



Obama Calls Out Microfinance

Taking the Measure of Microfinance

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President Obama has called out the microfinance industry. “A free market was never meant to be a free license to take whatever you can get, however you can get it.” ([The Independent](#), April 23, 2010). Speaking this past week to Wall Street bankers, his remarks could as easily apply to the profiteering merchants of microfinance.

Recently the New York Times published “Big Banks Draw Big Profits From Microloans to Poor.” ([N.Y. Times](#), April 13, 2010).

Just two weeks earlier, I heard Nobel Prize Laureate [Professor Muhammad Yunus](#), founder of the modern microfinance movement, scold 1500 microfinance leaders from 81 countries at the Global Microcredit Summit in Nairobi, Kenya, “Microfinance is not about making money from the poor. Some have not gotten the memo.”

Has microfinance, which proudly boasts financing millions of tiny business loans around the world, lost its way? Are a few bad actors tarnishing the movement? Are there structural flaws fatally at play?

One thing is certain: the drumbeat of review, evaluation, critique and criticism is just getting started. Microfinance leaders who think they can continue to hide behind the skirts of hard-working women in the Third World are counseled to reconsider.

The critics now smell a whiff of hypocrisy and the odor of malfeasance. For example, press and internet stories now regularly criticize [KIVA](#), a popular microfinance internet platform, for hiding its operational model or covering up critical facts about its overseas partners. It is as if KIVA – once a media darling – is being accused of selling rugs made with child labor under the guise of promoting jobs in the developing world.

As captured by the NY Times piece, microfinance stands accused of being exploitive and predatory, charging exorbitant microloan interest rates to ignorant, desperate women and amorally misusing marketplace mechanisms to promote economic opportunity without full disclosure to either the poor or to financial donors and investors.

The truth about microfinance undoubtedly lies somewhere between predation and panacea. Authoritative studies are infrequent. To attract donor and investor dollars, over-simplified hype abounds. As with any field experiencing rapid growth, charlatans and carpet-baggers appear along with responsible microfinance practitioners.

Both to correct abuses and to document its many benefits, microfinance deserves greater scrutiny. Let the scrutiny be patient, methodical and thoughtful – not the shrill voices of the uninformed, the ideological or the politically correct.

What follows is a summary of the major allegations against microfinance and, for each, my own viewpoint and perspective. Share my values or not, what are yours?

1 - Microfinance does not lift people out of poverty. The overwhelming majority of micro-borrowers remain enmeshed in poverty, debt and despair.

Microfinance is not a poverty silver bullet, not the next Industrial Revolution and not a cure-all for 10,000 years of economic and gender discrimination. “Poverty is much too complex to be cured by one intervention. We don’t ask if basic education alone ends poverty. We don’t ask if vaccinations alone end poverty. Why should microfinance be held to the standard of single-handedly reducing poverty?” notes Sam Daley-Harris, head of the [Global MicroCredit Summit](#).

Acknowledging that microfinance is hugely guilty of hype, hubris and deplorable short-hand marketing slang, we should ask what can realistically be accomplished with a small business loan for a single woman with 5 kids living on a \$1.00 per day? Let’s say she is illiterate and 35. And life expectancy in her country is 50, even 55. Within her remaining 20 years, how much money must she earn to “lift herself out of poverty”? Get real.

The impact is improved quality of life. A 20% increase in the income of a woman living on \$1.00 a day, a measly 20 cents per day, may not be enough to lift her out of poverty in an economic sense. But I’ve seen for myself how it lifts her out of despair.

2 - Microloan repayment rates by the impoverished are undeniably impressive, but repayment rates alone say next to nothing about microfinance’s impact on reducing poverty.

For the most desperately poor, microfinance is an urgent engine of economic survival. But microfinance, by itself, is not a universal remedy for poverty.

No one would accept living in a community with bad schools, little healthcare, no electricity and filthy water – but with a great bank. Best practices in microfinance must be about more than money and include other social services, like education, health, clean energy finance, etc. For organizations like [BRAC](#), [Freedom from Hunger](#), [Grameen](#), [Global Partnerships](#) and [Pro Mujer](#), best practices are already the norm.

