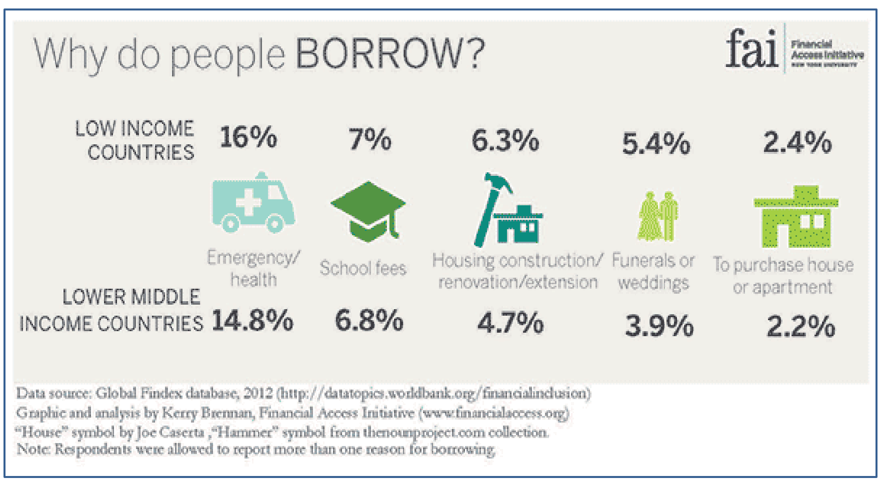
Big Questions in Credit

"Does microcredit work?" It's a question we hear a lot. But the answer depends on what the question really is. Does microcredit slash poverty? (Not clearly.) Does microcredit increase micro-enterprise profit? (Some of the time, but capital often gets channeled to other uses and not everyone is a great entrepreneur.) Does microcredit improve the lives of borrowers? (Yes it can, but seldom dramatically and sometimes microcredit can get borrowers into trouble.) Rather than being a single tool used to solve a single problem (like funding a business), microcredit is often one among a set of tools, whose usefulness as a set may be fundamental but whose individual impact is often incremental and thinly spread.

In this briefing note, we explore the motivations behind borrowing, innovations in the sector, and issues around regulation and financial sustainability in microcredit.

Why Borrow?

At the most basic level, credit provides the opportunity to move consumption or investment to the present. Borrowing can help smooth periodic ups and downs caused by the irregular income flows common in poor families. Borrowing also allows families to acquire a "usefully large" (Rutherford and Arora, 2010)[1] sum of money to be used for a big purchase. The alternative is waiting to accumulate such a sum through savings—a challenge that many households may find difficult or impossible. As a result, microcredit loans—even microloans targeted to entrepreneurs—are used in a variety of ways (Karlan and Zinman, 2012[2]; Attanasio et al., 2011)[3].



A big view can be seen through the Global Findex study, conducted by Gallup, which shows the uses of loans from all lending sources (not just

[1] Rutherford, S. and S.S. Arora (2010), *The Poor and Their Money: Microfinance From a Twenty-First Century Consumer's Perspective*, Practical Action.

[2] Karlan, D. and J. Zinman (2012), "List Randomization for Sensitive Behavior: An Application for Measuring Use of Loan Proceeds," NBER Working Paper 17475.

[3] Attanasio, O., B. Augsburg, R. De Haas, E. Fitzsimons, & H. Harmgart (2011), "Group lending or individual lending? Evidence from a randomized field experiment in Mongolia," European Bank for Reconstruction and Development.

microfinance institutions) across all income groups (not just low-income). The survey shows that 16% of households in low-income countries and almost 15% of households in lower-middle-income countries had borrowed to cover the costs of health-related emergencies. We also see that a significant percentage of households in both country groups had borrowed to offset the costs of school fees, housing construction, funerals or weddings, or to purchase housing. Respondents were allowed to report more than one reason for borrowing, so many households may have taken loans out to cover more than one type of expense. (Borrowing for business was not an option in this survey.)

