Sustainable Microfinance

As the goal to eliminate poverty moves from dream to reality, microfinance institutions struggle with the question of sustainability. How should they manage their funds to ensure lasting access to the poor but still make profit to expand their outreach? Maria Otero and Jonathan Morduch, experts on the business of microfinance institutions, pose two perspectives on how to create lasting sustainability.

Otero believes that microfinance institutions must have economic vitality in order to make a real and lasting impact on the world’s poverty—economic stability brings permanence and profit. She outlines the necessary characteristics institutions must have and the challenges they face in becoming and staying economically viable.

Morduch agrees that profitability is critical, but suggests that subsidies can play an important role. He appears to be at odds with Otero because the subsidy model seems to contradict the profitability model. Morduch addresses the major concerns of using subsidies, but gives strong evidence that they can drastically help the microfinance effort—the question is, when?

These authors share their ideas of achieving sustainability with hopes that their comments will spark new ideas from individuals and institutions—bringing this dream closer to fruition.
Last November I met a widow of ten years in Arusha, Tanzania. Intent on providing a better life for her children and surviving as best she could, she had started a business selling rice soon after her husband died. Sophia has little education, but with a first loan of $50 she purchased a few kilo bags of rice for on-selling to retailers. Now, many loans later, Sophia’s business employs several people and sells considerable quantities of rice, ground nuts, and beans.

Set in a gritty, dusty, run-down street, Sophia runs her business out of her house, which clearly required the addition of a couple small rooms. In the inner courtyard of her house, an elderly woman cleans the rice by passing it through a homemade tin strainer. The 150-kilo bags of cleaned rice stack floor to ceiling, filling two rooms. Each bag is carefully weighed in an old scale and divided up into smaller bags. Two young male employees deliver these bags throughout the city, carrying them in ancient, wooden, hand-pulled wagons. Sophia’s two daughters are at a university, and she also takes care of her aging, invalid mother and aunt, both of whom I met.

Sophia’s humble story, at first, strikes little interest in a passerby. However, played out over and over again in markets, slums, barrios, and villages around the world, it shines as a compelling and inspiring story of resolute perseverance, of the power of the human spirit, and of the dignity of so many people struggling to escape the enduring grasp of poverty.

The lesson we all draw from Sophia’s story is that very good things happen when small amounts of capital are placed in the hands of hardworking poor people. The dream we draw...
from Sophia’s story is about creating systemic change around the world, one in which we would rebuild the financial systems that have for decades exclusively benefited and protected the wealthy so that they serve the impoverished majorities, help lift them out of poverty, and make them full participants in their country’s social and economic development. That is the dream.

I don’t need to give you data about poverty around the world—we are well versed. We will see many more entrepreneurs like Sophia in the coming years. They will be running their tiny businesses to survive, to support their families, and to educate their children; for these purposes, they will seek financial services. Microfinance has proven that the poor of the world are credit worthy; they make productive use of loans to improve their personal lives and that of their families with the added income. In the next ten years, our task is to ensure that the millions of men and women currently excluded from the financial system because of their economic situation have access to financial services. But how do we get there? Let us first look at where we are.

Let me use this time to explore three key questions: (1) What is the starting point in microfinance to guide us through the next ten years? (2) What developments can we expect by 2015? and (3) What do we need to have in place to reach our goal? I will focus on what channels we use to extend financial services (the institutions), who we will reach (the market), what innovations we will need, and what role governments will need to play.

My primary point of reference is my experience with ACCION International. Permit me to give you a brief sketch. ACCION made its first loans in 1973 in Brazil, and has spent the last three decades developing a model for microfinance with two characteristics: the capacity to reach massive numbers of poor people and the reliance on self-sustaining institutions. ACCION’s work is done through a network of microfinance institutions, many of which ACCION created from scratch. It began in Latin America, spread to Africa around 2000, and now affects the global community.