For those microfinance programs who still limit themselves to just banking services for the poor, monetizing the poor may simply be creating more profitable chattel, not creating lasting economic development. The notion that the absence of financial services is the only structural condition of poverty is warped.

An often overlooked financial fact of life is that solid repayment rates are why microfinance programs can become self-sustaining and that, in and of itself, is a remarkable achievement in economic development. Repayment rates are important because they speak to financial viability and moving away from dependency on Western donors, not as a substitute for true poverty alleviation.

3 - What the poor really need are savings accounts, not more and more debt.

For the poor life is “fragile, cheap, dangerous and unpredictable.” (Michael Holman, [Last Orders at Harrods](#)). In lieu of health insurance, social security and other safety nets, the poor need safe places to keep their money to cover life’s uncertainties.

A useful and clear-eyed book about the lives of the impoverished, [Portfolios of the Poor](#), documents that poverty is the tyranny of the unexpected, the unknown. It means not having money, but also not having it when you need it. Earning a \$1.00 a day may mean days without any income at all, and then finally a payday.

But are credit and savings mutually exclusive? The choice is no choice at all. Not savings or credit, but both.

4 - Microloans are touted for financing grassroots businesses, but in reality the poor are misusing microloans for consumption and other non-productive uses.

Should microloans pay for TVs and other materialistic purchases? Microfinance provides the poor with money to start businesses, pay medical bills, cover marriage costs, put up a fence or even – oh, such a sin – buy a bit of entertainment. It is the credit card most of us carry and use every day.

Some micro borrowers, like people everywhere, will fail financially, misuse funds, make bad judgments, spend money with their hearts, etc. Empowerment starts with the poor making decisions over their own financial affairs.

To state the obvious, poverty is the absence of money. Of course, the poor use microloans for non-business purposes. Money is fungible. Businesses borrow from multiple lenders for multiple purposes all the time. Are we paternalistically presuming that the poor should not?

As microfinance has expanded, the poor, it is said, are incurring a measure of over-indebtedness and falling into a kind of microfinance debt bondage. Local MFIs, like lenders everywhere, need stringent client selection criteria, but the poor don’t need

Western debt wardens to monitor over-indebtedness, to police the use of loan money or to treat them like children with an allowance. Indeed, as pointed out in *Portfolios of the Poor*, the impoverished are expert financial managers, as they must be to survive.

5 - What the poor want and really need is a job.

With 3 billion people -- nearly half the planet – still in poverty, it is perhaps sophomoric to note there are different levels of impoverishment.

According to the industry trade group [IAMFI](#), the unmet need for microfinance is \$265 billion (yes, billion). At its best, microfinance targets the very poor struggling on \$1.00 per day. Miles from the formal economy, urban markets or global trade routes, these are the self-employed who comprise 70% of the world's poor.

Even more desperately deprived people need business grants like those provided by [Trickle Up](#). Or, savings programs like Oxfam's [Savings for Change](#).

The “better off” poor (perhaps urban slum dwellers earning \$2.00 a day) do need jobs spurred by private sector investment and smart public policy. The 300 million poor people propelled into the middle class by Chinese capitalism attest to the possibilities. Less optimistically, Western socialism in the form of protectionist trade barriers and tariffs remain this Century's financial apartheid.

6 - Microfinance is oversold as an instrument of women's empowerment and, in some regions, may even erode gender equality.

Impoverished women are the focus of microfinance because women and children suffer deeper and harsher poverty. Seventy percent of the world's poor are women and children. Women immediately use profits from their micro-businesses to feed, clothe and educate their kids and empowered women are an acknowledged community force for change.

Violence against women-borrowers or bookkeeping abuses whereby women use microloans to support a husband's business, instead of her own, have been reported. Undoubtedly true in some cases, but undocumented as widespread.

Can microfinance alone change societal norms and thousands of years of cultural traditions to liberate women? No. Is it a good idea to empower women with business loans, household finance loans, loans to pay medical bills, loans to buy school books for their kids? I have yet to meet a woman in any income class who thinks poverty is empowering or that not having an independent source of income has improved the quality of her life.

7 - Microcredit's famed “village banking” methodology is coercive and harsh.

Since the poor do not have traditional forms of collateral for loans, microfinance uses a form of “joint liability” whereby microloans are made to individuals within a group, but all members are responsible for ensuring the loan is repaid. Thus, peer pressure is placed on the microloan borrower.