There's another reason to borrow, and it has a behavioral twist. Behavioral economics gives psychological reasons for why it can be hard to save, and that naturally makes borrowing more of a necessity when you need money. But there's also a subtler (though more direct) connection: the activities around saving and borrowing look pretty similar in important ways. Saving usually involves making small, periodic deposits into an account in order to have a big sum in the future. Borrowing through microcredit also usually requires making small, periodic transfers and getting a stream of big sums in the future. Borrowing, however, has a useful commitment device attached; it is harder to skip periodic payments to a lender (who has the power to enforce a contract) than to skip deposits to yourself. It is also often easier for a poor household to obtain a loan than a secure, regulated, and convenient savings account. One implication is that if you have already managed to put away some savings, you have a good reason to want to protect them, maybe even by borrowing (Morduch, 2010)[4]. Another implication is that if you don't have great ways to save, microcredit borrowing can be a substitute accumulation device, as suggested by evidence from India (Bauer et al., 2011)[5]. In the end, saving and borrowing are often complements, not substitutes. Being able to borrow can help you hold on to your hard-earned savings. When important needs arise, you may use your savings *plus* borrow. Those who argue that credit is more important than saving – or vice versa – are missing the point.

Of course, the use of credit is not always so rosy. Some people continue to borrow because they are caught in "debt traps." It is not hard to find yourself in a debt trap; you borrow to cover the cost of an urgent need and use the income you earn in the following weeks or months to pay back the loan. But once you have used your income to pay it back, you do not have enough left over to cover your current expenses and you must borrow again to stay afloat. Some households may be able to escape these traps, but many others are stuck in them indefinitely or until they must default.

So why *not* borrow? Take-up rates of microcredit in poor communities are always well under 100 percent, and usually well under 50 percent. Some families choose to ration their use of credit out of fear of over-indebtedness. Other households may not borrow because the credit products available are expensive or do not suit their particular borrowing needs. Even as attention turns to other financial products, there's further in credit product design.

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[4] Morduch, J. (2010), "Borrowing to Save: Perspectives from *Portfolios of the Poor*," Financial Access Initiative.

[5] Bauer, M., J. Chytilová, and J. Morduch (2011), "Behavioral Foundations of Microcredit: Experimental and Survey Evidence From Rural India," Financial Access Initiative.

What credit products serve the needs of poor households?

Part of the microfinance narrative is that households who cannot access microcredit are at the mercy of moneylenders charging them exorbitant interest rates to borrow small sums of money. However, this rhetoric is misleading.

Data from the Global Findex database (Brennan, 2012)[6] shows that households in low-income countries overwhelmingly borrow from family or friends, rather than from other higher-interest lenders such as an employer, a private lender or via store credit. The "next best" option to microcredit is more likely to be a zero-interest loan from your brother than a 100 percent-interest loan from the moneylender.

There are two parts to the unraveling of the traditional narrative. The first is the questioning of business investment as the goal of microlending. As described in the "Why Borrow" section, households end up using loans for a range of purposes, even if the original intent was to finance business investment. The second is the questioning of the role of group lending itself. Using the "group lending" or "joint liability" contract remains common, particularly in South Asia, but other incentive mechanisms usually matter more than group lending. Dynamic incentives matter especially (Giné et al., 2011)[7] – promising another loan in the future only if the current loan is paid off.

The financial needs of households are complex. It should come as no surprise, then, that a "one size fits all" approach to microcredit products does not meet the borrowing needs of many poor households. It may be that some of the same features cited as crucial to the initial success of microcredit are now responsible for limiting its reach. Cautious or less socially well-connected borrowers may be hesitant to take out a group loan, for example. One of the reasons borrowers give for continuing to use local moneylenders, even at interest rates higher than microcredit options, is that they are willing to be flexible in times of crisis. The irregular incomes of poor people make products payable in small installments attractive, but there have been calls for even greater flexibility— a recognition that drove Grameen Bank to overhaul is entire product line (Dowla and Barua, 2006)[8]. Loans available in times of emergency are also highly valued but infrequently offered by microfinance institutions.

