

**Microfinance as Business**  
By David Roodman and Uzma Qureshi

**Abstract**

We analyze microfinance institutions (MFIs) as businesses, asking how some succeed in covering costs, earning returns, attracting capital, and scaling up. We draw on existing literature and interviews with industry players and academics. Key microfinance business challenges include building volume, keeping loan repayment rates high, retaining customers, and minimizing scope for fraud. Since the 1970s, microfinance innovators have developed clever solutions to these problems. Some have built huge organizations that serve thousands or millions of clients and have demonstrated an impressive capacity for change—in countries, to boot, with weak infrastructure and human capital. The individual innovations have spread both through a Darwinian process of selection and through cultural diffusion. We examine three kinds of determinants of commercial success: product design, management, and environmental factors such as regulation. We conclude that much about how microfinance is delivered can be understood as responses to business imperatives. Indeed, the discoveries of techniques for cost-effective microfinance delivery are the real genius of microfinance, rather than the “discovery” that the poor can repay that dominates its public image. But by Occam’s razor (simpler explanations are more plausible), the power of commercial imperatives to explain so many product design choices weakens an alternative explanation for them, namely that they are made primarily to help clients. These doubts point up the need for more rigorous impact evaluations of microfinance.

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## **Microfinance as Business<sup>1</sup>**

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## Executive Summary

In this paper, we analyze microfinance institutions (MFIs) as businesses, asking how some MFIs succeed in covering costs, earning returns, attracting capital, and scaling up. This is not to imply that commercial success is all that matters for microfinance, nor even that it should be pursued at all costs. The ultimate impact on borrowers and communities is what matters for MFI leaders and staffers, and for MFI investors, by which we mean all those who put money in, public or private, through grants, loans, or equity. But viewing MFIs as practical solutions to challenging business problems is a good place to start in understanding why microfinance operates in the ways it does, and what impact it is having.

Based on a survey of existing literature and interviews with key microfinance players—academics, MFI executives, industry analysts in MFI rating agencies, and investors (see Appendix)—we strive to uncover the major innovations in product design and management techniques that have allowed MFIs to offer financial products to a clientele that had been deemed too poor, too risky, and too costly for banks to serve.

Although the *capacity* of the poor to borrow and save may be counterintuitive, their *need* to do so is actually greater than for better-off people. Precisely because their incomes are tight, and often volatile, financial services that help them fill in mismatches between income and consumption needs can be a matter of survival. And though seemingly opposite, lending and savings are similar in helping households manage these mismatches. They can both help people accumulating capital for investment too.

In crass commercial terms, there is a market for microfinance. But to serve that market on a sustainable basis, and grow, MFIs must push costs below revenues—or at least bring them close so that the need for subsidy is manageable. That involves solving some tough business problems. Key microfinance business challenges include:

- Building volume.
- Keeping loan repayment rates high.
- Retaining customers.
- Minimizing scope for fraud.

Since the 1970s, MFI innovators have invented or discovered clever solutions to the microfinance business problem. Some have built huge organizations that serve millions of clients and have demonstrated an impressive capacity for change—in countries, to boot, with weak stocks of infrastructure and human capital. The individual innovations in product design and management have spread both through a Darwinian process of selection—the techniques that worked are found in the large MFIs because they help them become large—and through cultural diffusion as new or smaller MFIs imitated the most successful ones.

In surveying the diversity of microfinance today, the paper looks at three kinds of success factors:

- *Design of products*, such as group lending, individual lending, savings, and insurance. These are all financial services, but often referred to as products because in practice they are typically characterized by precise parameters (balance minimums, loan maximums, fees, etc.) and mass produced.
- *Management techniques* that build effective organizations to deliver these services on a large scale.
- *Environmental factors* that make some countries hospitable to microfinance and others not.

## Products

The term “microfinance” includes the provision of a wide range of financial services to the poor: savings, insurance, money transfers, and credit. The microfinance movement to date, however, has generally favored microcredit, so much of our analysis is devoted to that.

The dominant types of microcredit can be seen as arrayed along a spectrum. At one end, loans are smaller, relatively more costly to provide, and are made practical by shifting the job of client selection and monitoring onto borrowers themselves. At the other end, loans are larger, cheaper for the MFI to administer (relative to loan size), and less burdensome for the client. Village banking, in which borrowers help run the “bank,” represents the extreme small-loan end of the spectrum. It is relatively common in rural Latin America. A variant, called Self-Help Groups, has millions of clients in India. Solidarity group lending, in which self-selected groups jointly apply for loans and repay at regular, public group meetings, arguably sits somewhat closer to the center of the spectrum because MFI officers take more direct responsibility for transactions and pursuing delinquents. It is found most in Asia, though it has Latin American roots too. Individual micro-lending, dominant in urban Latin America and Eastern Europe, represents the other end of the spectrum, with larger more convenient loans to individuals without the requirements of group meetings and group liability.

Key features of product design include:

- *Emphasis on credit over voluntary savings.* Both credit and deposit-taking can help people manage mismatches between income and expenditure and assemble investment capital. But credit has practical advantages. Start-up MFIs are, rightly, barred from taking savings until they meet certain prudential criteria. In addition, credit more reliably compels people to make regular, uniform payments, which allows MFIs to build volume through “mass production.”
- *Progressive lending.* Almost all MFIs start small with new clients, offer bigger loans if the first ones are repaid, and so on. The “loan ladder” winnows out risky customers while the stakes are low and creates incentives for repayment.
- *(Group) lending to women.* A typical 89 percent of the borrowers from solidarity group lenders and 94 percent from village banking lenders are women, compared to just 54 percent for individual lenders. In the absence of collateral, group lending relies on the joint-liability of members to screen out bad credit risks and enforce repayment. Also, financial transactions are conducted in public view. Given the importance of reputation, honor, and shame in closed community groups, the peer pressure exerted during these public meetings constitutes an effective incentive to repay. In some cultures, if not most, women are more susceptible to this “shame factor” than men.
- *Frequent transactions and short loan terms.* Although microcredit was historically called “microenterprise credit,” typical loan terms are more incompatible with many investments. If a woman takes out a loan to buy and raise a calf, the calf will not start generating income a week later, when the first payment is due, nor fully pay for itself within the typical 6- or 12-month loan term. Given the speed at which fortunes can change for the poor, quick and steady repayment protects the MFI from the risk of default.
- *Charging high interest rates.* The once-intense debate over whether MFIs ought to charge high enough rates to cover costs, even if this is onerous or unaffordable for the poorest, has cooled somewhat as the icons of poverty focus, such as Grameen Bank, have reached operational self-sufficiency. Large MFIs, almost of necessity, aim to cover their costs. Although

raising rates could *reduce* revenue by repelling customers, one study suggests that within the range of observed variation it does not.

- *Limited product offerings and streamlined procedures.* Some fast-growing MFIs, such as SKS in India and ASA in Bangladesh, are noted for limiting product diversity and streamlining procedures for the sake of mass production.
- *Forced savings.* A common feature of group lending programs, forced or compulsory savings that are tied to current loans from the MFI, motivate timely repayment of loans and also reduce the MFI's financial exposure if default does occur.
- *Life insurance.* Increasingly offered or required in conjunction with loans, life insurance is a profitable product in its own right that also reduces risk for lenders.

In sum, the broad contours of the microfinance landscape—composed of individual and group lenders of various stripes—and the products they deliver are strongly shaped by financial imperatives.

## Management

The product choices outlined above are all fairly common; yet few MFIs can be called commercial success stories. In data from the years around 2000, the 1,813 smallest MFIs worldwide had 10 million loan accounts while the remaining 73 had 40 million. This lopsided distribution occurs in part because not all MFIs prioritize internally funded growth. In addition, commercial success requires effective management in order to grow rapidly and sustainably.

The report groups management approaches under these headings:

- *Hiring, training, firing.* Proper personnel practices help build an organizational culture that emphasizes breaking away from “business as usual.” In microfinance, that term can encompass the habits of conventional banking, the dominant culture in a “downscaling” commercial bank moving into microfinance, or a national commercial culture pervaded by corruption, self-dealing, and politically directed lending. Many MFIs hire young people as more idealistic and malleable, more easily inculcated with the organization's mission and culture. Successful MFIs also tend to hire from the same communities that the loan officers are to serve. Finally, willingness to fire is a clear sign of commitment to excellence through accountability.
- *Going to the customer.* Poor people cannot afford to travel long distances to meet their bankers—going by public transportation can be expensive and involve missing a day of work. To the extent practical, microfinance loan officers must go to the customer—bicycling among villages or walking through the slums. Going to the customer also helps loan officers gather information and apply pressure to control delinquency. However, it can become prohibitively expensive in sparsely populated areas; there, microfinance is weakest.
- *Standardizing branch structure.* Branch staffing at efficient MFIs tends to be tight and uniform. 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.
- *Leadership.* The drive for success—the vision, the mission, the modus operandi, the commitment to continuous improvement—must come from the top. For an independent MFI, this top-level commitment and leadership is usually provided by the founder; for microfinance subsidiaries of downscaling banks, there must be an operational champion, who runs the microfinance operation, understands all its facets, and has the stature and skill to advocate for the unit within the larger bank in the competition for capital and autonomy.

- *Monitoring and incentives.* The flipside of decentralization is close monitoring of overall performance of branches and development of incentives to reward good performance. The incentives should be crafted to reward loan officer productivity and portfolio quality and without penalizing branch-level teamwork.
- *Organizational capacity for learning.* Many successful MFIs work hard at creating employee- and customer-responsive organizations. MFI managers develop a culture and procedures that let them learn from staff. Managers at all levels spend time in the field. Regular staff meetings at branches become occasions for local managers to discuss problems and innovations, and similar meetings up the hierarchy facilitate knowledge transmission.

The picture that emerges is of the successful MFI as a decentralized organization. Retail units go to the customer and are the locus of production. They are where relationships with clients are made and maintained, where services are provided, where much learning should take place about the effectiveness of current approaches, where growth can occur through splitting of units. Excessive intervention in branch activities would slow and demoralize workers. Management—the center—picks and trains the right people; designs the products and the structure of local offices; gives them substantial operational autonomy for the sake of efficiency and morale; monitors their performance through strong management information systems (MIS); guides them by inculcating a culture of excellence and service and offering pay incentives; and seeks to learn continually from experience in the field.

### **Environment**

MFIs have not gained momentum in many developing countries with sizable populations. Only 10 countries had more than 3 microfinance accounts per 100 people circa 2000. Surely microfinance leaders such as Indonesia, Bolivia, and Bangladesh do not hold monopolies on microfinance know-how, talent, and initiative. Environmental factors such as government policies must also be at play. Indeed, in surveying the huge differences across countries it is hard to escape the conclusion that environmental factors explain more of the variation than anything else. Among the factors:

- *A history of directed, subsidized credit.* Competition from subsidized credit makes it hard for MFIs to charge cost-covering interest rates, and creates vested interests—subsidized state banks—opposed to new entrants.
- *Legal impediments,* such as rules preventing NGOs from lending, caps on interest rates, unfavorable tax policies, impediments to foreign investment, and red tape.
- *A “stable vacuum.”* Government policies to maintain macroeconomic stability are essential for microfinance; hyperinflation, for example, can destroy it. But many micro-level interventions can harm. In countries such as Turkey, what is not expressly allowed is, generally speaking, *de facto* prohibited. Such structures are anathema to early ventures in microfinance which typically go beyond the established regulatory framework. In contrast, Bangladesh after its war for independence and Bolivia after the economic crisis of 1985 were contexts where government was too weak or preoccupied to pay much attention to microfinance—and where microfinance sprouted and flourished.

### **Conclusions**

That microfinance today is the outcome of an evolutionary process means that nontraditional entrants, such as commercial banks, need to exercise care in adopting established models. Models that were optimal for non-banks may not be optimal for banks. In particular, to the extent that the

traditional emphasis on credit is an adaptive response to the difficulty that NGOs face in taking savings, rather than the demonstrably superior way to relieve the capital constraints of the poor and smooth their spending, banks should seriously explore savings. Savings can generate income, and do not impose the risk that comes with leverage. Notably, the Bank Rakyat Indonesia (BRI)—as a century-old bank, an anomaly within the microfinance world—had 32.3 million deposit accounts to 3 million loan accounts at end-2005.

This study also casts an interesting sidelight on the contribution of microfinance to development. Essentially all investors in microfinance are looking at a “double bottom line”—commercial success and what one might call *true* success, meaning social gain. But different investors may define true success differently. To the extent that true success is the enrichment of the institutional fabric in the financial sector, then the two kinds of success seem almost synonymous. The mere existence of BancoSol, Grameen, BRI, and other commercially successful MFIs is a kind of development in itself.

But many microfinance investors have a different notion of success: direct benefits for clients and their families. Unfortunately, rigorously derived evidence that microcredit helps people in this way is surprisingly thin. Despite the growing clientele and high repayment rates, it is not as clear as we would like that microfinance is directly improving lives. Many in the microfinance world recognize this reality, but it is nevertheless a contentious assertion. The observation of the present study, that commercial imperatives can explain so much about microfinance, lends the assertion credibility. For example, if the emphasis on women in group lending grows out of their greater susceptibility to peer pressure, then the burden of evidence rises for those arguing that it helps them too.

Thus perhaps the most important message is a reminder to microfinance investors and would-be investors about the importance of asking healthy questions about both bottom lines. Microfinance investors should develop good understandings of how MFIs succeed as businesses, how they contribute to development, and how the two kinds of success relate and differ.

## Introduction

Typical accounts of microfinance history tell us that in the early 1970s an imaginative experimenter—most often it is Muhammad Yunus in Bangladesh, but sometimes it is workers for Acción Internacional in Brazil or Opportunity International in Colombia—discovered that poor people can be trusted to repay small loans.<sup>2</sup> It was a striking find and it induced an enthusiastic faith in the power of microcredit to lift the poor out of poverty. Almost three decades later, the microfinance movement boasts numerous success stories—small, grass root organizations that have grown phenomenally in size while maintaining high rates of profitability. The Grameen Bank, for example, is today an organization with 1,700 branches, 16,000 employees, and 6 million customers, 96 percent of them women.<sup>3</sup> In Bolivia, the modern BancoSol, with 62,000 borrowers is a commercial offshoot of the non-profit PRODEM, which itself is descended from the world's first “solidarity group” lending experiments, by Acción. So far has BancoSol journeyed from its roots that today group lending accounts for less than 3 percent of its portfolio.<sup>4</sup>

The faith and hope in the poverty alleviation impact of microfinance has colored most accounts of the microfinance story. Yet, demonstrating the economic and social impact of microfinance has proven to be extremely difficult. In this paper we take a different approach. We try to get away from the rhetoric of microfinance by focusing on the business choices of successful microfinance institutions and analyzing them from a purely commercial perspective. This is not to imply that commercial success is all that matters for microfinance, for the ultimate impact on borrowers and communities matters greatly, not least to the public and private donors and investors that assist microfinance institutions (MFIs). Indeed, at the margin, MFIs can reasonably prioritize impact over financial self-sufficiency. In Bolivia, for example, ProMujer and Crecer bundle educational and health services with credit, and believe that dropping them for the sake of cost-cutting would undermine their mission to aid the poorest.<sup>5</sup> Rather, we believe that viewing MFIs as practical solutions to challenging business problems is a good place to start in understanding why they operate in the ways they do. As Pankaj Jain and Mick Moore write, “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.”<sup>6</sup>

Based on a survey of existing literature and interviews with key players in the microfinance sector—academics, MFI executives, industry analysts in MFI rating agencies and investors—we strive to uncover the major microfinance innovations that have allowed MFIs to successfully offer financial products to a clientele that had been deemed too poor, too risky and too costly to be served by banks in the past. In particular, we review the *products* that microfinance innovators have developed since the early 1970s to solve the business problem of delivering financial services, especially credit, at manageable cost to poor people. We go on to examine *management* techniques, from training to pay incentives, that they use to build and run effective organizations to deliver these services on a large scale. Finally, we investigate one of the tougher

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<sup>2</sup> [http://www.accion.org/about\\_our\\_history.asp](http://www.accion.org/about_our_history.asp); <http://en.wikipedia.org/wiki/Microcredit#History>

<sup>3</sup> <http://www.grameen-info.org/bank/index.html>; <http://www.grameen-info.org/bank/nineyearGB.htm>.

<sup>4</sup> Jonathan Morduch, Associate Professor, New York University, speech given at conference on Designing Better Microfinance, University of Michigan, Ann Arbor, MI, March 16, 2006.

<sup>5</sup> Elisabeth Rhyne, *Mainstreaming Microfinance: How Lending to the Poor Began, Grew, and Came of Age in Bolivia* (Bloomfield, CT: Kumarian Press, 2001), p. 100.

<sup>6</sup> Pankaj Jain and Mick Moore, “What Makes Microcredit Programmes Effective? Fashionable Fallacies and Workable Realities,” Working Paper 177, Institute of Development Studies, Sussex, England, 2003, p. 29.

puzzles in microfinance, the *environmental* factors that appear to make some countries good homes for microfinance and others inhospitable. Why does Bolivia have more microfinance than Brazil, Cambodia more than Vietnam, and Benin more than Nigeria?