The approach ACCION applied led to the creation of the first self-sufficient microfinance institutions and then, in an effort to capture private capital to grow their lending, to the first transformation of a nonprofit organization into a commercial bank, BancoSol in Bolivia. Many organizations in the ACCION Network—for example, Mibanco (Peru) and Compartamos (Mexico)—and others outside the network—for example, KREP (Kenya), BRI (Indonesia), and SKS (India)—have followed this model of operation. For ACCION this model has led to enormous growth in the number of poverty-level borrowers. For example, the ACCION Network has added over one million clients in the last four years. It took two decades to build a clientele of 450,000 (2000), and now we’ve expanded to 1.5 million (2004). We plan to at least double this number in the next three years.

ACCION’s International Network today comprises twenty-six MFIs in twenty-two countries—some of which are the leading institution in their respective country. ACCION’s USA Network operates in over thirty cities in the United States. ACCION also provides technical assistance; we have a team of over sixty people, and we manage two investment funds that invest equity in microfinance institutions that transform into banks.

ACCION’s experiences and the accomplishments of its partners, along with other leading microfinance institutions, indicate what can happen in the next ten years—and I emphasize here the leading institutions. We hear that there are somewhere between seven and ten thousand institutions, but, in fact, only about one hundred fifty or two hundred of them are doing the heavy lifting and are considered the industry leaders.

Let me focus for a moment on these microfinance institutions because they are central to our story; without them we have nothing more than transitory efforts and good intentions. The microfinance effort initially used donor funds to experiment and launch programs. Now we are at the point where in some countries—like Bolivia, Peru, Ecuador, and Kenya—these MFIs rank among the most effective and efficient formal financial institutions that specialize in reaching the poor.

While each country’s market has unique characteristics, microfinance, at its best, is defined by a set of common attributes that serve as the starting point for the next ten years. These attributes correspond to what is now referred to as the commercial approach to microfinance.

If microfinance institutions want to make a real impact, they have to be permanent; and in order to be permanent, they must be...
economically viable. Why is economic viability so vital? Just look at the scale of the problem. The poor make up the majority of the world’s population. Logically, the only way to address such a massive problem is to mobilize an equivalent amount of economic firepower. The only place where that economic firepower exists is in the financial markets of the world because they represent the savings of the world, the private capital. And the only way to connect to the savings of the world is to implement a commercial model that can access this capital on a continuing basis.

The most poignant argument for the permanence of microfinance institutions was defined in my conversation with five women from a solidarity group in Lima, Peru. Our affiliate, Mibanco, now a commercial bank, had operated as an NGO since 1979. A few years ago, I asked to meet with some of its long-time borrowers; I met with these women, who received their first loans in 1980. We gathered in the market where they work; each woman has a stall and makes food to sell. One woman had expanded her resources to include two stalls, a refrigerator, and a chicken rotisserie oven. The others had grown but not as much. They each expressed, however, the comfort they felt having had a steady source of income for the past twenty years. Most importantly, all their children were at universities or technical schools! What peace of mind it gave them, what hope and plans for the future; their lives were changed forever. This is why permanence of institutions is essential—running out of money to lend or being sloppy in the management cannot happen. Otherwise, these five women and the thousands like them would return to lives of poverty and misery.

The microfinance institutions responsible for this intermediation operate under general charters established by the national banking or financial authorities that are in charge of all financial institutions in their respective countries. Many of them—dozens—have converted from NGOs to commercial financial institutions. Their operations take place under the oversight of the national banking or financial regulatory and supervisory authorities, and their data is completely transparent and accessible to the public.

I will highlight four of the many common traits shared by these leading microfinance institutions.

**Understanding**

They understand their market and know how to develop products that are useful to it. They consider not just the microenterprise but also the financing needs of a poor household, and they develop financial products that include savings, home improvement loans, insurance, money transfers, and small consumer loans. This is why they have grown at a consistent and often dramatic rate, which they aim to maintain.