As with any solidarity support group, norms develop. No doubt some village banks apply undue pressure on its members, but critics conflate best practice and malpractice. A book club could be slandered as a coercive group which pressures its members to read.

Using the village banking system, it is not unusual for some local microfinance institutions to achieve microloan repayment rates as high as 99%. This remarkable innovation allows the poor to convert their informal social capital into formal financial capital.

It is “character collateral” which has underwritten this banking innovation for the poor. As J. Pierpont Morgan of the famed Morgan bank remarked in 1912 about his own lending and due diligence criteria, “character...before money or property or anything else....”

8 - Microfinance cannot simultaneously serve two masters: the poor and the capital markets.

The buzz about microfinance ranges from “a miracle, self-sustaining poverty reduction program” to “a new asset class suitable for investment portfolios of all sizes and shapes.” Mohammad Yunus argues access to credit is a human right and should not be subject to the whims of global investment trends or corrupted by unbridled greed any more than the right to vote should be dependent on literacy tests or property ownership.

If a business loan is a human rights issue, then everything (or nothing) is. Credit is a tool of business development, nothing more. The poor suffer under a myriad of market imperfections because markets themselves are imperfect.

Whether microfinance can at once remain responsive to the impoverished and return respectable financial returns is an open question. For every Microsoft, there is a General Motors.

What is profitable is not necessarily fair or just. In the end, the poor must have the power to speak up, speak out and speak for themselves. Open, transparent MFIs must be the industry standard. No exceptions.

As the need for [Microfinance Transparency](#) (backed by many microfinance leaders) demonstrates, the microfinance industry has been less than honest with the donors and investors who back it, not to mention its impoverished client-borrowers. True APR loan interest rates charged by overseas microfinance institutions remain undisclosed in most parts of the world.

Operating without even a basic code of ethics, let alone governmental oversight, an analogy to unregulated hedge funds could be made. The critical difference: microfinance is a public benefit, embodying public values and claiming public transparency, provided mainly by nonprofits and taxpayers (read: governments). For those who are converting the microfinance movement into an industry, presumably they know that government regulation, for good or ill, is around the corner.

9 - Local microfinance institutions (basically, mini-banks or credit unions) are realizing big profits by charging unconscionably high interest rates on microloans.

With the average worldwide microloan interest rate hovering around 37%, the consistent response is sticker shock. Is it defensible? Is it reasonable and fair?

First, microfinance programs must borrow funds to on-lend to their clients and the cost of borrowing those funds is set by others. This half-truth ignores 104 microfinance investment funds (with \$6.5 billion under management) who are the main financial backers for local microfinance programs. For these funds, the race to maximize return on investment is virtually unchallenged. Only a few are working to keep MFI borrowing costs in check.

The argument for mobilizing large sums of private microfinance capital is basically one of pragmatic desperation. To wit, government funds, foundations and donors are often parsimonious, cumbersome, finite and unreliable. With so many poor people still unbanked, well-respected microfinance leaders are understandably pushing hard to “achieve scale” or, in simple English, reach more poor people.

While private capital in the service of the poor or, inversely, the poor in the service of private capital, may or may not be ideal, it is understandable why the microfinance establishment has embraced private markets. At its operational core, microfinance is thematically aligned with capitalism and private markets.

Yes, financial returns will and do attract billions of new dollars to microfinance. That is a good thing. The common sense concern, and fair question, is: If the microfinance model truly requires high interest rates, is it an anti-poverty tool for the impoverished or a pro-profit tool for investors?

Second, administrative costs to handle thousands of smaller loans are necessarily high. As the logic goes, it is cheaper to make a single large loan in downtown Lima, Peru, than a large number of tiny loans in the Peruvian Andes.

But the case, which I have made many times myself, entirely misses the pro-poor point. When I hire any other service, say, a plumber, do I care that back office expenses might be cheaper if he did NOT take my business and, instead, only accepted clients with large, complex, low-overhead plumbing jobs?