Our purpose is to provide a conceptual survey of this vast topic, which we do with great humility about the actual diversity of microfinance experiences around the world. The big picture that emerges is of an interaction between human ingenuity and evolutionary dynamics. Microfinance leaders have found a suite of techniques in product design and management that solves the fundamental microfinance problems of controlling costs, building volume, and keeping repayment high, all while operating in a poor country. Most of these techniques they have consciously designed. Others they have stumbled upon, but because they work, their organizations moved to the forefront of the microfinance movement, through a process of “natural” selection. But so hostile is the environment in many countries that microfinance has so far flourished only in a few places.

## 1 Products

The term “microfinance” includes the provision of a wide range of financial services to the poor: savings, insurance, money transfers, and credit. The microfinance movement to date, however, has heavily favored microcredit, so much of our analysis will focus on innovations in loan product design and credit delivery systems. Throughout, our interest will be in how products are designed for what is usually called “financial sustainability.”

### 1.1 *The core product types*

Group lending products are the ones most commonly associated in the public’s mind with the microfinance revolution. They come in two major types.

#### 1.1.1 Group lending

In classic *solidarity group lending*, which both Acción and Grameen developed, borrowers are asked to form groups of three to seven members, most commonly five. Borrowers in a group are jointly and severally liable for all loans taken out, meaning they are each liable for the others’ loans and any one of them can be held fully responsible for an outstanding loan. Typically the pattern of disbursements and repayments is regimented. In the classic Grameen model, payments begin immediately after disbursement, are due weekly, and are constant over the life of the loan. Entry into the regimen is staggered within a group: first two women take their loans and begin to repay, then two more, and then the fifth. When a loan is repaid, the borrower becomes immediately eligible for a larger one as long as all group members are in good standing and approve the individual loan requests. In the classic model, eight solidarity groups are federated into a larger group called the “center,” which gathers each week with a loan officer to perform all financial transactions.

The other major type of group lending is *village banking*, and was developed in 1984 in Bolivia by John Hatch, who went on to found FINCA International. Village banks bring together 15 to 30 people, give them a single loan, then delegate authority to them for on-lending to individual members. This delegation distinguishes village banking from most other forms of microfinance. Members elect the office holders of the village bank, who assume responsibility for conducting its affairs. Usually, loan sizes are allowed to differ among individual members at any given time. But all loans carry the same repayment and interest rate terms, and borrowers are generally offered a loan ladder, a sequence of 3 to 5 loan cycles with a maximum loan size speci-

fied for each cycle. For example, Compartamos, a profitable and fast-growing microfinance institution in Mexico, offers a three-step loan ladder for its village banking product: the first loan cannot be greater than \$150 and the third loan cannot be greater than \$1400.<sup>7</sup> Village bank members act as co-guarantors and help decide how much each person borrows. Because the groups are larger than solidarity groups, village banking more frequently faces the problems that arise when there are large spreads in loan size within the jointly liable group, which can expose the poorest members to inordinate risk. To protect them, most village banking MFIs try to maintain a 10:1 ratio of maximum loan to the minimum loan size within a group.<sup>8</sup>

Though distinct, the two dominant forms of group lending have much in common. Both have regular, compulsory public meetings, typically weekly, where loan repayments are made and savings collected. In both kinds of lending, it is not uncommon for the attending loan officer to refuse to end the meeting till all scheduled loan repayments have been made—by someone.

Economists have taken note of one traditional feature of both forms of group lending, that members of a group are liable for each others' loans. The theoretical literature has viewed joint liability as a major technological innovation that reduces problems arising from "informational asymmetries" between lender and borrower.<sup>9</sup> In both village banking and solidarity group lending, the members of the group decide who gets to be included in the group. Given their superior knowledge of the character and economic circumstances of friends and neighbors, group members can do better at screening out risky borrowers prior to the loan decision and monitoring loan use after approval and disbursement.

Though economists initially saw joint liability as the key innovation that kept repayment rates high, there were puzzling questions. If members knew that others in the group would make up their repayments if they defaulted, why didn't they free ride on others and default more often? This highlighted the peer pressure exercised in closed community groups, and the importance of reputation, honor, and shame. Honor is a matter not only of public reputation but is also a private concept: the popularity of death insurance offered by some MFIs demonstrates that people in some cultures think they have failed their worldly and religious duties if they leave debt for their heirs.

Case-studies have also revealed that, while requiring their clients to formally sign the joint-liability clause, MFIs usually do not enforce the clause when a group member does default. Instead, a common practice is to encourage other members of the solidarity group *center*—the larger or "secondary group" that is not party to the formal joint-liability clause—to make up the default amount. Jain and Moore write:

Secondary groups play a more specific role in facilitating loan repayment in the initial phase of some programs. When a member can neither meet loan repayment schedules nor source other money for this purpose, field workers encourage her to take a short-term, interest free and typically informal (but publicly known) loan from other member(s) of the secondary group (not especially the primary group) and agree to repay installments in parallel with the program loan....In the longer established MCPs, and secondary groups, willingness to provide such temporary loans has declined over time. In such cases, and especially within the Grameen Bank and BRAC pro-

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<sup>7</sup> Westley, Glenn D., 2004, "A tale of four village banking programs: Best practices in Latin America," Inter-American Development Bank, Washington, D.C., p. 29

<sup>8</sup> *Ibid.*, p. 31

<sup>9</sup> See, for example, Joseph Stiglitz, "Peer Monitoring and Credit Markets," *World Bank Economic Review* 4, no. 3 (September 1990), pp. 351–66, and Maitreesh Ghatak, "Group Lending, Local Information, and Peer Selection," *Journal of Development Economics* 60 (1999), pp. 27–50.

grams, potential defaulters are expected to find alternate loan sources outside of the secondary group, and prior to the weekly group meeting to avoid disrupting it.<sup>10</sup>

The above quote highlights the multiple sources of peer pressure being exerted on the defaulter. First, the defaulter is identified in front of the entire village center. Second, she is put in a position where she must publicly ask for help. Third, she becomes responsible for the community center meeting being prolonged and any unpleasantness that might ensue. Lengthy meetings have been cited as an important reason clients drop out from group lending programs, so when a loan officer does not allow the meeting to end unless all defaults have been covered, it must add to the social pressure being exerted on the defaulter.<sup>11</sup>

The public nature of group lending and the resulting play of honor and shame thus appear to be as crucial to ensuring timely repayment as formal co-guarantees by group members. Consider the rapid growth of the Association for Social Advancement (ASA) in Bangladesh, which does *group lending* with *individual liability*. ASA's success is likely a reason that Grameen Bank dropped joint liability as part of its reforms around 2001, dubbed "Grameen II," but retained the rest of the credit delivery system (group formation, center formation, regular meetings, etc.).<sup>12</sup> Even MFIs that do not employ either joint-liability clauses or regular group meetings for transaction purposes try to tap into this "shame factor" for delinquency control: XacBank in Mongolia posts names of clients and their installment repayment reports on the walls of its branches.<sup>13</sup> Peer pressure, it seems, is a broader concept than first assumed within a group liability context. It is not simply the pressure exerted by fellow group members who are afraid of losing access to future loans or having to cover loan delinquencies, it is pressure arising from public transactions in communities where individuals worry about reputations. And the discovery is not really new to microcredit; money lenders too have used public honor to motivate repayments. When interviewed, a woman street vendor who was a client of a group of money lenders called "the Bombays" in the Philippines "noted that the Bombays always picked the busiest hour of the day to collect so that there would always be witnesses to her embarrassment."<sup>14</sup>

Empirical research is isolating the various channels through which group lending reduces delinquencies. In an experiment run with the Green Bank of Caraga in the Philippines, Xavier Giné and Dean Karlan found that after borrowers in randomly chosen, ongoing solidarity groups were notified that joint liability had been dropped, repayment rates and other indicators of portfolio health showed no change in the following year—except that centers without joint liability attracted more new clients.<sup>15</sup> These results challenge the claim of the theoretical literature that formal joint-liability, as distinct from the more informal aspects of peer pressure, is important in reducing informational asymmetries by motivating group members to monitor loan usage and

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<sup>10</sup> Jain and Moore, *op. cit* note 6, p. 17

<sup>11</sup> Judith Painter and Barbara MckNelly, "Village Banking Dynamics Study: Evidence from Seven Programs," Small Enterprise Education and Promotion (SEEP) Network Research Paper, Washington D.C., 1999; Westley, *op. cit* note 7, p. 22: "Pro Mujer, in both its Bolivia and Mexico programs, does not end its village bank meetings until all loan delinquencies are cleared up. 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 instead of enjoying them."

<sup>12</sup> Stuart Rutherford, *Grameen II: The First Five Years, 2001–2005* (Dhaka: MicroSave, 2006).

<sup>13</sup> Cheryl Frankiewicz and Marc de Sousa-Shields, "XAC Bank: From the Liability Side of the Balance Sheet," *MicroBanking Bulletin*, August 2005.

<sup>14</sup> Masilungan, E. M. O., "Hometown Corporation (B): Expansion Plan," Asian Institute of Management, Makati City, the Philippines, case number AIM-5-05-0002-CS, p. 7

<sup>15</sup> Xavier Giné and Dean Karlan, "Group versus Individual Liability: A Field Experiment in the Philippines," draft, April 9, 2006.

repayment (moral hazard). It remains to be seen whether the role of formal joint liability is similarly small in the earlier, group formation stage, where self-selection appears to screen out bad risks (adverse selection). The experiments reported so far have been done only by switching *existing* borrowers, who already went through a joint-liability-bound group building process, from joint- to individual-liability.

In sum, it is becoming clear that group lending works in part by substituting the “shame factor” for conventional collateral (section 1.2.2 describes “forced savings” which also function as collateral for group lenders). And the preference shown for individual liability by the growth of ASA or by the results of the Green Bank’s experiment suggest the obvious: the poor like joint liability no more than the rich, will go for individual liability groups when they can, and accept joint liability only when they have no better option. Group lending is public banking for the poor, in contrast with private banking for the rich.

A relative of village banking is the *self-help group* (SHG) system that dominates microfinance in India. The system evolved from the efforts of NGOs to organize the rural poor, especially women, into groups for purposes of social and economic empowerment through group savings, education, and microenterprise support. NGOs train the group in saving, lending, and account-keeping, and then link up the group with a bank where the group can deposit its accumulated savings into a collective account. Based on these savings, the bank then grants a block loan to the group, typically four times as large as the savings balance<sup>16</sup>, for which members are jointly and severally liable. The group decides how, and on what terms, to distribute the loan to individual members. Self-help microfinance took off when the Indian government decided to support it through the National Bank for Agricultural Development (NABARD), which provides subsidized refinancing to banks for their lending to SHGs. Because several steps separate clients from NABARD, there are no national statistics on how many Indians participate in SHGs. In fiscal year 2004–05, 798,000 SHGs received bank loans, 539,000 for the first time, bringing the cumulative number of SHGs receiving loans to 1.618 million.<sup>17</sup> At a typical 17 women per group, that suggests that up to 27 million women have joined SHGs.<sup>18</sup> However, many of the SHGs may have gone defunct, and their members may have joined new groups, so this figure could be high by a factor of two or three.

The success to date of SHGs in India is attributable to a combination of factors specific to the country: 1) a proliferation of grass-root NGOs dedicated to the economic and social uplift of rural communities, 2) a vast network of public-sector rural banks, 3) the popular acceptance, even expectation, of state-subsidized poverty alleviation programs, and 4) a committed champion in the NABARD. However, some of these same factors pose potential challenges to a major scaling up of the Bank Linkage Program—which even at its current size reaches only a small fraction of Indians. The central problem is the misalignment of incentives. The state banks appear to be charging interest rates too low to cover their costs. A rate of 12% is typical, while studies suggest 15–28% is often needed to break even.<sup>19</sup> The willingness of state banks to take losses reflects institutional incentives that do not prioritize commercial viability; indeed, some politicians are pushing for rapid expansion of the program since it is popular. Meanwhile, since the

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<sup>16</sup> Priya Basu and Pradeep Srivastava, “Scaling-up Microfinance for India’s Rural Poor,” Policy Research Working Paper 3646, World Bank, Washington, DC, 2005.

<sup>17</sup> [http://www.nabard.org/roles/microfinance/files/publications/stmt05\\_02.pdf](http://www.nabard.org/roles/microfinance/files/publications/stmt05_02.pdf).

<sup>18</sup> Average of 17 from Malcolm Harper, “Grameen Bank Groups and Self-help Groups: What are the Differences?” 2002, p. 5., available at <http://www.alternative-finance.org.uk/rf/grameenbankgroups.rtf>.

<sup>19</sup> Basu and Srivastava, op. cit. note 16, p. 21.

job of the partner NGOs is to form groups, not run them on an ongoing basis, they do not face the same financial incentives as MFIs to maintain portfolio quality. In the worst case, the incentives they do face may reward them for colluding with borrowers against the lender for short-term gain. The professionalism and commitment to mission of the established NGOs that historically formed SHGs may have compensated for the perverse incentives. But as NABARD pushes for growth, the risk increases that new groups arise purely to form SHGs, and will not behave so well. The misaligned incentives for NGOs are why the private ICICI Bank, which has lent to 12,000 SHGs, is now moving to MFIs as a channel as it scales up in microfinance. It does not see the SHG model as sustainable.<sup>20</sup> Likewise, since SHGs do not seem to offer a model for commercial success, this paper will devote little space to them.

### 1.1.2 Individual lending

*Individual lending* is the other major type of microcredit methodology. As its name makes obvious, it is built around more conventional lending relationships with individual clients. But in contrast with traditional lending, individual microlending of course offers smaller loans, on the order of \$1,000, and relies less on traditional sources of security, such as marketable collateral, credit reports, and formal legal recourse. It also relies heavily on character assessment. Group lending puts the burden of this assessment on the group through the group self-selection mechanism; individual lending requires the loan officer to perform this screening through character and reputation checks. In dense urban areas, notably in Latin America, where social bonds may not be strong enough to support group lending, individual lending must tap into the borrower's social assets by forming a character sketch from interviews with friends, neighbors, and business associates. Gabriel Solorzano, President of Nicaragua's FINDESA, explains that his finance company extends not "asset-based credit" (ABC) but "integrity-based credit" (IBC).<sup>21</sup> Claus-Peter Zeitinger, founder of the German ProCredit juggernaut, which now operates in Eastern Europe, Latin America, and Africa, echoes Solorzano, calling his loans "information-based credit."

Those phrases accentuate the contrast with conventional lending. But from the standpoint of group lending, individual lending looks relatively conventional. Loan officers do assess clients' business operations with an eye on current earnings and potential earnings if the proposed investment is made. They do often accept or require physical collateral, mortgages, or even credit-scoring. Bank Rakyat Indonesia (BRI), one of the world's largest microlenders, only lends individually, and requires titles to land, buildings, motorcycles, or other property as collateral.<sup>22</sup> Given the low market value of most assets pledged, however, MFIs prefer to use such collateral to motivate timely repayment rather than to cover losses in the event of default. The incentive to repay is rooted in the high replacement cost of the pledged asset to the household and by the borrower's desire to avoid the social shame of having his or her household items seized in front of family and neighbors. Similarly, from the MFI perspective, the low market value of the asset affords little financial advantage and runs the risk of negative publicity from selling off household items of the destitute. As Solorzano puts it, FINDESA "doesn't want a used, rusty refrigerator.

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<sup>20</sup> Bindu Ananth, "Financing Micro Finance: The ICICI Bank Partnership Model," *Small Enterprise Development* 16 (No. 1, March 2005), pp. 57–65.

<sup>21</sup> Gabriel Salorzano, President, FINDESA, Nicaragua, Interview, April 27, 2006.

<sup>22</sup> Klaus Maurer, "Bank Rakyat Indonesia: Twenty Years of Large-Scale Microfinance," in Consultative Group to Assist the Poor (CGAP) and the World Bank, *Scaling Up Poverty Reduction: Case Studies in Microfinance* (Washington, DC: 2004), p. 96.

We lose two-thirds of the value when we seize collateral.”<sup>23</sup> It is only when lending to small or medium enterprises that loan sizes may be large enough for collateral to become valuable in the traditional sense.

### 1.1.3 A conceptual framework for microcredit methodologies

This bare-bones introduction to microcredit offerings does not convey their full complexity, variety, and dynamism, which will be described below in greater detail. Nor does it touch on other financial services, including savings, insurance, and transfers, that MFIs are increasingly offering. It suffices, however, to ground an important observation about the nature of the challenge for microfinance practitioners, and their response to the challenge. Specifically, the dominant microcredit products can be seen as arrayed along a spectrum. At one end of the spectrum, loans are smaller, relatively more costly to provide, and are only made practical by shifting burdens onto borrowers. At the other end, loans are larger, cheaper for the MFI to administer, and more convenient for the customer. They also go to the relatively better-off.