**Self-Sustaining**

They have a history of being self-sustaining, using income earned from their financial services to cover costs and to generate a profit; this profit, and access to the capital markets, allows them to grow. For example, Compartamos, our affiliate in Mexico, added one hundred thousand new clients in 2004 alone—how did they...
do this? They plowed their earnings back into the institution, and they issued paper on the local Mexican market, based on their sterling performance, which generated almost $50 million in funds to on-lend to that clientele.

Competitive

They have learned how to operate in competitive environments. In more and more countries there are several microfinance institutions competing for the same borrowers. We see this in Bangladesh, Bolivia, Uganda, and Nicaragua, to name a few.

I’ll give you an example that illustrates why this competition is beneficial. When ACCION started in Bolivia in 1986, a very poor woman, who sold onions, applied for a loan and asked incredulously, “You mean if I pay this loan back you will give me another?” Today, that same woman can choose between several institutions, comparing products, interest rates, and other benefits. She now chooses which institution works best for her.

Competition also makes institutions more efficient; they seek to lower their costs and, therefore, their interest rates to the borrower. Data from several countries in Latin America show that with competition the annual interest rate to the borrower has steadily decreased. The rate at BancoSol, for instance, decreased from 70 percent in 1992 to just over 20 percent today. The data also show important innovations in the use of technology and other means to lower costs.

Affordable

Their late payments are maintained at a very low level, usually below 5 percent, regardless of growth. These microfinance institutions also set aside a reserve, or provision, against bad loans. Some are as high as 100 percent of their late portfolio. Finally, for most, repayment over the years remains above 97 percent.

Advancing microfinance to its current state is, under any measure, an outstanding achievement. This achievement has been accomplished by the leading microfinance institutions of the world. I have placed my focus on these institutions because the future of microfinance will be built on the quality of the MFIs we develop today.

Now let’s look ahead. The success that I have outlined has opened the way for a series of events that have the potential to significantly alter the microfinance industry and create explosive growth in the coming years. Principal among these are:

1. The leading microfinance institutions have fueled their growth by constantly expanding their access to more and more commercial sources of funds. In the next decade, some of them will complete this process. BRI in Indonesia has already completed the next step: it issued the first IPO of an MFI. Others will issue bonds in their local markets, as several have already done in Latin America. We will see more microfinance institutions follow their lead, relying on the local and international capital markets to build their institutions. And we will have an explosion of interest from private capital, especially social investors from North America and Europe who wish to invest in microfinance.

2. Additional microfinance institutions will join the two hundred leading ones as the lessons of good transparent performance are learned and applied. Some of these will continue to operate as NGOs and play the role of pioneers and innovators—for example, by working in very remote areas or experimenting with self-sufficient models that may include education or health service delivery.

3. Conventional banking will enter the microfinance field. Being completely ignored in its early days, microfinance has emerged as a segment that conventional banking is beginning to study from a commercial perspective. Many banks are losing their current markets to international banks, and are seeing that microfinance’s record is very good and that microenterprises are very resilient during economic cycles and political and financial crises.

They are reading about the fortune at the bottom of the pyramid. In preparation for the Microcredit Summit in Chile and the plenary speech I’ve been asked to deliver there, ACCION interviewed over thirty key players in microfinance in that region—all but one believe that the banks will become important players in Latin America within the next ten years.

The banks’ large infrastructures, internal systems, and capital make them very capable of expanding microfinance rapidly. Banks will find different models to become involved. ACCION developed one model that creates a separate private company that operates much like a microfinance institution but uses the bank’s
capital and systems. In Haiti, Ecuador, and Brazil, we tested our model in several large banks; with this model they are reaching poor and very poor borrowers. Other large banks in Africa and India are becoming similarly active in microfinance.

4. The dominance of today’s microfinance leaders will be sustained only if these institutions can develop a set of abilities which, by and large, they do not possess today. They will face more competition, consolidation of microfinance institutions, the entry of banks, and the need to maintain high performance over time. To be prepared for such situations, they will need excellent governance and management that will avoid the complacency of success and will continue to evolve and improve. More importantly, they will need to remain focused on who they are trying to reach—the poor and the very poor.

