFIs will remain dynamic. In particular, it suggests that more MFIs will soften the sharp edges of the financial products that they have honed in order to survive and grow in tough environments. But the Grameen II story only reinforces the thesis that economic expediency dominates in shaping the microfinance services that clients experience today. Grameen changed when it had to.

Conclusion

On reflection, this thesis explains a remarkable amount about how microfinance is usually done: the focus on credit over savings and insurance; the tendency to work with women; the exclusion of the poorest; the small, regular payments mismatched to agriculture; the public nature of meetings in group lending; and more. This observation leads to a grand question about microfinance: to what extent are its business imperatives and social mission consonant and to what extent are they in tension? On the one hand, charging enough to cover costs may shut out the poorest, foiling the charitable mission. On the other, if women are more reliable when it comes to repayment, they may also be more reliable when it comes to putting the credit to good use. The next three chapters confront the question head-on.

[58] Ibid.