In general, lenders face three costs: financial (costs of capital), default (which appears in accounting through loan loss provisioning), and operational or transactional costs. The last two are more under the MFI's control, and the last is disproportionately high for small loans, thus dominating in microfinance. A \$1,000 loan does not cost ten times as much to administer as a \$100 loan. Thus the poorer the borrower, and the smaller the appropriate loan, the higher the cost per dollar lent. (See Figure 1.) To cut costs per loan and make small loans practical, lenders must eliminate what operating costs they can and shift much that remains onto borrowers. (See Figure 2.) Important subcomponents of the potentially transferable operating costs are for underwriting (loan approval), monitoring of use and repayment, and enforcement.<sup>24</sup> Borrowers in turn will only accept those costs to the extent that they need capital and have no better alternative. And it is the poorest who have the fewest alternatives. The less-poor, on the other hand, will opt for individual lending. (See Figure 3.)

Village banking takes cost-shifting the farthest, even if the delegation of responsibility in the model primarily is also a form of empowerment. Solidarity group lending puts somewhat fewer costs onto borrowers, since loan officers work directly with all clients and shoulder some responsibility for collection from borrowers having difficulties. It compensates by imposing more routine on the credit relationship, in order to speed transactions. Finally, individual microlenders absorb much more of the underwriting, monitoring, and enforcement costs themselves.

The bottom lines in the bargaining between lenders and borrowers are that individual lending is unattractive for lenders at the low end of the loan 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 more to the less poor. Among MFIs reporting to the *MicroBanking Bulletin (MBB)* for 2004, individual lenders gave larger loans. The small loans of the solidarity and individual lenders were cheaper to provide but still more expensive per dollar lent, illustrating the continuing cost pressure.

Table 1 has the numbers behind these charts. In viewing these figures, it should be born in mind that all but a core of dedicated poverty-focused solidarity lenders have moved into the mixed individual-solidarity category, and may not be representative of solidarity lending per se. For example, the true typical loan size for solidarity *lending* is probably between those shown in

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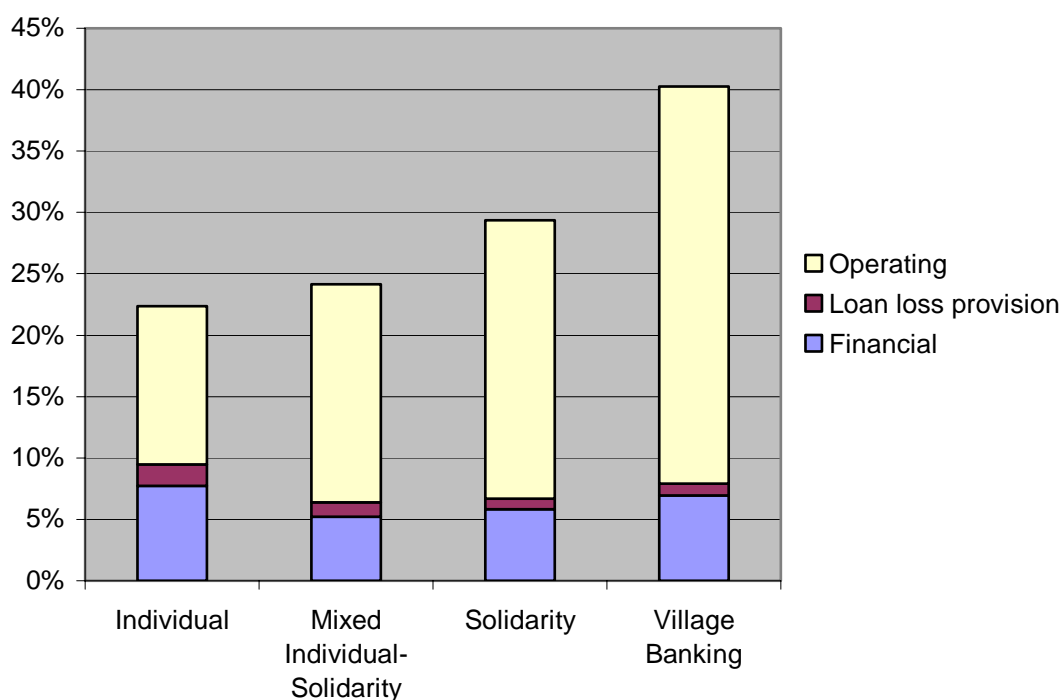
<sup>23</sup> Salorzano, op. cit. note 21.

<sup>24</sup> Gary Woller, President, Woller & Associates, interview, May 11, 2006.

Figure 3 for solidarity *lenders* and mixed ones, and above that for village banking, as is the case in a 1999–2002 sample reported by Robert Cull, Asli Demirguc-Kunt, and Jonathan Morduch.<sup>25</sup>

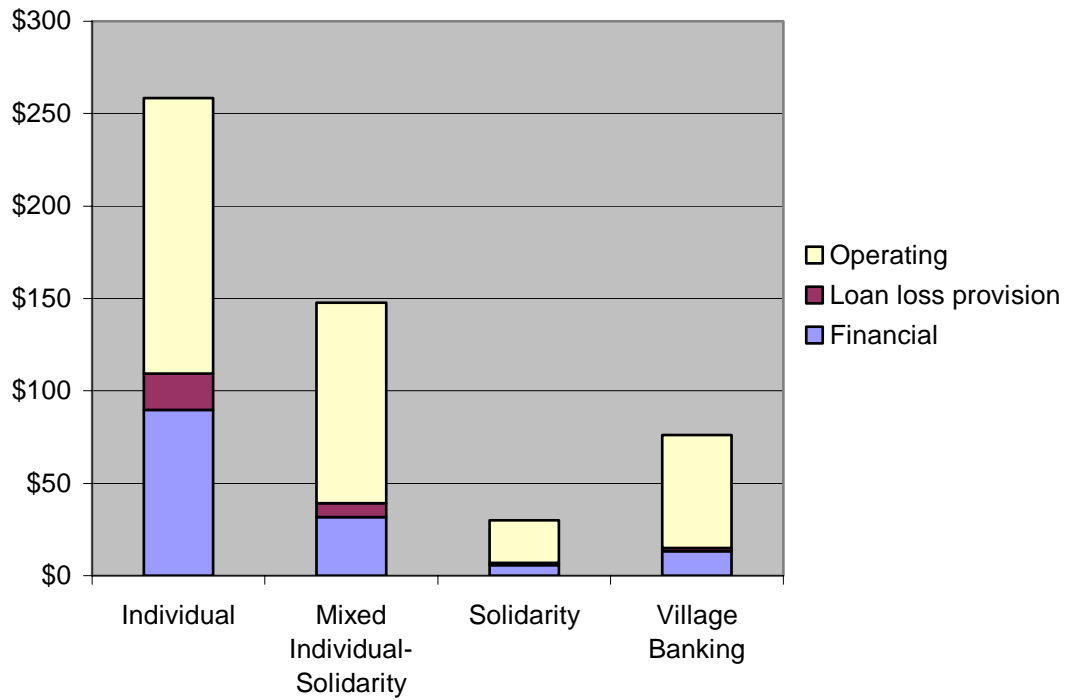
These data suggest that successful microfinance programs are designed not just to fight poverty. It is not simply the case that village banking, say, is more prevalent in rural Mexico than individual microcredit because village banking with its emphasis on empowerment and group formation, happens to do a better job of helping rural Mexicans. Rather, in a successful MFI, the choice of basic product type is an adaptive response to what could be called the business environment. Central to the adaptation is a choice about how much cost to shift onto clients.

**Figure 1. MFI expenses by lender type (median, % of assets), *MicroBanking Bulletin* survey, 2004**

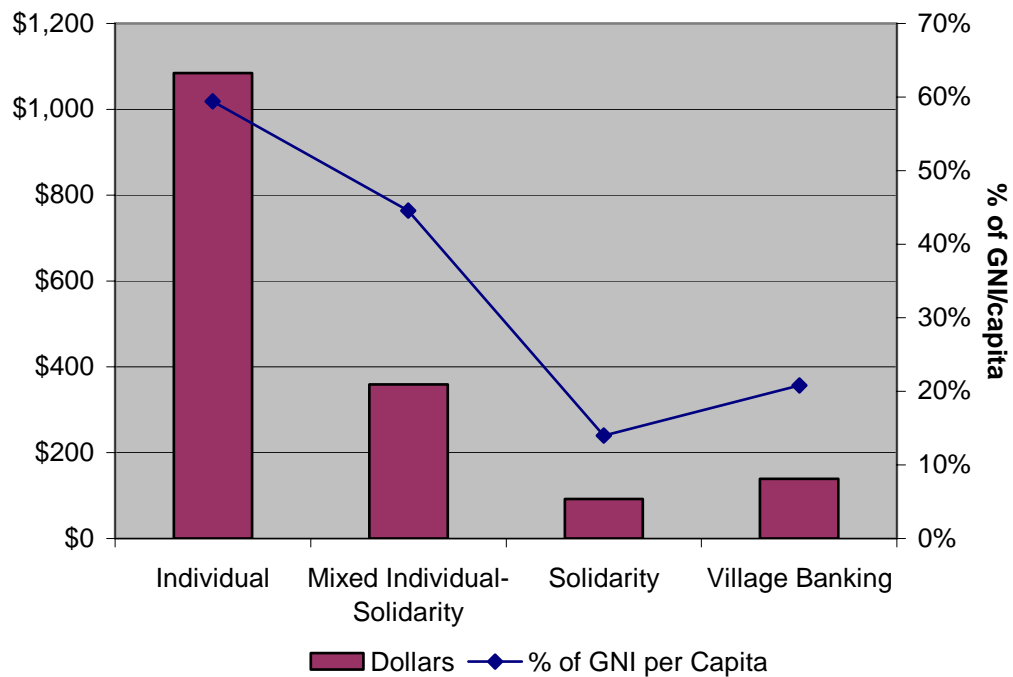


<sup>25</sup> Robert Cull, Asli Demirguc-Kunt, and Jonathan Morduch, "Financial Performance and Outreach: A Global Analysis of Leading Microbanks," Policy Research Working Paper 3827, World Bank, Washington, DC, February 2006.

**Figure 2. MFI expenses by lender type (median, \$ per loan), *MicroBanking Bulletin* survey, 2004**



**Figure 3. Loan sizes in dollars and fraction of GNI/capita by lender type (median), *MicroBanking Bulletin* survey, 2004**



**Table 1. Characteristics of MFIs reporting to the MIX, end-2004 (medians)**

Type	Number in sample	Expenses (% of assets)				Average loan balance	
		Financial	Loan loss provision	Operating	Total <sup>1</sup>	Dollars	% of GNI per Capita
Individual	104	7.8	1.7	12.9	24.6	1,084	59.5
Mixed Individual-Solidarity	132	5.2	1.2	17.8	25.9	359	44.6
Solidarity	32	5.8	0.9	22.7	30.3	92	14.0
Village Banking	34	7.0	1.0	32.4	39.8	139	20.8

<sup>1</sup>Previous columns do not sum to totals because median totals differ from total medians.

Source: MicroBanking Bulletin: 2004 Benchmarks, available at [http://www.mixmarket.org/medialibrary/mixmarket/2004\\_MFI\\_Benchmarks\[2\].xls](http://www.mixmarket.org/medialibrary/mixmarket/2004_MFI_Benchmarks[2].xls).

## 1.2 Aspects of product design

Having introduced the major product methodologies and a way to think about them, we turn to a more thematic survey of product design, with an emphasis on choices that have been made that advance microfinance as a business proposition. Although they are not the focus here, some of these design choices, such as targeting women, may also directly serve social ends.

The business problem for MFIs can be stated most broadly as finding ways to keep costs below revenues—but that generalization is essentially tautologous, and needs unpacking. Subsidiary challenges include:

- *Building volume.* The ability to spread fixed costs of lending over a large portfolio helps lenders reduce their operating costs as a percentage of assets. This makes building loan volume particularly important for MFIs with small average loan balances who want to reduce costs.
- *Keeping loan repayment rates high.* Searching for defaulters and cajoling or threatening them into repaying is extremely expensive for small loans. Moreover, default can spread, since people will ask, “Why should I repay if she did not?” This puts a premium on keeping arrears extremely low.
- *Retaining customers.* Even the most efficient MFIs find it hard to cover costs on the smallest accounts; most need to cross-subsidize these through larger loans to clients who have proven their ability to pay. This makes it essential for MFIs to grow with their customers, moving to progressively larger accounts.
- *Charging high rates.* High interest rates are a well-known and controversial aspect of microfinance. But MFIs cannot succeed in the commercial sense if they do not cover their costs.
- *Compliance with prudential regulation.* Banking regulations have much to say on what financial institutions can and cannot do. Many MFIs, for example, are not licensed to take deposits.
- *Minimizing scope for fraud.* This is a real challenge for MFIs in developing countries with corruption-ridden state banking sectors.

The remainder of this section explores ways that MFIs have met these challenges. Two points should be borne in mind in reading it. First, none of the strategies discussed is truly essential for sustainability: for every strategy, there are MFIs that eschew it yet succeed. Second, some were developed or copied by people who saw them as primarily serving a social mission.

Through an evolutionary process of selection, however, those strategies still came to the fore for what were essentially business reasons. We suggest below, for example, that the focus on women in group lending arose through a process of experimentation in the late 1970s at what became the Grameen Bank, as the institution discovered that women were easier to work with in rural Bangladesh. Some Grameen imitators are probably unaware of this history and lend to women out of reasons of social mission.<sup>26</sup> The ubiquity of credit itself seems to have arisen for practical reasons, yet some now call it a human right.<sup>27</sup> In sum, strategies may seem to dominate for social reasons but actually do so for commercial reasons.

### 1.2.1 Credit versus voluntary savings

Stuart Rutherford eloquently reminds us that “financial services for poor people are largely a matter of mechanisms that allow them to convert a series of savings into usefully large lump sums.”<sup>28</sup> Poor people do set aside money, if in small amounts and irregularly, not because they have surplus income left over from meeting basic needs, but because their “basic” needs include larger purchases like medicine or clothing or spending at important religious and family ceremonies, that cannot be matched by the uneven trickle of income. Indeed, while the *capacity* of the poor to borrow and save may be surprising, their *need* to do so is greater than it is for the better-off. Precisely because their incomes are tight, their need for financial services in order to cover mismatches between often-volatile incomes and consumption can be a matter of survival.

Savings and lending, though seemingly opposite, are actually similar in helping households convert small payments into larger lump sums. Their usefulness to poor households, however, depends crucially on the end use for which the lump sum is needed. If funds are required for household consumption smoothing in the presence of volatile income, then savings may be a cost-effective alternative to borrowing. If, on the other hand, funds are needed to invest in capital, then credit provides a quicker route to income gains.

Microcredit is commonly viewed primarily as a vehicle for microenterprise. Numerous success stories of individual clients who have struggled out of poverty by their own entrepreneurial efforts have been documented. Assuming that microcredit finances microenterprise, then the willingness of the poor to keep borrowing at high interest rates seems to imply that the rates of return on borrowers’ projects is even higher. There are several reasons, however, to believe that microcredit often finances consumption. There is surprisingly little evidence on average returns earned by borrowers, so little empirical assurance that those returns exceed interest payments. It is generally accepted that many poor people borrow at even higher interest rates from moneylenders for consumption, so willingness to pay cannot be assumed to demonstrate profitability of investments. In practice, MFIs, like moneylenders, require high-frequency, regimented payments on a schedule unrelated to the gestation periods of investments—unlike many business loans, which come due with a single balloon payment. Finally, MFIs assess repayment capacity based on current income and assets rather than expected returns from the proposed investment.

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<sup>26</sup> Or one can imagine that in the early 1980s, a second John Hatch labored with equal enthusiasm to bring financial services to rural Bolivia’s poorest, but opted for individual lending; the imaginary experiment failed and was lost to history.

<sup>27</sup> On “human right,” see Muhammad Yunus, “What is Microcredit?” January 2003, available at <http://www.grameen-info.org/mcredit>.

<sup>28</sup> Stuart Rutherford, “The Poor and their Money: An Essay about Financial Services for Poor People,” Institute for Development Policy and Management, University of Manchester, January 1999.

Borrowing to smooth consumption is not always bad. Indeed, it can literally help people survive difficult times. But to the extent that clients borrow to smooth consumption, voluntary savings seemingly offers a viable alternative, since it equips poor households to manage income volatility without interest expense and the stress of debt. Ideally then, clients should have opportunities to save *along with* opportunities to borrow. To quote Malcolm Harper, chairman of India's Basix Finance Group, "most people, including the poor, want to have savings nearly all the time and to be in debt less frequently."<sup>29</sup>

New research has confirmed that even the poorest households are willing and able to save, and that the existing informal methods (jewelry, cash-under-the-mattress, rotating savings and credit associations or ROSCAs, etc.) do not provide sufficient means for them to save and also carry considerable risks, of theft, inflation, fall in asset prices after natural disasters, and so on.<sup>30</sup> Also, while the ability of the poorest to profitably utilize credit for microenterprise is still an open empirical question, the desirability of promoting savings to act as buffers against income volatility, especially for the poorest households where such volatility can threaten their very survival, cannot be denied.<sup>31</sup>

Why then has the microfinance movement emphasized credit over voluntary savings? From the point of view of the MFIs, credit is more practical in several ways. First, there are, appropriately, fewer regulatory barriers to lending than to taking savings. A small NGO cannot and should not easily become a bank (though the requirements for getting a banking license are arguably too stringent in many countries from the point of view of microfinance, as section 3.2 discusses). Second, and in the same vein, a higher level of trust and recognition may be needed to persuade people to save with an institution than to borrow from it. Third, for lenders, the regularity of repayment schedules speeds transactions at weekly meetings, and may also increase total financial flow. Finally, credit imposes discipline and routine, which encourages clients to repay more regularly than they might save. There is more shame in not repaying than not saving.