5. Two new key and massive markets, to date not significant in the development industry, will open to microfinance—China and India. The sheer size of these countries carries with it the potential to affect the whole microfinance industry in ways that are complex and not readily discernible. Success will hinge on the application of the lessons of successful microfinance: they understand their market; they price their loans to cover their costs and yield a profit; they keep their costs low; and they think about long-term survival.

These advances raise important challenges for the different players in microfinance.

**Government Involvement**

The role of governments is to develop a regulatory framework that facilitates the growth of microfinance. The work to be done in this area is enormous. When one considers that the development of a good regulatory framework in Uganda—which is leading to the transformation of FINCA Uganda, UMU, and other NGOs—took six years and the full-time presence of two excellent German consultants, the outlook is discouraging. Regulatory and supervisory work has been left in the dust by the dramatic growth of microfinance and urgently needs to catch up. This requires building awareness, lobbying, drafting the regulatory norms, and equipping supervisory agencies to provide good oversight—it is a huge job.

Governments can negatively interfere by making microfinance part of their political campaign, a practice appearing in most campaign promises now, unfortunately. Governments may insist on directly lending themselves or make policy decisions that adversely affect microfinance by setting ceilings on interest rates.

**Industry Shakeout**

More microfinance institutions will apply the lessons of the leading institutions or they will gradually run out of funds to lend. If donors continue to provide soft funds to finance portfolios, weak institutions will continue to survive. In small countries like Nicaragua, where there are over one hundred microfinance institutions, we will likely see more mergers and purchases of portfolios.

**Collective Wealth of the Poor**

BRI has been a global pioneer in mobilizing savings, demonstrating
both the great need and the magnitude of the collective wealth that can be unlocked with appropriate savings, products, and distribution channels. Several members of the ACCION Network are covering half of their $100 million portfolios with deposits. Most Latin American institutions have been far less successful at mobilizing savings and can learn a lot from their Asian and African counterparts.

**Innovation**

Growth in new products and in the use of technology will explode. Credit cards, smart cards, and others will be added to the list of products. We will use technology to add point-of-sale systems, to make the administrative work of the loan officers more efficient, to transfer information, and to lower costs even more. This is a very exciting development in the coming years.

**Conventional Bank Outreach**

While they have many advantages, conventional banks face significant barriers in reaching a market they have formerly excluded or ignored. They lack information, they suffer from deeply-rooted cultural preconceptions regarding the poor, and they lack the methodology to lend with no collateral. Banks will do well to form partnerships and proceed hand in hand with well performing microfinance institutions.

**Donor Participation**

As part of their millennium development goals, donors will continue to be essential players in microfinance. They provide resources to develop the institutional capability necessary for microfinance. Today, there are many countries that lack even one strong microfinance institution. The donors need to help build this capacity, using the lessons we know work.

The task will continue to be enormous and will require the open hands, the committed spirits, and the restless brains of many of us. Our vision is grand and it may require new ways of operating and new ways of thinking. We must heed this advice: Do not be afraid to reinvent yourself along the way, but remain steadfast and unwavering in the mission of helping lift the poor out of poverty.
ABOUT THE AUTHORS

Maria Otero serves as the president and CEO for ACCION International. She joined ACCION in 1986 and was executive vice president for eight years before assuming the role of president. Otero chairs the MicroFinance Network and co-chairs the Microenterprise Coalition. She sits on the boards of the Calvert Foundation and the U.S. Institute of Peace, and is an adjunct professor at the Johns Hopkins School for Advanced International Studies. Otero has worked with the Inter-American Foundation, CEDPA, the U.S. Agency for International Development, the World Bank, and Bread for the World. She is coeditor of The New World of Microenterprise Finance and has written numerous articles. Otero holds master’s degrees from both the University of Maryland and Johns Hopkins University.

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