Third, “the most orthodox and compelling rationale for high interest rates is that they stimulate investment, growth, competition, and, ultimately, better rates for consumers. With more investment comes more MFIs competing for both investors and customers.....In other words, as competition and scale increase, charging the destitute of today high interest rates in the near term may give the destitute of tomorrow lower interest rates.” (Lewis, “Microloan Sharks”, [Stanford Social Innovation Review](#), Summer, 2008).

This argument sounds good in textbook economic theory classes, but “...in most regions of the world, competitive microfinance markets are a long way off. The microfinance industry estimates that 2.5 billion poor are either unbanked or underbanked, and that it currently meets only 10 percent of this demand.” (Lewis, “Microloan Sharks”, [Stanford Social Innovation Review](#), Summer, 2008).

Fourth, the underlying -- and radical -- premise behind high interest rates is that overseas microfinance programs must become profitable or, in economic development terms, sustainable. “...there is now widespread agreement...MFIs ought to pursue financial sustainability by being as efficient as they can and by charging interest rates and fees high enough to cover the costs of their lending and other services.” (Rosenberg, et al, “Are Microcredit Interest Rates Excessive?”, [CGAP](#) Brief, February, 2009).

This is not a standard typically used for other public goods. While most anti-poverty programs -- from health clinics to environmental clean-up, from water projects to schools -- are expected to need long-term external subsidies, micro-business development requires the poor to bootstrap themselves into profitability. If local microfinance programs don't increase interest rates to at least cover costs, development funders and commercial markets alike look away.

Fifth, “This is the peculiar logic of subprime credit markets: that they are simultaneously instruments of financial inclusion and instances of exploitative, even predatory, lending. Such also is the logic of microfinance, for it allows the poor access to credit but on terms that are significantly different from those enjoyed by ‘prime’ consumers.” (Roy, [Poverty Capital](#), p. 218).

Virtually no microfinance website or promotional literature enthusiastically publicizes the actual microloan interest rates charged to poor borrowers. Who would invest in a microfinance fund if it declared “we maximize your profits by charging poor women an average of 37%, and sometimes as much as 70-85%, interest”?

Microfinance is not only pitted against a global economic system which has bypassed 50% of the world's population. Microfinance itself is a human institution still in search of its own perfection.

Microfinance is not a cure-all, an economic development elixir. Microfinance does not build roads, schools or clinics, it has not stopped a war or cleared a mine field, nor does it preserve pristine rivers, protect endangered species or restore cultural treasures.

A bit of humility is warranted. According to the World Bank, the current global food crisis, which is doubling and tripling food prices, will push 100 million people into hunger and undernourishment, virtually wiping out the gains made by microfinance in the last decades.

The public brand of microfinance is impoverished micro-entrepreneurs, mostly women, valiantly raising families while operating tiny businesses. For a nation whose self-image extols the self-made man, the maverick Western sheriff and the college drop-out who becomes the richest man in the world, the narrative is seductive. It converts the self-employed poor, victimized by the formal economy, into an icon of economic opportunity.

Microfinance is vulnerable to brand risk. If microcredit deviates from its higher and loftier objectives, drifts away from its noblest aspirations for economic justice or becomes just another financial “asset class”, then what is it?

Even with ostensibly high interest rates, microfinance has opened up financial services for the poor and pushed loan sharks out of the slums and isolated hamlets where the poor live. At its best, microfinance means opportunity and hope, providing an impoverished person with choices: the choice to feed a child, pay a medical bill, buy a new metal pot, fix a leaky roof. Not bad for a program that can become wholly or partially self-financing.

Surely abuses and fraud exist, but no one forces a person to take a microloan. In my experience, women are very careful about taking on debt and often wait years until they think they are ready.

To the critic falls an awful burden. Who chooses to tell the next woman waiting in line for her microloan that because microfinance it is not yet perfected, or because we think she is over-indebted, or because her chickens died or were stolen, or because she may be a financial front for an abusive husband, “Sorry, the teller is closed.”

About the author: Lewis is the founding Chair of MicroCredit Enterprises which lends debt capital to microfinance programs in 15 countries around the world. LAPO in Nigeria, which is referenced in the NY Times article, is a MicroCredit Enterprises partner. MicroCredit Enterprises is an active supporter of MFTransparency. Lewis is also the founding CEO of the Opportunity Collaboration, a global anti-poverty conference.