From the perspective of the borrower, the discipline provided by regular payments can be useful in maintaining commitments to put aside funds for specific purposes when faced with constant competing use of funds and demands from other family members. It is for this reason that even popular savings schemes like the ROSCAs rely on regular, compulsory contributions by members. Joining the ROSCA is a voluntary decision but once in, members have to meet fixed payments, and, much like the loan repayment schemes, both shame and loss of access to future finances provide the motivation to stick to the payment schedule.

A final factor in favor of credit is created through donor policy: credit programs are more investible from the point of view of foreign donors. Ironically, their *greater* need for outside capital may make it *easier* to attract from official donors and socially minded investors, who often feel a perverse career incentive to disburse larger amounts with less staff time. With the same effort, a donor could place \$100 million in a lending program or \$10 million in a savings program.

All that said, the dominance of credit may be waning. Of the 302 MFIs included in the 2004 *MBB* data, 89 (29 percent) reported voluntary savings in excess of 20 percent of total as-

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<sup>29</sup>Malcolm Harper and Robert Vogel, "The Role of Savings as a form of MFI Funding: Debate," *MicroBanking Bulletin*, August 2005.

<sup>30</sup>Beatriz Armendáriz de Aghion and Jonathan Morduch, *The Economics of Microfinance* (Cambridge, MA: The MIT Press, 2005), pp. 59–68, 158–61.

<sup>31</sup>Manohar Aharma and Gertrud Buchenrieder, "Impact of Microfinance on Food Security and Poverty Alleviation: A Review and Synthesis of Empirical Evidence," in *The Triangle of Microfinance*, edited by Manfred Zeller and Richard L. Meyer (Baltimore, MD: The Johns Hopkins Press, 2002).

sets. This figure will probably rise as more microfinance organizations become banks, and as more banks enter microfinance. Foremost among the savings-taking institutions is BRI, whose Unit *desa* system held \$3.6 billion in savings for 32.3 million people at the end of 2005, ten times the number who had loans.<sup>32</sup> Notably, BRI is a century-old institution, government-run at the birth of its microfinance program in the mid-1980s, and now government-controlled, though partly privatized. It never faced prudential barriers in taking microsavings, nor lacked for capital. In Bangladesh, in a startling development, Grameen saw its savings “portfolio” exceed its loan portfolio at the end of 2004. (Grameen became a bank under special legislation in 1983.<sup>33</sup>) The icon of microcredit now does more savings than credit.<sup>34</sup> Another important exception to the dominance of credit operates in the slums of Dhaka. SafeSave’s workers visit clients daily in their homes to collect deposits as small as 1 *taka* (1.5 cents).

Several MFI heads interviewed for this paper said they preferred savings as a source of capital because it comes with fewer strings attached and less managerial hassle than donor and investor money. The biggest constraint to mobilizing savings may not be the shortage of savers in poor communities, but rather the abilities to lower transaction costs of small deposits and manage liquidity. It is in the latter that downscaling banks (traditional commercial banks moving into microfinance) might have an advantage over small-scale MFIs. Apart from the regulatory issues regarding deposit-taking institutions, such as minimum capital requirements, which tend to favor a larger scale of operations, the ability to manage liquidity requires the type of back-office support and expertise that is not otherwise necessary for credit-only organizations. Excess savings need to be invested and a bank that can lend these to corporate clients has a clear advantage. As early as its sixth year of operation, in 1989, BRI achieved self-sufficiency in funding: it mobilized \$533 million in savings against a loan portfolio of \$471 million. Deposits continued to increase relative to loans in subsequent years, with an average deposit-to-loan ratio of almost 2:1, and the excess savings were channeled into loans to the corporate sector.<sup>35</sup>

### 1.2.2 Forced savings

A common element in both classic solidarity groups and village banking is compulsory, or “forced,” savings. Forced savings are collected during the group meetings, usually pay no interest, and cannot be withdrawn till the member exits the group. Compartamos collects 10 percent of the loan and FINCA-Nicaragua collects 32 percent of the individual loan as forced savings. In the case of Compartamos, the forced savings are collected at the time the loan is granted and are returned to the borrower at the end of the loan cycle while, for FINCA-Nicaragua, the forced savings are paid in equal installments during each meeting and are not returned unless the borrower exits the village bank.<sup>36</sup> Both MFIs also have recourse to village bank forced savings in the case of loan default by a village bank member or if the entire village bank fails.

MFIs offer two main reasons for collecting forced savings: 1) to serve as cash collateral for loans, and 2) to inculcate the habit and discipline of regular saving. From the way forced sav-

<sup>32</sup> [http://www.ivpbri.com/index.php?option=com\\_content&task=view&id=12&Itemid=26](http://www.ivpbri.com/index.php?option=com_content&task=view&id=12&Itemid=26)

<sup>33</sup> Hassan Zaman, “Microfinance in Bangladesh: Growth, Achievements, and Lessons,” in Consultative Group to Assist the Poor and the World Bank, *Scaling Up Poverty Reduction: Case Studies in Microfinance* (Washington, DC: 2004), p. 50.

<sup>34</sup> However, the growth appears driven by the popularity among relatively well-off Bangladeshis of its Grameen Pension Savings (GPS) commitment savings product, which pays out after five or ten years at an annualized rate of 12 percent. It is not yet clear that this rate, and Grameen’s shift to savings, is fully sustainable

<sup>35</sup> Maurer, *op. cit.* note 22.

<sup>36</sup> Westley, *op. cit.* note 7, p. 49

ings are actually structured, however, the collateral explanation appears most compelling. The habit and discipline of regular saving can equally well be inculcated by offering voluntary time deposit accounts (analogous to certificates of deposit), or by commitment savings accounts, where each client commits to depositing a fixed sum at regular intervals. If, however, forced savings are constructed on the premise that the poor are unwilling to save unless forced, then this is clearly a false premise since ample evidence now exists that the poor are both willing and able to save.

Unlike the goal of savings accumulation or saving discipline, the cash collateral motive for forced savings does make sense when viewed as part of MFI delinquency control and risk management. Forced savings reduce MFI financial exposure when a village bank or a solidarity group center ceases to function. Indeed, the threat of losing savings can deter such failure. The fact that MFIs often do not return forced savings till a member leaves the program thus makes business sense. Similarly, using forced savings to cover the missed payments of individual clients helps the MFI recover losses. Equally importantly, by making the entire group center or village bank share the financial cost of default, social pressure is exerted on clients to make timely payments and to offer cross-loans to each other to cover the shortfall when difficulties arise.

Citing the example of Pro Mujer in Bolivia, which was forced to abandon its policy of confiscating village bank forced savings to cover missed loan payments, Westley (2004) has this advice for other village banking institutions (VBIs): “VBIs must not oversell clients on the virtues of accumulating a significant savings balance because clients will then be confused when they are asked to give up these balances to help control loan delinquency.”<sup>37</sup> He also advises village banks to vary forced savings rates according to the past payment histories of clients and to allow clients greater access to forced savings, since “most low-income people who save prefer to be able to access their savings as often as they wish in order to meet emergencies, business needs and opportunities, and household and other demands that arise—rather than having these locked up in an illiquid account.”<sup>38</sup>

### 1.2.3 Life insurance

In addition to compulsory savings, some group lenders also require their members to take a credit-life insurance product. Grameen Koota, a solidarity group MFI in India, has members pay 2 percent of the loan amount in equal weekly installments into an “Emergency Fund” that is used to write off the outstanding loan balance if the borrower dies. In addition, \$11 (Rs. 500) are paid to the family for funeral expenses if the deceased borrower had been with the MFI for less than one year, and double that amount for a longer membership period.<sup>39</sup> FINCA-Uganda, a village banking MFI, pioneered a credit-life insurance product in Uganda in 1996 in partnership with the American Insurance Group (AIG). FINCA-Uganda charges its clients 1 percent of the loan amount as the cost of insurance, of which half is paid to AIG and half retained by FINCA. In the case of the client’s accidental death, the outstanding loan is written off, and the heirs receive US\$1100; if the death is not by accident, only the loan is written off. There is a \$600 pay-out for the accidental death of a spouse, and \$300 for a child.<sup>40</sup> The product turned out to be so profitable that by 2004, AIG Uganda was selling credit-life insurance through 26 MFIs in Uganda,

<sup>37</sup> Ibid., p. 25.

<sup>38</sup> Ibid., p. 52.

<sup>39</sup> <http://www.grameenkoota.org/ratingreports/GKSecondMcrilratingreport.pdf>.

<sup>40</sup> Michael J. McCord, Felipe Botero, and Janet S. McCord, “AIG Uganda: Good and bad practices in microinsurance,” CGAP case study No. 9, 2005, p. 12

Tanzania, and Malawi, and was projected to earn just under \$200,000 from the product, 25 percent of total earnings.<sup>41</sup>

Like forced savings, credit insurance helps both clients and MFIs. It helps client, of course, by reducing risk. For the MFIs, it earns fee income at low administrative expense. It lowers the direct risk from death of borrower. It reduces risk for the group because the members are protected from having to choose between running after deceased's grieving family or covering the loss themselves. Assuming it is mandatory for all members and only covers accidental death, it minimizes adverse selection, which is when people join the lending program because they know they are particularly likely to need the insurance.

#### **1.2.4 Progressive lending**

Almost all MFIs start small with new clients, offer bigger loans if the first ones are repaid, and so on. Group lenders, in particular, follow highly standardized and rigid loan ladders which specify a maximum loan size for each loan cycle, usually maintaining a ratio of 10:1 between the highest and the lowest maximum loan size. Economists say that these expanding cycles create a “dynamic incentive” for clients, because what a client does today affects her options tomorrow. Jain and Moore point out that in group lending, staggering the entry of group members into the lending cycle amplifies dynamic incentives. For at any given time, at least one member is just a few months away from repaying one loan and getting a bigger one. She will have a strong incentive to keep the group going by making sure all her fellow members remain in good standing.

Progressive lending, by first testing the waters with a new client, can also be viewed as another mechanism for winnowing out risky customers. As a rule of thumb, because of economies of scale in loan size, MFIs do not fully cover their costs until the third or fourth loan to a client.<sup>42</sup> But progressive lending is also worrying, in that for borrowers who lack the capacity to repay, it may create a powerful incentive to go to a second lender—a moneylender or another MFI—for a bridge loan, to be repaid as soon as the new, larger loan comes through from the first lender. It can thus feed a cycle of debt, concealing, deferring, and exacerbating the ultimate confrontation with trouble. Successful MFIs therefore cannot rely on dynamic incentives alone to keep the portfolio healthy, but must also use other mechanisms, whether the “shame factor” of group lending, networking in the community, or ongoing assessment of repayment capacity to check unsustainable loan growth.

Individual lenders have harnessed dynamic incentives most effectively because they do not have to deal with the restrictive loan ladders of group lending and can more freely tailor individual loans in terms of lending periods, interest rates, and repayment schedules. And in scaling up, they do not need to worry about imposing inordinate risk on poorer, jointly liable fellow borrowers. Individual lenders are better positioned to use such cost saving devices as automatic loan renewals and parallel loans for repeat borrowers.

#### **1.2.5 Frequent transactions and short loan terms**

Although microcredit was historically called “microenterprise credit,” typical loan terms are more compatible with consumption-smoothing. If a woman takes out a loan to buy and raise a calf for example, the calf will not start generating income for her a week later, when the first payment is due. Similarly, microloans usually mature in six or twelve months, though presuma-

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<sup>41</sup> Ibid., p.36

<sup>42</sup> Conversation with Jonathan Morduch, New York University, New York, March 28, 2006.

bly many investment opportunities open to the poor would take more time than that generate a return.

Clearly the frequent payments and short terms are pragmatic. Allowing microcredit borrowers to pay all principal and accumulated interest in a single transaction years after disbursement would invite default disaster, just as it would for home mortgages. Much of the discipline that one hopes for from a loan—on the borrower and her family—would evaporate. Likewise, the need to immediately repay filters out prospective clients in the same way as forced savings. Thus, microcredit restricts itself to those who already have enough income to repay the loan from other sources, regardless of the success of any new enterprise they pursue.<sup>43</sup> Again, we see that the MFIs designing a structure that elicits compliance from borrowers.

### 1.2.6 Limited product offerings and streamlined procedures

An unfortunate side-effect of frequent transactions is a high administrative burden. It is therefore imperative for MFIs to streamline transaction processing. One way to do this is to limit field officer travel time per client. In urban areas such as the Dhaka slums where SafeSave operates, it is practical for field workers to go door to door; SafeSave reports that its officers visit up to 200 clients a day.<sup>44</sup> 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 insist that clients come part-way to the field workers, through regular meetings. Thus, in addition to making banking a public event, the meetings facilitate mass production. A group field worker can bicycle into a village, process a large number of transactions, and move on. The workers follow highly regimented schedules, typically visiting two to three centers each morning to manage the weekly meetings. The loan repayments and savings collected at the meeting are taken back to the branch office at noon, where the worker logs all the transactions, leaving enough time in the late afternoon to follow up on either new group formation or members with payment arrears.

Given that each center has 15–40 borrowers and meets weekly, each loan officer can manage at least 225 clients ( $15 \times 3$  centers  $\times 5$  days) or, on average, each loan officer can manage 344 clients ( $27.5$  clients  $\times 2.5$  centers  $\times 5$  days). These estimates are close to the actual averages for village banks and solidarity groups in the *MBB*: in 2004, village banks reported an average of 367 borrowers per loan officer and solidarity group MFIs had 287 borrowers per loan officer. The same statistic for MFIs using individual lending was 209 borrowers per loan officer.

Another way to keep transactions efficient is to limit the diversity of product offerings. This is one reason why loans tend to have inflexible 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, frequency and size of transactions. In sum, the drive for transactional efficiency has earned microfinance the mildly disapproving label of “supplier-driven.”

Vikram Akula, who founded SKS Microfinance in India after several years observing self-help groups and the Grameen Bank, expects his company’s edge to be in transactional efficiency. SKS makes sure all loan payments are multiples of 5 rupees, the smallest bill, and ac-

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<sup>43</sup> Jain and Moore, *op. cit.* note 6, p. 15.

<sup>44</sup> <http://www.safesave.org/people-staff.htm>.

cepts no coins.<sup>45</sup> 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.<sup>46</sup> SKS holds no monopoly on these practices; Bangladesh’s ASA is also noted for its regimentation and efficiency. It is noteworthy that these MFI, among the fastest-growing now, stress regimentation.

As with credit dominance, which in a sense is another example of limiting service diversity, here too there are exceptions to the trend. Grameen II has brought a wider diversity of services, in no small part a response to competition, which shifts power to the client. So far, Grameen’s loan officers appear to be handling the complexity.<sup>47</sup> SafeSave dedicates itself to serving the customer through flexibility, letting them decide how much to save each day.

### 1.2.7 Lending to women

The face of microfinance is usually a woman’s. Some MFIs, like SKS in India, and Kashf in Pakistan, lend exclusively to women. But while 89 percent of the borrowers of the median solidarity group lender and 94 percent of the village banking lender are women (in the 2004 *MBB* survey), only 54 percent of borrowers of the median individual lender are women. (See Figure 4.) Why the gender split between individual and group lenders? One explanation is that it is a matter of mission. Poverty-focused, group-oriented MFIs target women with their tiny loans because their oppression only compounds their poverty in limiting their options in life. And women are more likely to channel the support to their children. The larger loans of individual lenders may go more for enterprise investment than consumption smoothing, and men dominate in the sphere of commerce.

