In Search of “Sound Practices” for Microfinance

by Christopher Dunford

ABSTRACT: The notion of “best practices” for all microfinance is challenged in favor of “sound practices” that are appropriate for particular organizational strategies and situations. A simple conceptual framework is offered to facilitate understanding of the current diversity of experiments with product-market pairs (e.g., group-based lending to poor women struggling to earn enough for family survival). Since the microfinance movement is still in a mode of intensive learning, we should not presume too soon what will be “best” for all product-market pairs. We can expect to discover a somewhat different set of sound practices for each distinct product-market pair.

Many microfinance practitioners are committed to sustainable institution building but refuse to be satisfied with the current notion of “best practices.” Proponents of best practices have often seemed unconcerned about impact. While they may care deeply about impact, they seldom talk about, much less measure, progress toward their ultimate development objectives. To talk of best practices without reference to impact objectives begs the question: best for what? Why are we doing all this microfinance? The only explicit concern in most of the best practices writing has been to foster financial sustainability of institutions that provide financial services to people who have a tough time getting services
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from the traditional providers, like banks. Concern for the very poor, which was driving the pioneers of the microfinance movement, very often gets lost somewhere along the way.

I have found this to be an exceedingly difficult message to get across without generating a lot of misunderstanding and dismissive responses. “He’s just stuck in the old charity paradigm.” With much help from fellow travelers down this difficult road, I’ve learned a few things that may help the message be better understood.

Hans Dieter Seibel of Germany’s Cologne University (and now IFAD, the International Fund for Agricultural Development in Rome) writes that there is no such thing as “best practices” in microfinance, because the adjective “best” implies that we have found the optimal way of doing things. But this is not likely in a newly emerging field in which there is still a lot to learn. Seibel says, however, there can be “sound practices” that are appropriate for particular organizational strategies and situations.

This bears repeating: There can be practices that are sound for particular organizational strategies and situations. Given the great diversity of microfinance organizations, strategies and situations, there cannot possibly be a unitary set of best practices, only diverse sets of sound practices. This diversity is still waiting to be fully explored and articulated. The microfinance movement needs to remain for some time to come a “learning organization” or a movement of experiments in sound practices geared to the different organizational strategies and situations.

I’ve spent the past ten years trying to sort out the pieces of the current experiments in sound practices. The conceptual framework I’ve come up

Christopher Dunford is president of Freedom from Hunger. This article is taken from a presentation made to the 2nd Annual MicroEnterprise Conference “Investing in the Poor” held at Brigham Young University, Provo, Utah on March 26–27, 1999.
with is very basic, but sufficient perhaps for taking our thinking back to basics (see the figure below).
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There are four components of every one of these experiments: an institution, a product or service, a market or customers, and a development impact.

Private sector business is focused on the institution, whether or not it is profitable and therefore financially self-sufficient. A for-profit institution may be built around a particular market or a particular product, but as it grows, it diversifies its products and markets. It may eventually abandon the products and markets that gave the institution life in the first place. The institution is like an organism, whose behavior must focus on self-preservation through growth and change. The development impacts of this institution are incidental, perhaps minimal, perhaps enormously good, perhaps enormously bad, but mostly unintentional.

On the other hand, development programming is focused on the development impact. It defines its impact very intentionally in terms of a particular market, like a geographic area, or certain communities, or classes of families or individuals who are to benefit from the intended impact. Products are designed specifically to produce this impact. An institution is created to make and distribute these products to have this development impact on this market. The notion that the market for these products can generate revenue to sustain the institution financially is a relatively new one. Even so, the institution is supposed to remain committed to this development impact for this market, regardless of the market’s willingness and ability to pay for the product.

Microfinance started in the “development programming” mode. It created or rediscovered a new product—lending to joint-liability groups—to achieve a variety of mostly unspecified welfare impacts for the poorest of the economically active poor. Upon realizing that the very poor could and would pay handsomely for credit, almost any kind of credit, the prospect of building financially self-sufficient institutions became an active goal. This attracted those who welcomed the opportunity to show
that development programming could function as efficiently and as free of donor support as private sector business. They have created “best practices” designed to complete the transformation of microfinance into the private sector business mode. In that mode, microfinance institutions are already growing and diversifying their products and markets in pursuit of self-preservation, even when that means abandoning the product and market that gave microfinance life.

The obvious but difficult solution is to find a middle ground that allows microfinance to be both focused on the institution and on development impacts.

Here is where we have to be a learning movement, experimenting with sound practices. The focus of these experiments must be on products and markets. Products are nothing without markets; markets are defined by the products they buy. Institutions depend on product-market dyads or pairs that generate more revenue than cost. Development impacts depend on product-market pairs that generate more benefit than cost. A productive partnership will be one in which those of us oriented to institutional sustainability experiment with a variety of product-market pairs to see which ones can be profitably delivered. And those oriented to development impacts should experiment with a variety of product-market pairs to see which ones can yield specified development impacts. Donors and social investors seeking specified development impacts can provide incentives to both orientations to work in coordination, so that both are experimenting with the same set of promising product-market pairs.

Notice that this approach calls for everyone to be very clear, very explicit about their objectives. The institution-oriented people need to do careful operations research to test the profitability of different market-pairs in various institutional and economic situations. The development-oriented people need to do careful cause-and-effect research (that means
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science) to determine the impacts of the different product-market pairs in various social and economic situations. In combination, the results of this work should produce a set of sound practices for each viable product-market pair.

The abstract way I have presented this scenario may make it sound like pie-in-the-sky. But this process is already happening—it is well under-way. We need to encourage rather than suppress it. Most of all, we need to be broadminded and honest, with ourselves and others, about our ori-entations, objectives and our appropriate roles in the bigger picture of the microfinance movement.

Already evidence has been acumulated for sound practices regarding certain product-market pairs in microfinance:

• If you seek economic growth, export growth, sector or subsector development, your credit products had better be appropriate to corporate or otherwise good-sized businesses. That means more traditional lending products, such as capital equipment and working capital loans and business lines of credit.

• If you want to lift large numbers of people out of poverty through increased farm output, nonfarm enterprise development, and resulting job creation, you had better target your credit services to well-organized, even if small, livestock and agriculture operations or nonfarm manufacturers, wholesalers, and even mom-and-pop retailers. That probably means agricultural input credits or small business loans to individual farmers and entrepreneurs.

• If you want to relieve the crushing burden of poverty through improved food and nutrition security, public health improvements, women’s empowerment, or child health and education, your credit package should be designed for family survivalists, by which I mean people doing something—anything—to earn a little income
to keep their families alive. Untargeted lending through joint liability groups seems to work well for these very poor people.

There is no inherent reason why these multiple products cannot be offered to these multiple markets by one and the same institution seeking self-preservation and yet generating development impacts. However, some product-market pairs will have higher profit margins than others, and some institutions are better structured than others to operate as going concerns with lower profit margins. Some even are very capable of tapping into reliable sources of partial subsidy for many, many years running.

Granting that microfinance practitioners know a great deal already, we nonetheless are still in a phase of intensive learning. It is too soon to make hard and fast conclusions about what will be “best.” We can make good estimations only of what will be “sound” and then see if we’re right or wrong.

References