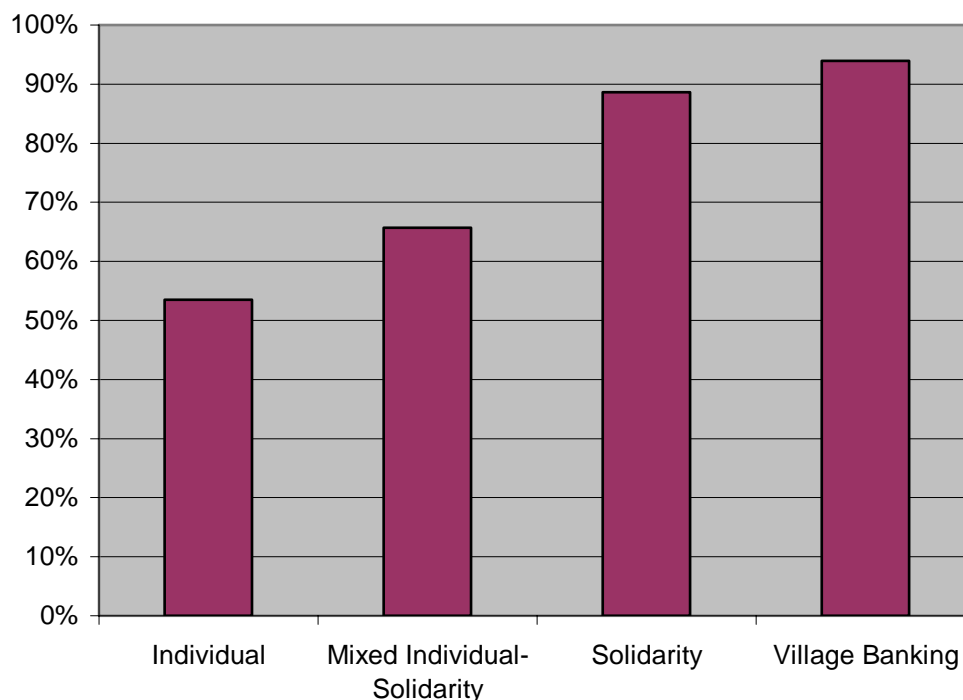
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<sup>45</sup> Eric Bellman, “Invisible Hand: Entrepreneur Gets Big Banks to Back Very Small Loans,” *Wall Street Journal*, May 15, 2006.

<sup>46</sup> Vikram Akula, Chief Executive Officer, SKS Microfinance, Hyderabad, India, interview with author, April 16, 2006.

<sup>47</sup> Rutherford, op. cit. note 12.

**Figure 4. Share of borrowers who are women by lender type (median), *MicroBanking Bulletin* survey, 2004**



However deserving and appropriate women may be for microcredit, this may not be the main reason they have historically gotten more of it. MFIs that target women draw inspiration from Grameen. But in Grameen's early years, men actually dominated. As Yunus and his team refined the methodology, they shifted toward women. The focus became official in 1985.<sup>48</sup> (See Figure 5.) BRAC, the giant Bangladeshi NGO that entered microfinance, moved on the same path.<sup>49</sup> After 13 months of field work in Bangladesh, anthropologist Aminur Rahman of University of Manitoba came to the conclusion that the real reason for the move toward women was practical. For cultural reasons, the "shame factor" of public banking worked better with women, precisely because of their relative lack of power. In rural Bangladesh, at least, 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 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, and they know it. In addition, in the local cultural context, if not everywhere, women are more sensitive to and accountable for how their family is seen within the community. 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

<sup>48</sup> Data from Grameen Bank web site, [http://www.grameen-info.org/bank/hist2005\\$.html](http://www.grameen-info.org/bank/hist2005$.html), viewed June 23, 2006. Policy change from Shahidur R. Khandker, Baqui Khalily, and Zahed Khan, *Grameen Bank: Performance and Sustainability*, Discussion Paper 306, World Bank, Washington, DC, October 1995, p. xii.

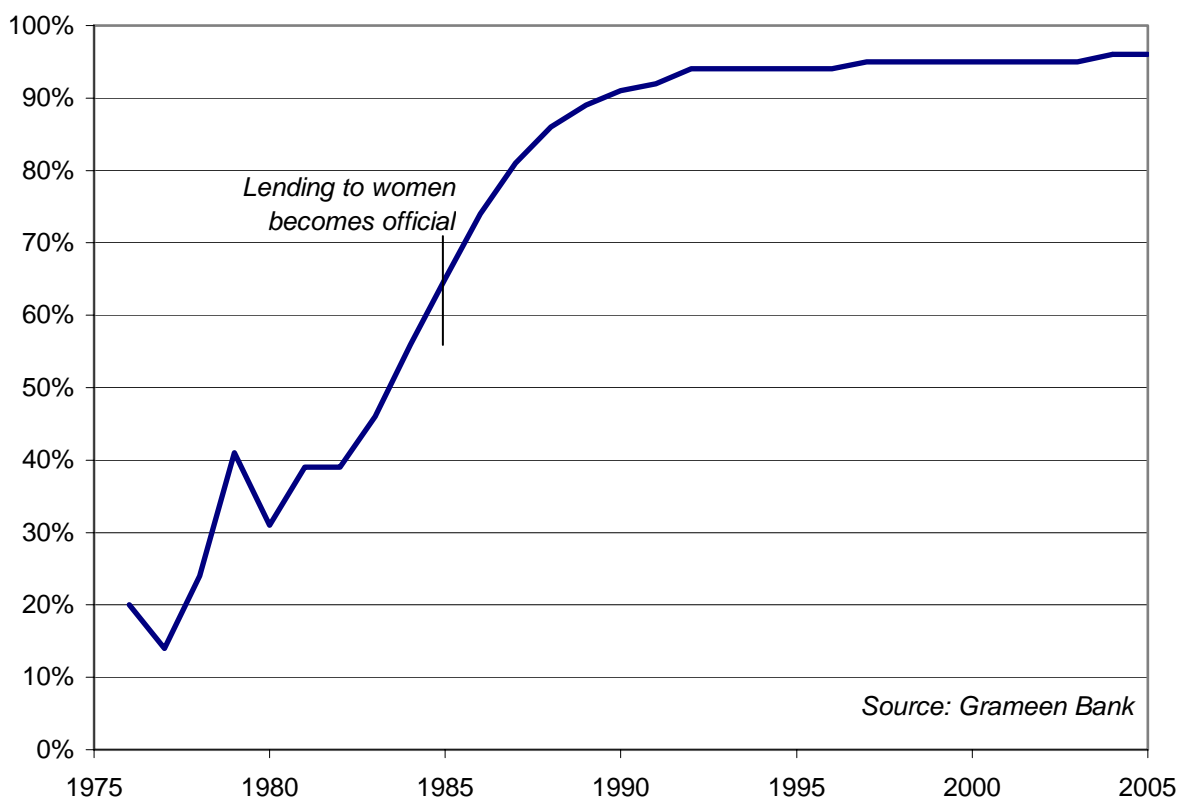
<sup>49</sup> Anne Marie Goetz and Rina Sen Gupta, "Who Takes the Credit? Gender, Power, and Control over Loan Use in Rural Credit Programs in Bangladesh," *World Development* 24:1 (1995), p. 46.

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.<sup>50</sup>

Reinforcing this picture is Rahman's finding that 60 percent of the women in his sample joined Grameen at the request of their husbands, and another 11.67 percent did so at the request of other men. Then, about 60 percent of the time, men in the household decided how the loans were used. In another sample of microcredit borrowers in Bangladesh, not just from Grameen, Anne Marie Goetz and Rina Sen Gupta found that 63 percent of borrowers had partial, very limited, or no control over the use of loan funds.<sup>51</sup>

None of this proves that microfinance does not help women. That 37 percent of women *did* control loan use may be a victory for female empowerment in rural Bangladesh. But it does demonstrate that women are often conduits for loans to men. That the MFIs prefer to work with the women strongly suggests that they do so in no small part because it helps them solve a business problem. So does the minimal gender tilt among individual lenders. Evidently, women in some cultures are more susceptible to peer pressure. As we emphasized at the outset, the business logic can operate even when MFI managers are unaware of it.

**Figure 5. Share of members who are women, Grameen Bank, 1976–2005**



<sup>50</sup> Aminur Rahman, "Micro-credit Initiatives for Equitable and Sustainable Development: Who Pays?" *World Development* 27:1 (1999), p. 70.

<sup>51</sup> *Ibid.*, p. 49.

### 1.2.8 Charging high rates

A final product design strategy for commercial success is to charge rates generally considered usurious in rich countries. The microfinance world was once intensely divided over the question of whether interest rates ought to be subsidized, to help the poorest, or not, so that MFIs can grow faster. The debate has cooled somewhat as the icons of poverty focus, such as Grameen and BRAC, reached operational self-sufficiency. We do not take a position on that question. Rather, we merely observe that if the objective is commercial viability—or being close enough to it that the need for subsidy does not throttle growth—rates must be high enough to cover most or all costs, which are often substantial.

How high the interest rates actually are in any particular case can be difficult to ascertain. Indeed, one has to wonder whether one design strategy is to obscure the true cost. Perhaps for simplicity, MFIs often state their interest rates on a “flat” basis—that is, relative to the original loan amount. But if an MFI makes a \$100 loan that has to be repaid in equal installments over 50 weeks, then over the course of the year the *average* balance is only about \$50. Thus the effective interest rate, relative to the average balance, is much higher than it appears. In addition, MFIs may charge origination fees, charge high prices for credit life insurance, or force savings that earn below-market interest or none at all. The best, systematically collected measure of the interest rate, then, may be the gross portfolio yield, an MFI’s ratio of income on loans to loans outstanding. In the 2004 *MBB* sample of 302 MFIs, individual lenders reported a gross portfolio yield of 32.0 percent at the median (24.9 percent after adjusting for inflation), while solidarity lenders charged 41.7 percent (32.7 percent after inflation) and village banks 48.9 percent (39.1 percent after inflation). (These figures slightly understate the actual charges, to the extent that arrears reduce yield.) Since these figures are medians, half of the solidarity lenders charge *more* than 41.7 percent and half of the village banks charge more than 48.9 percent.

Of course, raising rates does not automatically improve financial performance, since high prices can deter customers. Rajeev Dehejia, Heather Montgomery, and Morduch confirmed that principle for microfinance by studying how demand for credit from SafeSave (which lends as well as taking deposits) varied with the interest rate. They found that a 1 percent increase in interest charges (not a 1 percentage point increase) reduced uptake of credit by 0.25 percent in the short run and 1.18 percent in the long run.<sup>52</sup> Moreover, higher rates can theoretically exacerbate a form of adverse selection. As the rate goes up, potential borrowers with safe, predictable investment plans drop out because they *know* they will not be able to earn enough to cover the interest charges, leaving a pool of clients with riskier plans, ones who have a shot at covering the interest but also greater chance of failure.<sup>53</sup>

Given the contradictory effects of raising rates, the overall effect is an empirical matter. A study by Robert Cull, Asli Demirgüç-Kunt, and Morduch finds that within the observed range of variation for *individual* lenders, higher rates correlate with greater financial self-sufficiency. They find no pattern, positive or negative, among group lenders. It may be that the group sample is too small to pick up such effects. Or the low-income customers of group lending may be more sensitive to interest rates, so that increases in revenue per client are offset by loss of clients. Or more group lenders may be heavily subsidized, thus insulated from market forces, so that income from higher rates is dissipated by administrative inefficiency. Overall, higher rates do not appear to *hurt* financial self-sufficiency of either individual or group lenders within the observed range

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<sup>52</sup> Rajeev Dehejia, Heather Montgomery, and Jonathan Morduch, “Do Interest Rates Matter? Credit Demand in the Dhaka Slums,” Discussion Paper No. 37, Asian Development Bank Institute, Tokyo, September 2005.

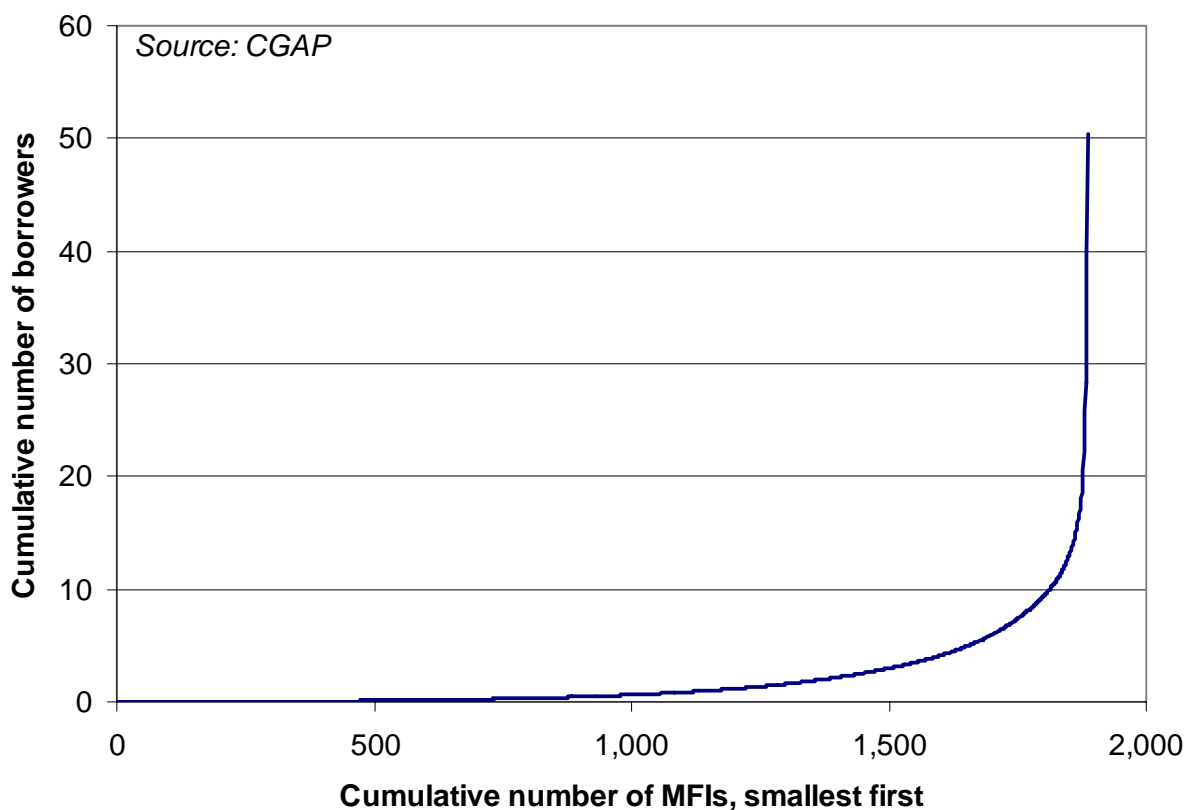
<sup>53</sup> Armendáriz de Aghion and Morduch, op. cit. note 30, pp. 37–41.

of variation. But they do not appear to help group lenders on average either. In cases where they do not help, MFIs have to focus all the more on the cost side to achieve self-sufficiency.

## 2 Management

The previous section surveyed how successful MFIs design their products to solve the business problem of microfinance. Many of the choices they make, such as lending to women and requiring frequent repayments, are widely known and copied. Yet most microfinance operations are small: they are not commercially successful. Figure 6 dramatizes the skewed size distribution of MFIs (including microfinance operations of commercial banks by sorting them from smallest to largest and graphing the cumulative number of borrowers against size, using data from a survey by the Consultative Group to Assist the Poor (CGAP).<sup>54</sup> For example, the 1,813 smallest MFIs have 10 million loan accounts while the remaining 73 have 40 million.<sup>55</sup>

**Figure 6. Cumulative number of borrowers by size of lender, circa 2000**



Why are so many MFIs so small and so few so large? The reasons are of three sorts. First, some MFIs do not prioritize internally funded growth. They may care more about keeping inter-

<sup>54</sup> Data from CGAP, "Financial Institutions with a 'Double Bottom Line': Implications for the Future of Microfinance," Occasional Paper 8, July 2004. They include NGOs, commercial banks, non-bank financial institutions, and charitable projects with a microfinance component.

<sup>55</sup> Individuals may hold more than one account with an institution, or with more than one institution, so the numbers of *people* represented by these figures is somewhat lower.

est rates low to help the poorest, covering their losses with grants from public and private donors and leaving little in the way of retained earnings for expansion. Second, commercial success is about more than product design. MFI staff must also manage their organizations to deploy those products efficiently and on a large scale. Some do and some do not. What the successful ones do is the topic of this section. Finally, forces external to MFIs, such as regulations and cultural attitudes toward debt, shape their prospects; these environmental factors are the subject of the next section.

Managing an MFI for commercial success involves all the usual challenges of business: defining job roles, hiring and training, monitoring employee performance and inculcating an appropriate culture to motivate staff, wooing investors, and more. Thus, to a significant extent, the keys to effective MFI management are universal to business. The nature of the product, however, influences specific management choices. This section will review broad management themes with an eye toward what they mean for microfinance. Much of the preamble to the review of product strategies above applies here: Most of the choices MFI leaders have made are intentional, and their astuteness is often underappreciated. In some cases, though, managers have developed or copied strategies unaware of their true contribution to the organization's sustainability, but in an evolutionary perspective they are business survival strategies nonetheless. Also, as before, exceptions prove the rule.

The overall picture that emerges is that the successful MFI is a decentralized organization. Retail units go to the customer and are the locus of production. They are where relationships with clients are made and maintained, where services are provided, where much learning should take place about the effectiveness of current approaches, where growth can occur through splitting of units. Excessive intervention in branch activities would slow and demoralize workers. Management—the center—picks and trains the right people; designs the products and the structure of local offices; gives them substantial operational autonomy for the sake of efficiency and morale; monitors their performance through strong management information systems (MIS); guides them by inculcating a culture of excellence and service and offering pay incentives; and seeks to learn continually from experience in the field.

### *2.1 Hiring, training, firing*

As demonstrated in Figure 3, operating expenses, as distinct from the cost of capital and loan loss provisioning, dominate the cost side of most MFIs' income statements. Operating expenses in turn consist largely of the wages for field staff. That reflects the reality that microfinance to date has been a service delivered by people to people, unlike the increasingly automated financial services for the better-off. The field staff is the heart of any MFI, and so strategies for hiring, training, and even firing are leading determinants of success.

A common theme in MFI management is the need to break away from "business as usual." "Business as usual" can mean conventional banking, seen as embodying attitudes and assumptions inimical to serving the poor. It can refer to the parent company in the case of a downscaling commercial bank. "Business as usual" can also refer to a national commercial culture pervaded by corruption, self-dealing, and politically directed lending. A nearly universal response is to hire young people. In Cambodia, for example, where corruption is prevalent, ACLEDA Bank says it is now the largest recruiter of fresh university graduates in the country.<sup>56</sup> Young people have several advantages. They are cheap. They are more idealistic and malleable,

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<sup>56</sup> In Channy, General Manager, ACLEDA Bank, Phnom Penh, interview with authors, April 19, 2006.

so that the social mission of microfinance motivates them. They are more willing to spend hard hours on the “street.” In rural Bangladesh, they are ready to live campus-style in remote areas.

Elisabeth Rhyne and Linda S. Rotblatt of Acción write that “good field workers are made rather than found, but... a certain level of education and key personal and social traits are essential prerequisites.”<sup>57</sup> In fact, one way to paraphrase this is to say that good field workers are both made and found. Not everyone is cut out for the job. Some characteristics of the ideal candidate are subtly contradictory and not always found in the same person. On the one hand, to earn clients’ trust and judge their reliability, field workers need good knowledge of local communities, best ensured by hiring right from those communities. The workers must also like working with people, especially people with difficult lives. On the other hand, MFIs are often in a position to skim the cream of local talent. They can choose workers who are better off than most of the clients, have climbed the social ladder through education, or have migrated from countryside to city—and may not want to look back. To quote Susan Gibson, a microfinance training consultant,

When I interview people to run programs, I do not ever interview them in the office. When they come all [well-dressed,] I say, “Well, we’re going to Coronation Market,” (this is in Kingston, Jamaica). They look at you as though something is wrong with you. They say, “But there’s crime down there,” and I say “that’s where we’re going to do our microfinance program.” You can save yourself an incredible amount of time, and you can also learn whether that person is well-suited to the job. So we will get on the bus; I would not even take them in a vehicle because I expect they will take the bus everyday. I want to see if they have bus fare. If they do not have it, they are not accustomed to taking the bus; we might have a problem right up front.”<sup>58</sup>

So MFIs must strike a difficult balance, hiring educated young loan officers, often from a social class above their clients, who are willing to work with people less blessed, who are motivated by a sense of social mission, and yet, who view their work as business and not charity. To quote the same consultant,

The problem with a lot of microfinance programming around the world is that it comes out of a charitable mindset, and you are trying to get people who gave out blankets and food distribution to now make loans. It’s not a good combination and in many cases, we have had to tell people, “you know, this is not for you.” You cannot just convert people from a social service worker to a loan officer. It doesn’t work.<sup>59</sup>

Cost also enters the mix of hiring considerations: workers with professional degrees or prior work experience are more expensive. As a result, a trade-off must often be made between skill and proximity to clientele, and how best to make it depends greatly on the lending methodology. Efficient solidarity group lending consists in no small part in implementing routines. That argues for less-skilled workers, closer in social class to the clientele. About 40 percent of SKS hires, for example, are children of clients, and few have any university education.<sup>60</sup> But efficient individual lending, as will be discussed below, requires more independent judgment on the part of loan officers, which is why the typical hire at an individual lender is at least college graduate. These workers must assess the quality of the information given by the client, which cannot be

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<sup>57</sup> Elisabeth Rhyne and Linda S. Rotblatt, *What Makes Them Tick? Exploring the Anatomy of Major Microenterprise Finance Organizations*, Monograph Series No. 9, Acción International, 1994, p. 69.

<sup>58</sup> Susan Gibson, “Recruiting, Training, and Retaining Excellent Staff,” *Countdown 2005*, Microcredit Summit Campaign, Washington, DC, January/February 2000, available at [www.microcreditsummit.org/newsletter/best9.htm](http://www.microcreditsummit.org/newsletter/best9.htm)

<sup>59</sup> *Ibid.*

<sup>60</sup> Lokesh Kumar Singh, Manager, Sales and Marketing, SKS Microfinance, Hyderabad, India, interview with authors, April 15, 2006.

taken at face value even when supported by financial statements. Good individual loan officers develop indirect techniques for getting at the truth, such as asking borrowers about both the value and volume of their sales in order to see whether the implied price is realistic. Others can tell a lot about a retailer's business by scanning the merchandise on the shelves.<sup>61</sup> Are the shelves empty or full, the products new or old? All this requires a habit of critical thinking, of generating hypotheses and testing them against evidence. As a result, financial viability may hinge in part on the ratio between the wages that must be paid to skilled workers in a country and the income of the less-skilled people to be served, which limits loan size.

For effective MFIs, the tasks of finding and making good field workers intertwine. For no candidate is proved until he or she works in the field, and while some training can take place in the classroom, much is more effective on the job. This makes the finding and making of field workers an intensive process that plays out over months. As of the mid-1990s, BancoSol in Bolivia put candidates through a battery of tests and interviews. At Grameen, between a third and fourth of new hires dropped out during the initial probationary period.<sup>62</sup> Today, ACLEDA puts new recruits through three weeks of field and classroom training before deciding whether to channel them into group or individual lending operations.<sup>63</sup>

Training is important not only for teaching products and procedures but also inculcating a sense of mission, making employees feel that they are part of something larger than themselves. In interviews with MFI directors about "secrets of success" one factor they invariably mentioned was creating a shared sense of mission within the organization. Few large organizations anywhere are better positioned than MFIs to do it. MFI employees can take pride in their service to the poor and their professionalism in a milieu of state-dominated and -distorted financial sectors and corruption. Sense of mission motivates long hours. It also spreads excellence by encouraging workers to go beyond the written rules of their jobs—to do not just what they *have* to do, formally, but what they *can* do, informally, to improve efficiency and serve the customer.

Serious investment in training is thus a hallmark of commercially successful MFIs, especially for individual lenders where skill levels are higher. The regimen at the ProCredit group, an individual lender, includes five two-week sessions per year for the first three years. The company runs a training center near Frankfurt and is planning new ones in Ghana and Nicaragua.<sup>64</sup> XacBank in Mongolia maintains a training center with several full time staffers at its headquarters and uses distance learning technologies to reach its far-flung branches.<sup>65</sup> FINDESA regularly sends employees to training seminars.<sup>66</sup>

A final note on personnel management is that effective MFIs need to be willing to fire, especially in the event of fraud. This can be especially difficult in rural East Asia, where cultural norms about the importance of saving face are adapted to preventing such open ruptures. Historically, BRI in Indonesia has sought to avoid firings by transferring or demoting employees, but

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<sup>61</sup> Damian von Stauffenberg and Sebastian von Stauffenberg, MicroRate, Arlington, VA, interview with David Roodman, April 6, 2006.

<sup>62</sup> Rhyne and Rotblatt, op. cit. note 57, p. 70.

<sup>63</sup> Channy, op. cit. note 56.

<sup>64</sup> Claus-Peter Zeitinger, Chairman, ProCredit Holding, presentation at Pangea, International Finance Corporation, Washington, DC, June 19, 2006.

<sup>65</sup> Ganhuyag Chuluun, Chief Executive Officer, XacBanc, Ulaanbaatar, interview with authors, April 13, 2006.

<sup>66</sup> Gabriel Solorzano, President, Financiera Nicaraguense de Desarrollo, Managua, interview with authors, April 27, 2006.

even it will terminate workers for poor performance when other options are exhausted—all the more a sign of excellence for its cultural difficulty.<sup>67</sup>

## 2.2 *Going to the customer*

Poor people cannot afford to travel long distances to meet their bankers—public transportation can be expensive and involve missing a day of work. Even if they could, their lack of knowledge of the formal financial system would be a deterrent. And even if they were to set foot inside a commercial bank, chances are high that they would not be made to feel comfortable or that they would be patiently instructed in the working of the system. By contrast, a loan officer who comes to the village or neighborhood and transacts in public not only reduces the transaction costs for the borrower, he also promotes an understanding of the financial process. The demonstration effect of observing neighbors apply for loans and make repayments lends moral support to others.

From the lender's perspective, going to the customer helps them build relationships, acquire information, speed transactions, and enforce compliance. Given the lack of public documentation of assets and income, and lack of credit histories, the loan officer has to assess repayment capacity through indirect means: he can observe the lifestyle 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 valuable clues about their default risk. FINDESA loan officers, for instance, 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. They also know that the financial statements in loan applications never include the salary of the owner. To estimate the "shadow salary," they look for evidence of the borrowers' household spending, be it children in college, a new car, or the size of a home.<sup>68</sup>

On-site loan analysis, combined with the discretionary powers granted to loan officers and local branch offices, significantly speeds up the application process. Given the tight budgets of poor households, access to quick funding in emergencies carries a great premium, usually exploited by moneylenders. Reducing the lag time between loan application and funds disbursement, therefore, is critical for MFIs in attracting customers and competing with other lenders. FINDESA, for example, strives to be "faster than the competition" by cutting this lag to 48 hours and by providing repeat customers with smart cards that require no approval process.<sup>69</sup>

Last but not the least, access to a customer's home and/or business environment serves an important function in terms of delinquency control, especially for individual lenders who cannot exert peer pressure through group meetings or through loan co-guarantors. Having a loan officer drop by and demand action on a late repayment in front of family, neighbors or business associates, or publicly haul out items pledged as collateral, is bound to exert social pressure on borrowers even in dense urban areas where social bonds are assumed to be weaker than in closed rural communities.

The principle of going to the customer operates in tension with the need to control costs by shifting them onto customers. The tension is minimal in cities and dense rural areas like in Bangladesh, but is a real barrier to microfinance in sparse rural areas. In low-density Mongolia, XacBank has built a network of branches in rural towns; market towns, after all, have been the locus of commerce in rural areas since ancient times. Still the ratio between overhead costs and

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<sup>67</sup> Rhyne and Rotblatt, *op. cit.* note 57, p. 81.

<sup>68</sup> Solorzano, *op. cit.* note 66.

<sup>69</sup> *Ibid.*

clients reached tends to be high in this approach. A modern solution is being tried in Kenya. With support from the U.K. Department for International Development, Kenya's Equity Building Society deployed mobile banking units—bullet-proof SUVs adorned with solar panels, mobile network-based computer links, and drop-down teller windows. Impressively, Equity reports that it is covering the costs of this advanced equipment through earnings from new business.<sup>70</sup>

### 2.3 Standardizing branch structure

Branch staffing at efficient MFIs tends to be tight and uniform, with an organizational structure tailored to the context and the services delivered. The classic 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. In lower-volume areas, branches operate outposts with just a teller and a bookkeeper, and are open only a few days a week. Grameen branches have tended to be simpler, reflecting the greater rote nature of solidarity group operations, with a branch manager, sometimes an assistant, and a small corps of field officers.<sup>71</sup>

One crucial advantage of these simple, standardized units is that they 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 is 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.

Standardization also brings the usual disadvantages and advantages of mass production. It imposes some inflexibility, which can impede customer service. But as discussed in the products section above, it can make operations efficient and facilitate learning loops between branches and the center. Any aberrations that signal trouble or innovation are easier for the center to detect against the backdrop of uniformity. And any procedural changes the center issues are meaningful for all branches, where they would not be if each ran differently.

### 2.4 Leadership

For an independent MFI, it almost goes without saying that the drive for success—the vision, the mission, the modus operandi, the commitment to continuous improvement—must come from the top. For microfinance subsidiaries of downscaling banks, whether domestic or international, the need for leadership is worth elaborating on. In fact, two kinds of leadership are needed, argues Liza Valenzuela in a report for the U.S. Agency for International Development. First, the board and CEO of the parent bank must give the microfinance operation a strong mandate, because it breaks from usual bank practices in many ways (such as in the use of pay incentives, below), takes time to break even, and is usually not solely justified by profits. Such a commitment is evident, for example, at ABN AMRO, whose Brazil operation appears to be the sole example of retail microfinance by an international commercial bank.<sup>72</sup> Second, there must be an “operational champion,” who runs the microfinance operation, understands all its facets, and has the stature

<sup>70</sup> Douglas Pearce and Myka Reinsch, *Equity Building Society of Kenya Reaches Rural Markets*, CGAP Agricultural Microfinance Case Study No. 4, August 2005.

<sup>71</sup> Rhyne and Rotblatt, op. cit. note 57, pp. 31–35, 111–12.

<sup>72</sup> [http://www.abnamro.com/com/about/sd/sd\\_microfin.jsp](http://www.abnamro.com/com/about/sd/sd_microfin.jsp).

and skill to advocate for the unit within the larger bank in the competition for capital and autonomy. Valenzuela tells a story of an effective operational champion in a downscaling bank in Latin America:

Asked why his bank's microcredit program succeeded, a board champion said he had selected one of his finest managers to lead the microcredit unit. The manager was an enthusiastic younger man with an excellent understanding of bank products as well as back-office operations. He also came from a rural area and understood rural and lower-income clients. He was an *operational champion*, someone who knew what it takes to develop a new product line within the bank and could oversee its service delivery. This is a refreshing story, since in many other cases the managers selected have lacked the qualities needed to lead a microcredit program. In fact, many viewed the microcredit job as a demotion.<sup>73</sup>

A 2006 report surveying the experiences of seven downscaling domestic banks concurs, finding that “[m]ost of the successful banks in the analysis had at least one strongly committed manager.”<sup>74</sup>

## 2.5 *Monitoring and incentives*

The management discussion so far has looked at how to find, cultivate, and inspire good workers. But to achieve excellence, managers must also closely monitor workers after launching them into the field. Data collection helps in several ways. Any signs of repayment troubles must be detected and pounced upon quickly. And since workers are involved in the collection, they absorb messages about what constitutes good performance. Most successful MFIs go beyond collecting performance data to basing a part of employees' pay on it. The result is a flow of information which all involved have strong incentives to care about.

Since a commercially successful MFI's greatest cost is field staff and its greatest risk non-payment, the most important field worker performance measures to collect are on productivity and arrears. Productivity can be measured as accounts per officer or outstanding portfolio per officer in currency terms. The first relates more closely to the mission of outreach, while the second should correlate more with financial sustainability. The second tier of indicators has to do with growth, a high priority after financial sustainability; candidates include gross or net increase in the number of accounts and gross or net increase in portfolio. The goal, in the words of FINDESA head Gabriel Solorzano, is “safe growth.”<sup>75</sup> Whatever indicators are chosen, they should be few and easy to understand, in order to minimize the administrative burden for all concerned and maximize their psychological impact.

A more sophisticated approach to performance measurement is to treat each retail unit as an accounting unit as well, requiring it to generate regular profit and loss statements. P&Ls do not suffice by themselves, since they may mask portfolio quality problems or “mission creep” away from low-balance clients. But in combination with other indicators, they should align the thinking of field workers more closely with the goal of financial sustainability. The pioneer here is BRI, which since the inception of the Unit *desa* system in 1984 has required regular income statements and balance sheets from all branches.<sup>76</sup>

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<sup>73</sup> Liza Valenzuela, “Getting the Recipe Right: The Experiences and Challenges of Commercial Bank Downscalers,” Development Alternatives, Inc., Bethesda, MD, October 2001, p. 26.

<sup>74</sup> European Institute for Business Ethics, *Global Banks and Microfinance* (Amsterdam: ING Bank, 2006), p. 27.

<sup>75</sup> Solorzano, op. cit. note 66.

<sup>76</sup> Maurer, op. cit. note 22, p. 96.

For all information to be useful, management information systems (MIS) must be in place to transmit it efficiently, reliably, and quickly. In the rich world, good MIS is seen as synonymous with high technology. Computers, certainly, should be the nerve center of an MFI's information system. But just as an MFI's money flows are not purely electronic (field officers spend much of their time transacting in paper cash) neither need their information flows be. Historically, primary transaction records at Grameen Bank have been kept on paper. Recently, it has accelerated the installation of computers at regional ("area") offices, but it remains to be seen how well the new systems will take—how much, that is, this bit of high technology will improve information flow.<sup>77</sup> "It is important," wrote Rhyne and Rotblatt in 1994, "to resist the temptation to equate a good information system with computerization."<sup>78</sup> Since then, the trend does appear to have been toward pushing modern technology out to the branches and leaves of the organizational tree. Solorzano at FINDESA speaks of putting personal digital assistants (PDAs) in the hands of all field workers.<sup>79</sup> But the point stands: the key is not whether the technology is paper or silicon but that it serves the essential functions of MIS.

However collected, core performance indicators are typically used as the basis for pay incentives. By "putting money first," this practice has the potential disadvantage of undermining commitment to the organization's social mission. Grameen Bank says it eschews pay incentives for this reason.<sup>80</sup> Nevertheless, even MFIs targeting the poorest through group lending use pay incentives. The fast-growing, profitable Compartamos in Mexico uses them for both its individual and village banking field workers.<sup>81</sup> Pay incentives are almost universal among successful individual lenders because they solve what economists call an information problem. In particular, for the sake of efficiency, individual loan officers must be given more discretion to exercise their own judgment in factoring different kinds of (imperfect) information into loan decisions, especially if they work on the streets, where the clients are. It would be costly for managers to attempt to observe and second-guess every choice they make, so managers cannot be sure field workers are making the best choices. It becomes that much more important to guide their behavior through bonuses for success.

Effective pay incentives must possess three characteristics, according to Sebastian von Stauffenberg of MicroRate, an MFI rating agency.<sup>82</sup> They should be significant enough for field workers to care about them. They should be simple, because it is hard for people to respond to incentives based on formulas they do not understand. And they should be high-frequency, so that performance affects pay relatively soon. In addition, the basis for incentives needs to be carefully aligned with the MFIs ultimate objectives. Rewarding loan officers only for the number of new accounts opened each month, for example, could tilt operations dangerously in the direction of overlending, even fraud. This, Eduardo Bazoberry reports once happened at PRODEM in Bolivia, which he runs.<sup>83</sup> Bazoberry was burned enough by the experience to abandon pay incentives. That put him out of step with most successful individual microlenders.

Managers at effective MFIs view incentive formulas as reins to guide operations. Just as for a horse, the tension on the reins can be adjusted to steer the organization. If managers become

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<sup>77</sup> Rutherford, op. cit. note 12, p. 21.

<sup>78</sup> Rhyne and Rotblatt, op. cit. note 57, p. 62.

<sup>79</sup> Solorzano, op. cit. note 66.

<sup>80</sup> Rhyne and Rotblatt, op. cit. note 57, p. 58.

<sup>81</sup> Carlos Labarthe, Co-Chief Executive Officer, Compartamos, Mexico City, interview with authors, May 2, 2006.

<sup>82</sup> Sebastian von Stauffenberg, MicroRate, Arlington, VA, interview with David Roodman, April 6, 2006.

<sup>83</sup> Eduardo Bazoberry, "We Aren't Selling Vacuum Cleaners: PRODEM's Experiences with Staff Incentives," *MicroBanking Bulletin*, April 2001.

convinced that branches are lending too conservatively, with near-perfect repayment records but slow growth, they can adjust the incentives to favor growth more, then carefully observe how much it affects behavior and performance. In an interesting variant, BRI managers adjust the transfer prices (interest rates) on capital flows between branches and the center. During a nationwide liquidity crunch in 1991, for example, they raised the interest rate paid to branches for mobilized savings. That showed up on the branches' income statements, and since employees shared in the branch's profits, they responded by shifting their energies from the lending program, which temporarily stopped growing, to the savings business. After the credit squeeze passed, they flipped the incentives to restart lending growth.<sup>84</sup> Managers can also use this technique to mask the subsidy element in the capital they secure, in order to promote efficiency, by setting transfer prices closer to market rates.

## 2.6 *Organizational capacity for learning*

It is well recognized in rich industrial countries that an organization's capacity for change is essential to success, even survival. The context in which organizations operate is constantly changing—competition arrives, technology advances, or, at MFIs, clients outgrow the strictures of the standard lending ladder—and so organizations must change too. Even if the context were static, it would remain the case that excellence in complex organizations is not so much achieved as continually pursued. And treating employees respectfully as sources of knowledge boosts morale.

One striking thing about leaders of successful MFIs that we spoke to for this study was the extent to which they had imbibed these rich-world management ideals as they sought to create world-class institutions at home. Solorzano said FINDESA models itself after successful Japanese corporations, such as the car companies who imported just-in-time delivery and total quality management from the West then implemented them better than any had before. FINDESA executives visited Peru to study its well-developed microfinance regulatory system, to Bolivia to understand why some MFIs came through the late-1990s microfinance crisis better than others, to Mexico to learn from Comportamos, to El Salvador to study a more local example, and to Harvard to study management. In the Japanese model, he says, learning has three parts: class-room learning, on-the-job training, and “self-illumination.”<sup>85</sup>

Organizational learning takes many forms, differing in subject (who is learning), object (what is being learned about), and source (internal or external). One kind of learning is about how to improve processes, which Japanese manufacturers exemplify. Excellent MFIs obsess over field officers' time use. In the case of individual lenders, as they mature, the size of a client file shrinks radically, in the experience of Sebastian von Stauffenberg.<sup>86</sup> Paralleling this is a reduction in how many people are involved in a loan decision and how long it takes to make. Management learns over time which questions and pieces of document will most efficiently inform decisions.

Another kind of learning is learning from without, imbibing from the great world of experience and ideas in management and microfinance. Vikram Akula founded SKS in India after observing self-help groups and lenders such as Grameen for years—and watching how Coca-

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<sup>84</sup> Rhyne and Rottblat, *op. cit.* note 57, p. 55.

<sup>85</sup> Solorzano, *op. cit.* note 66.

<sup>86</sup> Stauffenberg, *op. cit.* note 61.

Cola made itself ubiquitous in India in 15 years through mass production of a standardized product.<sup>87</sup>

Still another kind of learning is learning from within. As organizations that mass produce services delivered through large field staffs, power in successful MFIs necessarily flows from the top down. A strong hierarchy dictates standards for products and procedures. Yet knowledge must also flow from the bottom up. Field staff and local branch managers possess the most direct knowledge of what works and what doesn't, of how things are changing on the ground. Consulting them also raises their morale and helps them buy in to any policy changes that emanate from the top. And staff that buy into a policy change are more likely to carry it out effectively and efficiently. Ultimately, a learning *organization* is not just a collection of people who learn, but a corporate entity capable of changing in response to new information.

Effective MFI managers therefore develop a culture and procedures that let them learn from staff. Managers at all levels spend time in the field. Regular staff meetings at branches are occasions for local managers to discuss problems and innovations, and similar meetings up the hierarchy facilitate knowledge transmission. Grameen Bank takes an unusual approach: branch managers are required to write monthly essays about conditions in their area, recent successes, challenges, and so on. The essays are sent straight to top management, bypassing the intermediate levels in the hierarchy. "Observers have credited this system with ensuring that the policy makers at Grameen have a detailed grasp of the status of their organization."<sup>88</sup> Certainly, Grameen has demonstrated impressive capacity to learn in the organizational sense in recent years. In response to outside criticism, growing repayment problems, and pressure from clients given added voice by competition, and despite its size, it carried out the thoroughgoing "Grameen II" reforms in a few years.<sup>89</sup>

### 3 Environment

We begin this section as we began the last, with an observation about the uneven distribution of microfinance in the world. This time, we organize the data geographically to highlight that a few countries have a lot but most have little. (See Table 2.) As we have said, the visionaries who created successful MFIs in Bangladesh, Indonesia, Bolivia, and elsewhere deserve much credit, as it were, for their vision, creativity, intelligence, and stamina. But equally talented people work in countries with little microfinance activity. Moreover, during the 1990s, both bilateral and multilateral donors have promoted microfinance in countries with sizable informal sectors that do not have access to formal finance. International networks like Acción, Women's World Banking, and the Grameen Foundation have also been active in forming alliances with local NGOs—either "start-ups" focused on microlending or older, broad focus social development organizations interested in starting credit programs. Furthermore, private capital funds, attracted by the microfinance success stories, have become active in supporting microfinance initiatives, and international commercial banks have also explored possibilities of downscaling. And now international banks are entering the mix.

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<sup>87</sup> Akula, op. cit. note 46.

<sup>88</sup> Rhyne and Rottblat, op. cit. note 57.

<sup>89</sup> Rutherford, op. cit. note 12.

**Table 2. Active loan accounts per capita, countries with at least 1 percent, circa 2000**

Country	Loan accounts (thousands)	Population	Loan accounts/ capita (%)
Bangladesh	17,300	130,407	13.3
Indonesia	15,159	224,138	6.8
Guatemala	833	12,820	6.5
Bolivia	494	8,153	6.1
Nicaragua	220	4,932	4.5
Gambia	50	1,367	3.6
Tunisia	313	9,564	3.3
Niger	322	10,174	3.2
El Salvador	191	6,123	3.1
Honduras	183	6,201	3.0
Thailand	1,728	62,352	2.8
Ecuador	345	12,505	2.8
Sri Lanka	524	19,239	2.7
Malawi	260	10,874	2.4
Senegal	233	9,784	2.4
Mongolia	61	2,601	2.3
Peru	588	25,980	2.3
Nepal	492	24,702	2.0
Cambodia	243	12,433	2.0
Benin	122	6,428	1.9
Togo	90	5,033	1.8
Colombia	699	39,686	1.8
Uganda	407	23,496	1.7
Bosnia and Herzegovina	59	3,836	1.5
Paraguay	69	5,586	1.2
Dominican Republic	97	8,354	1.2
Georgia	54	4,777	1.1
Samoa	2	179	1.0
Ethiopia	638	62,651	1.0

Source: Authors' calculations, based on CGAP.

Why then the uneven geographic distribution of microfinance? *Path dependence* is part of the story. It is easier to do microfinance where it has already been done because clients and regulators have learned how to work with it. But there is more to the story than that. A country's history, as manifest in its culture and government—is a major determinant of failure or success in microfinance.

### 3.1 *The demonstration effect*

One commonality of countries with multiple MFI success stories is the demonstration effect of the first MFI to attain large outreach and financial viability. This illustrates a phenomenon known as path dependence, whereby microfinance begets microfinance. The demonstration model does several things. It creates public awareness of microfinance. Especially if the demonstration model is an NGO, the organization's credentials as a civil society organization promote public acceptance of financially viable styles of microfinance, in particular the necessity of charging high interest. This function can be especially important in democracies with a tradition

of state subsidized programs of poverty alleviation because some MFI practices can be easily politicized. Given the diversity of credit methodologies and organizational structures, and the importance of creating market-responsive products, others can learn immensely through the experiences and innovations of the first MFI that successfully tests the local waters. Also, if the pioneer is a private MFI, the response of the public sector to private microfinance initiatives—helpful or hostile—becomes evident. Other MFIs learn whether the government will provide a supportive environment or burden MFIs with excessive regulation.

NGOs have perhaps the easiest time pioneering microfinance. But some downscaling state banks, such as BRI, are also well-positioned to take the lead, since they can start with financial muscle, large branch networks, public credibility, and a minimum of worries about regulatory barriers. They can also offer deposit services. Downscaling commercial banks have some of these advantages, but the potential for destructive politicization makes it is harder for foreign-owned ones especially to serve as the demonstration model.

Path dependence also shapes the institutional *form* of microfinance. If the initial success story is an NGO, other NGOs might be set up; if the NGO has transformed to a non-bank finance company (NBFC) or even a bank, then it might also attract other NBFCs or banks. This is because the new entrants have to compete with the kind of services being provided by the existing MFIs. For example, if the demonstration model is a downscaling state bank or a microfinance bank able to mobilize savings, a credit-only NGO might be a weak competitor. Potentially more successful entrants in such a market would be downscaling commercial banks.

### 3.2 *National context*

Accepting the importance of path dependence in explaining the uneven international distribution of microfinance still begs a question: why do certain countries succeed in producing a demonstration model with momentum while others never get past a few small-scale attempts?

Lack of funding is *not* what prevents an MFI initiative from taking off: government donors are currently disbursing \$0.5–1.0 billion a year for microfinance and ready and willing to step up.<sup>90</sup> If local, potentially viable MFIs are facing problems raising funds, the real hurdle is probably not the *unavailability* of donor funds, but rather the inability of MFIs to *access* such funds because of government activity. The most obvious examples of such activity are direct controls such as foreign currency and foreign ownership restrictions that prevent local MFIs from taking advantage of international donor funds and technical expertise. Equally important, however, is the broad political-economic environment manifest in government policies that prevent MFI initiatives from achieving the kind of growth and financial stability needed to become a “success story.”

Foremost amongst such government policies is subsidized credit for agriculture or other “priority” sectors. Direct competition from state subsidized credit programs poses a real challenge to MFIs struggling to expand operations. Such competition can lead to crowding out of the MFIs—although, given that subsidized credit has a history of landing in the hands of the non-target population, its scope in significantly reducing the ranks of the unbanked might be limited. Perhaps more importantly, however, the low interest rates and poor repayment that usually characterize directed credit programs create a culture of easy “credit” that makes it hard for MFIs to politically defend their interest rates and control their delinquency levels. The target population that does not gain access to government-subsidized funds ends up resenting the fact that it is

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<sup>90</sup> Consultative Group to Assist the Poor, “The Market for Foreign Investment in Microfinance: Opportunities and Challenges,” Focus Note 30, August 2005.

forced to pay the higher MFI interest rates and not the below-market rates that it feels entitled to. Such resentment is a ready base for politicization of MFI interest rate policies.

While the failure of directed credit programs is seen as adding to the appeal of the market-friendly microfinance model, in many countries the failure is publicly perceived not as an intrinsic feature of subsidized credit programs but, rather, as a result of the mismanagement of the *government at the time*, thus leaving the door open for new directed credit projects with improved delivery systems to be initiated by the latest government—which it will do when it is seeking reelection. In such situations, the public sector continues to be viewed as a better solution than the market for pulling people out of poverty. This puts pressure on governments to have more pro-active policies—providing subsidized credit directly or putting interest rate ceilings on MFI lending.

A history of directed credit also creates vested interests in the shape of public sector bank managers and employees and the politicians that typically run the local branch of the state bank as if it were part of their general municipal operations. These vested interests can influence government policy into creating a non-supportive MFI environment. The history of India's directed credit program goes as far back as 1954, when a central bank report recommended expanding the rural cooperative system to provide financial access to the informal sector.<sup>91</sup> Commercial banks were nationalized in 1969 and rural regional banks were set up in 1976 to further extend the rural reach of financial institutions. As a result of this sustained development policy focus spanning decades, India today has a vast network of rural financial institutions: over 32,000 rural branches of commercial banks and regional rural banks, some 14,000 cooperative bank branches and 98,000 primary agricultural credit societies, and a vast post-office network with 154,000 outlets providing deposit and money transfer services.<sup>92</sup> Government support for the SHG bank linkage program, discussed in section 1.1.1, is thus not surprising.

Unlike the SHG bank linkage program, however, the Grameen replicators in India present a direct challenge to the existing state banking infrastructure because of their separate branch system and their greater scalability. If such MFIs succeed in building rural outreach and in gaining public support, then they would undermine the *raison d'être* of the rural directed credit system. In March 2006, addressing a committee of bankers, the Chief Minister of the Indian state of Andhra Pradesh accused MFIs of charging “moneylender” interest rates and “unethical recovery measures.”<sup>93</sup> Two months later, the same Chief Minister launched a state credit plan to provide funding to SHGs and told reporters that the government was considering regulating MFI interest rates.<sup>94</sup> In India, the image of a ruthless, cunning, rural moneylender charging usurious rates and pushing the poor to acts of desperation, even suicide, has long persisted in the public imagination<sup>95</sup> and has made it easier for politicians to harness this sentiment to their own goals.

While different cultures may provide a more or less fertile ground for the politicization of MFI practices, the tendency is latent in almost all societies and can suddenly come to the fore even in countries where microfinance seems well on its way to success. For example, in Nicaragua, the fifth country on the list in Table 2, the parliament introduced interest rate ceilings in

<sup>91</sup> 1954 RBI report on the All-India Rural Credit Survey of 1951–52

<sup>92</sup> Priya Basu, “Scaling-up Microfinance for India’s Rural Poor,” World Bank Policy Research Paper 3646, Washington D.C., June 2005.

<sup>93</sup> <http://www.thehindubusinessline.com/2006/03/18/stories/2006031802930900.htm>

<sup>94</sup> <http://www.thehindu.com/2006/05/23/stories/2006052321420500.htm>

<sup>95</sup> <http://www.hinduonnet.com/2006/04/20/stories/2006042005220900.htm>

2001.<sup>96</sup> Few in the general public understand the business necessity of MFIs charging cost-covering interest rates that happen to be considerably higher than formal market rates. It does seem unfair that the poor have to pay a 40% interest rate when the rich pay 10%. Making the justification harder is the relative paucity, to date, of conclusive studies vouching for the positive economic and social impact of microfinance (see the Conclusion). Absent such clear evidence supporting the poverty alleviation properties of microfinance, both the necessity and the difficulty of gaining popular support will remain a challenge for MFIs and a tool in the arsenal of vested interests opposed to microfinance.

Development policies other than directed credit can also influence the general enabling environment for microfinance. If the government is seriously interested in promoting a small and medium enterprise (SME) sector, for example, then it is also more likely to lend support to MFI initiatives. On the other hand, if government policy tends to favor large-scale development projects, it might not be very enthusiastic about measures to promote microenterprise. A U.N. Development Programme study of the microfinance sector in Turkey asserts that the government's economic development policies have favored large-scale industrial projects, that the country lacks an overall SME policy, and that the few disjointed steps that have been taken to promote SMEs have sometimes turned out to be inconsistent: e.g. providing subsidized credit to promote microenterprise while, simultaneously, raising income-taxes for the self-employed.<sup>97</sup> According to the director of Maya Enterprise for Microfinance, a Turkish NGO founded in 2002, concerns about possible tax evasion create a tendency in the government to view unregistered businesses in the informal sector with suspicion.<sup>98</sup>

The example of Turkey also highlights the role of non-prudential regulations in creating a supportive environment for a demonstration model to emerge. For an incipient microfinance sector, the most relevant legal issues are non-prudential<sup>99</sup>, e.g. allowing NGOs to start credit operations, developing policies that relate to how MFIs can set interest rates, determining how they are taxed, if they can be owned by foreigners, and even mundane factors like how many permits are required and how long the application process takes. In Turkey, there is no clear legal framework that allows NGOs to start credit operations. In some countries, what is legally not prohibited is *de facto* allowed, and an enabling environment can be as easy as the state apparatus looking the other way. But elsewhere, not so. In Turkey, KEDV, an NGO, set up a for-profit company, Maya Enterprise for Microfinance, to start a lending program. While Maya received permission to operate after a lengthy application process, its legal status still appears unclear. While not a bank, Maya is still subject to banking tax laws.<sup>100</sup> To make the situation worse for NGOs like Maya, a Draft Law submitted in 2003 and still under consideration three years later, proposes regulations for licensing microfinance banks and allows NGOs to lend but does not permit them to own equity in microfinance banks. This seriously constrains the ability of NGO MFIs to grow and achieve financial viability, and as a result reduces incentives for donors to fund local NGOs interested in microlending. To date, Maya is the only MFI in Turkey, a country of 69 million people, with a stated goal of pursuing financial viability.

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<sup>96</sup> Brigit Helms and Xavier Reille, "Interest Rate Ceilings and Microfinance: The Story So Far," CGAP Occasional Paper No. 9, September 2004.

<sup>97</sup> Kiendel Burritt, "Microfinance in Turkey," draft paper for the United Nations Development Programme, published by the United Nations Capital Development Fund, August 2003.

<sup>98</sup> Belgin Guzeltan, Director, Maya Enterprise for Microfinance, Turkey, Interview, May 18, 2006.

<sup>99</sup> For definitions of concepts like prudential regulation, licensing, supervision, etc., please see Robert Peck Christen et al., "Microfinance Consensus Guidelines," published by CGAP/The World Bank Group, 2003.

<sup>100</sup> Burritt, op. cit. note 97.

Other factors influencing the emergence of a demonstration model include the level of development of the local banking sector, prudential regulations, and supervision. To quote Damian von Stauffenberg, founder of MicroRate:

A relatively well-developed financial system and above all, reasonably functioning banking laws and institutions that enforce them form a combination that is usually lethal to the emergence of microfinance. Banking supervisors have firm ideas about who should be engaged in financial intermediation and they will nip anything that doesn't conform to those ideas in the bud. It takes a determined political decision—as occurred under Fujimori in Peru and under Gonzalez de Lozada in Bolivia—to change banking laws and to knock the banking supervisors into a cooperative mood. Unfortunately most governments that jump onto the microfinance bandwagon don't realize that the most important thing they can do is boring, largely invisible technical and supervisory work. They want publicity. So they go for lending rate controls and large injections of subsidized funds. Both are poison for microfinance.<sup>101</sup>

Persistent macroeconomic problems, combined with limited domestic resources or need for foreign capital, can make governments more interested in allowing private microfinance initiatives and to be more receptive to international donors pushing microfinance. The World Bank pressure, for example, has played a crucial role in helping set up success stories such as PADME in Benin and the Agricultural Bank in Mongolia. The super-efficient PADME was initiated by the government of Benin in 1993 with funding from the World Bank as part of a larger structural adjustment program for the country, while restructuring the state-owned Ag Bank was a condition of the World Bank's Financial Sector Adjustment Credit Program for Mongolia.<sup>102</sup> In the case of Turkey, however, the World Bank actually assisted the government in continuing its subsidized credit program when faced with a budgetary crunch in 2001. The Bank backed establishment of a Social Risk Mitigation Project that included funding for the government's Micro-Projects program that provides five-year, interest-free loans to microentrepreneurs.<sup>103</sup>

While episodes of financial crises and natural disasters might push more people into the informal markets and incline governments, NGOs, and donors to look with hope to microfinance to help them, MFIs can hardly do well without macroeconomic stability. In Bolivia, PRODEM, the NGO that created BancoSol, Bolivia's "demonstration model" for successful microfinance, was founded in 1986, barely a year after inflation hit a record high of 24,000 percent and a new government instituted drastic economic liberalization measures to stabilize the economy, including deregulation of interest rates. The measures proved effective, the inflation rate fell to 14 percent by 1987 and economic growth resumed. During the 1990's, the decade that Bolivian microfinance achieved its remarkable success, economic growth continued and inflation remained well below the 1987 level. By 1998, the Bolivian microfinance providers served a total of 415,609 clients, accounting for over half of all clients served by the Bolivian financial system.<sup>104</sup>

We conclude that donors are ready to fund, there is plenty of demand, donors and networks are willing to give technical support, and there is no shortage of the type of human capital that highly standardized MFIs require. The real bottleneck is the interplay of government policy, the macroeconomic situation, and the public image of microfinance.

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<sup>101</sup> Damian von Stauffenberg, MicroRate, Arlington, VA, e-mail to David Roodman, April 27, 2006.

<sup>102</sup> Jennifer McDonald, "PADME, Benin," *MicroBanking Bulletin*, February 2000; Jan Dyer, J. Peter Morrow, and Robin Young, "The Agricultural Bank of Mongolia," in CGAP and World Bank, op. cit. note 22, p. 29.

<sup>103</sup> Burritt, op. cit. note 97.

<sup>104</sup> Sergio Navajas, Jonathan Conning, and Claudio Gonzales-Vega, "Lending Technologies, Competition and Consolidation in the Market for Microfinance in Bolivia," *Journal of International Development* 15 (2003): 747–70.

## 4 Conclusion

Microfinance leaders have developed a suite of techniques in product design and management that solve the business problems of controlling costs, building volume, and keeping repayment high in countries with weak infrastructure and human capital. Most of these techniques were invented, others stumbled upon. Through a process of selection, the strategies came to the fore for what were predominantly business reasons—the MFIs that followed them became “success stories” in a commercial sense, growing large.

Lending to women is a case in point. In Bangladesh, the focus on women in group lending arose through a process of experimentation in the late 1970s at what became the Grameen Bank, as the institution discovered that women were easier to work with in rural Bangladesh. Some Grameen replicators are probably unaware of this history and see themselves as lending to women purely out of reasons of social mission. The ubiquity of credit itself, as opposed to savings, seems to have arisen for practical reasons, yet some now call it a human right.

Our focus in this report has been on commercial success. But hardly a dollar goes into microfinance that is not motivated in part by the desire to help the poor. True success is contributing to development. Commercial success is a distinct notion, but the findings of this report about commercial success have implications for thinking about the success of microfinance in the broader sense.

To understand why, one needs to appreciate that how much microfinance helps people is a complex and unsettled matter. It is natural to view the growing clientele and high repayments of MFIs as signs that microfinance must work—that fears of debt traps are overblown. People are voluntary partaking of it, and must be doing something right if they are able to repay. Even if they are not investing the loan monies in enterprises with returns that cover the interest cost, they may be using the funds to smooth consumption—a technical term that means having enough to eat on more often. Moreover, growing availability of high-quality financial services, like health and education services, is clearly part of economic development. To the extent that enriching the financial fabric of a country is development, the commercial success is almost automatically true development success. Certainly, institutions such as BancoSol, Grameen, and BRI are remarkable for their scale and dynamism.

Yet similar things might be said for moneylenders—people have used their services for millennia—or even tobacco companies moving into developing countries. These analogies are explosive and may be inapt. But they demonstrate the logical shortcoming of equating patronage with success—especially for microfinance investors who define success as direct benefits for clients.

This ambiguity argues for direct, rigorous evaluation of the impact of microfinance. The need for good evaluation of development projects such as microfinance is not news. What seems underappreciated, however, is that rigorous evaluation of how microfinance affects the poor (which differs from evaluation of how poor microfinance clients are) is rather scarce.<sup>105</sup> There are several reasons for this. First, rigorous evaluation is technically difficult and expensive. Presented with a prospering microcredit client and a struggling non-client, one could explain the difference in many ways. The MFI may have selected villages or slums, or people within them, that seem most promising. Or selection may operate on the client side, with the more prosperous

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<sup>105</sup> For a thorough review of the impediments to rigorous evaluation and a proposal for removing them, see “When Will We Ever Learn? Improving Lives through Impact Evaluation,” Report of the Evaluation Gap Working Group, Center for Global Development, Washington, DC, 2006.

more likely to borrow and the less prosperous more likely to stay away—or drop out after trying it, thus disappearing from the evaluator’s radar.<sup>106</sup> Rigorous evaluation distinguishes these stories from the one of interest, that microfinance is contributing to the prosperity of the client. That turns out to require extensive data collection, such as survey of hundreds of client and non-client households, and, ideally, a randomized implementation of the microfinance program studied, in order to rule out the possibility, say, that the MFI is focusing on villages or neighborhoods where people are already better off.

Another disincentive is that a rigorous evaluation is a “public good”: its costs are borne by a few institutions even when it benefits the entire microfinance community. If the institutions funding the evaluation are unlikely to reap most of its benefit, they are less likely to fund it. This might seem a strange assertion given that most of the backers of microfinance are in it for the public good; seemingly, aid agencies and foundations should be eager to generate knowledge on what works. This brings us to the third barrier to evaluation: incentives within funding agencies and MFIs. In general, people within these bodies feel they have more to lose from an unfavorable evaluation that they have to gain from a favorable one.

The upshot, from a decade or so of microfinance evaluation, is a handful of high-quality studies. The chapter on impacts in the 2005 textbook, *The Economics of Microfinance*, by Armendáriz de Aghion and Morduch, essentially finds two, both of group lending.<sup>107</sup> One, done in Northeast Thailand, found few statistically significant signs of impact of village banking, except among borrowers on the banks’ organizing committees. One explanation is that only these connected borrowers obtained loans large enough that they could reasonably be expected to make a difference.<sup>108</sup> The other study is based on surveys of 1,800 households in Bangladesh carried out in 1991–92 and 1998–99, with backing from the World Bank. It finds that microcredit for women increased their incomes by 5 *taka* for each 100 lent.<sup>109</sup> Thus a \$250 one-year loan would raise a borrower’s income by \$12.50/year, or about \$0.03/day. For someone living on \$2/day, that is a 1.5% increase. This is a modest, positive impact. But if the financing cost for the donor is more than 5% per annum of loan value, direct transfers might be more efficient.<sup>110</sup>

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<sup>106</sup> A common variant on this scenario is a comparison of long-time clients with those just starting in a microfinance program, who are taken to proxy for non-clients. For a critique of the method, see Dean Karlan, “Microfinance Impact Assessments: The Perils of Using New Members as a Control Group,” *Journal of Microfinance* 3(2), Fall 2001, pp. 75–85.

<sup>107</sup> Armendáriz de Aghion and Morduch, op. cit. note 53.

<sup>108</sup> Brett Coleman, “The Impact of Group Lending in Northeast Thailand,” *Journal of Development Economics* 60 (1999), pp. 105–42.

<sup>109</sup> Shahidur R. Khandker, “Microfinance and Poverty: Evidence Using Panel Data from Bangladesh,” *World Bank Economic Review* 19(2), pp. 263–86. 5 *taka* figure is from the distillation in Armendáriz de Aghion and Morduch, op. cit. note 53. An earlier paper also belongs in the canon of rigorous studies, but is based only on the 1991–92 survey and is essentially superseded by the Khandker 2003 pa51 Mark Pitt and Shahidur Khandker, “The Impact of Group-Based Credit Programs on Poor Households in Bangladesh: Does the Gender of Participants Matter?” *Journal of Political Economy* 106(5) (October 1998), pp. 958–96

<sup>110</sup> Freedom from Hunger has also commissioned high-quality and encouraging studies of its methodology, which packages credit with basic education in health, nutrition, and business management. But it is impossible to determine whether credit per se is helping, beyond its ability to bring groups together for teaching. See Barbara McNelly and Christopher Dunford, *Impact of Credit with Education on Mothers and Their Young Children’s Nutrition: Lower Pra Rural Bank Credit with Education Program in Ghana*, Freedom from Hunger, Research Paper No. 4 (Davis, CA: Freedom from Hunger, 1998), and idem, *Impact of Credit with Education on Mothers and Their Young Children’s Nutrition: CRECER Credit with Education Program in Bolivia*, Freedom from Hunger, Research Paper No. 5 (Davis, CA: Freedom from Hunger, 1999).

Many in the microfinance world recognize that the evidence of positive impact is not as solid as all would like. But this is nevertheless a contentious assertion. It gains credibility, though, from the observation that commercial imperatives can explain so much about microfinance. For example, if the emphasis on women in group lending grows out of their greater susceptibility to peer pressure, then the burden of evidence rises for those arguing that it helps them too.

None of this means that microfinance should be written off. More good studies are needed, not least of individual lending, and of services other than credit. Researchers could also put more energy into the more mundane but too-often overlooked task of measuring the investment returns that microentrepreneurs earn and comparing those to the interest they pay.

For commercial banks, nontraditional entrants into microfinance, there are some important twists to this general caution. First, if the evidence of benefit is weak, there is a risk that public perceptions of microcredit could flip; the rhetoric of empowerment might even give way to that of enslavement, as it did in the Jubilee 2000 movement to cancel the debt of poor nations. Once, the donors who made those loans were the “good guys” in public perception. Today, there are signs of such a challenge to microcredit in Andhra Pradesh, Bolivia, and elsewhere. The new Bolivian president, for one, called for sweeping debt forgiveness.<sup>111</sup>

Second, it is not necessarily optimal for banks to copy methodologies developed by non-banks. In particular, to the extent that the traditional emphasis on credit is an adaptive response to the difficulty that NGOs face in taking savings, rather than the demonstratively superior way to relieve the capital constraints of the poor, banks should not continue the tradition unquestioningly. They should seriously consider a greater emphasis on savings. The government-controlled BRI, recall, had 32.3 million micro-deposit accounts to 3 million loan accounts at the end of 2005. Banks have a competitive advantage in savings. And unlike with credit, there seems little reason to worry that savings could harm some clients. It can smooth consumption too and generate income, without the risk that comes with leverage.

All investors in microfinance, by which we mean all those who put money into it, public or private, through grants, loans, or equity, need to understand the distinctions between the two kinds of success, financial and social. As always, “double bottom-line” investors need to ask tough, healthy questions of the MFIs they support about both kinds of success. In other words, they should understand how MFIs succeed as businesses, and seek good evidence on how they help people—funding collection of the latter if it is lacking. The two kinds of success are related, but distinct, and should not be confused.

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<sup>111</sup> Elizabeth Littlefield, President, CGAP, keynote speech at conference on Access to Finance, World Bank, Washington, DC, May 31, 2006.

## Appendix. Experts Interviewed

Vikram Akula CEO SKS Microfinance India	Carlos Labarthe Co-CEO Compartamos Mexico	Moumita Sensarma VP, Head of Microfinance and Sustainable Development ABN AMRO India
Robert Annibale Global Director, Microfi- nance Citigroup	Levan Lebanidze Executive Director Constanta Foundation Georgia	Lokesh Kumar Singh Lead Manager SKS Microfinance India
Deborah K. Burand Executive Vice President Grameen Foundation USA	Elissa McCarter Director, Office of Develop- ment Finance CHF International	Gabriel Solorzano President FINDESA Nicaragua
In Channy General Manager ACLEDA Bank Cambodia	Kate McKee Director, Microenterprise Development office USAID	Damian von Stauffenberg CEO MicroRate
Paul Christensen President ShoreCap Management	Ann Miles Director Blue Orchard	Sebastian von Stauffenberg MicroRate
Ganhuyag Chuluun CEO XacBanc Mongolia	Jonathan Morduch Professor New York University	Blaine Stephens Senior Analyst Microfinance Information eXchange (MIX)
Gil Crawford General Manager MicroVest	Didem Rastgeldi Operations Manager Maya Enterprise for Microfi- nance Turkey	Brad Swanson Partner Developing World Markets
Martin Holtmann Lead Microfinance Specialist CGAP	Beth Rhyne Senior Vice President Acción	Gary Woller President Woller & Associates
Jennifer Isern Lead Microfinance Specialist CGAP	David Schwarzbach Vice President, Business De- velopment Net1 UEPS Technologies	Flavio Weizenmann Senior Vice President Banco Real Brazil
Gautam Ivatury Manager, Microfinance Technology Program CGAP		