Microcredit providers have recognized this need for further innovation and now offer individual loan products, less frequent or delayed-start repayment schedules, and credit plus financial education or other training. But are these the products that poor households truly need? Should consumer lending be embraced as part of the microcredit movement? Do new business models offer hope products that meet the needs of customers sustainably? What further innovation is needed to ensure that appropriate and timely options are available when households need them?

Should microcredit be sustainable?

The promise of financial sustainability was a feature that first sparked interest in microcredit and has helped spur its continued growth.

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[6] Brennan, K. (2012), "Lending Sources by Country GDP," Financial Access Initiative.

[7] Giné, X., J. Goldberg, and D. Yang (2011), "Credit Market Consequences of Improved Personal Identification: Field Experimental Evidence from Malawi," NBER Working Paper No. 17449.

[8] Dowla, A. and D. Barua (2006), *The Poor Always Pay Back: The Grameen II Story*, Kumarian Press.

Unlike many other interventions, lending has a built-in mechanism—interest rates—to generate income and cover costs. The model has attracted billions of dollars in "social investment" (MicroRate and Luminis, 2012)[9] from investors and donors hoping to move beyond charity to sustainability. The question of whether microcredit can be financially sustainable appears to have been answered by Mexico's Compartamos Banco, among a growing list of others.

What is less often highlighted, however, is that the majority of microfinance institutions—for-profit or non-profit—have themselves benefited greatly from both explicit and implicit subsidies, grants, and concessionary capital. When economic profit[10] (rather than accounting profit) is measured, many "financially sustainable" microcredit providers no longer fit the bill. Grameen Bank, for example, posted profits throughout the mid-1990s. But if the subsidies it received had been market-priced, they would have reported losses around $26–30 million per year instead (Morduch, 1999)[11].

Sustainability is often viewed as the path that microcredit programs must follow if they hope to scale-up and reach the poorest and most isolated communities. How does subsidy, implicit or otherwise, change the way that MFIs provide services? Reviewing data from institutions around the world, it appears there is a tradeoff between sustainability and outreach: the institutions likely to be most attractive to investors are not those that reach the greatest number of women and poorer clients (Cull et al., 2009)[12]. Another method, which models the ideal profit-maximizing costs of an institution and compares it to actual performance, finds that greater efficiency is associated with less outreach to the poor (Hermes et al., 2008)[13]. Reaching poor, higher-cost clients does not necessarily preclude profitability (Cull et al., 2008)[14] but serving relatively wealthier communities can provide the margin to fund expansion and broader outreach (Conning and Morduch, 2011).[15] The sector continues to struggle with key questions: What are the true costs of pursuing sustainability? Will ongoing innovation in service delivery make it possible to reach poor and isolated communities in a sustainable way?

For much of history, the discussion of access to credit instead painted low-income households as victims—of greedy lenders as much as of their own lack of self-control. Microcredit turned this way of thinking around by emphasizing the agency of borrowers and offering loans as the antidote to usurious moneylenders and as an escape from poverty through enterprise. Regulators have tended to accept this proposition and provided accommodating regulatory environments for microcredit providers.

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[9] MicroRate and Luminis (2012), "The State of Microfinance Investment 2011," MicroRate and Luminis.

[10] Wikipedia.org (2013), "Profit (economics)," Wikipedia.

[11] Morduch, J. (1999), "The role of subsidies in microfinance: evidence from the Grameen bank," *Journal of Development Economics*, 60: 229-248.

[12] Cull, R., A. Demirgüç-Kunt, and J. Morduch (2008), "Microfinance Meets the Market," World Bank Policy Research Working Paper No.4630.

[13] Hermes, N., R. Lensink, and A. Meesters (2008), "Outreach and Efficiency of Microfinance Institutions," Working Paper.

[14] Cull, R., A. Demirgüç-Kunt, and J. Morduch (2009), "Microfinance Tradeoffs: Regulation, Competition, and Financing," World Bank Policy Research Working Paper No. 5086.

[15] Conning, J. and J. Morduch (2011), "Microfinance and Social Investment," *Annual Review of Financial Economics*, 3:407-434.

Macro- and regional financial crises have shown that regulation is necessary to protect consumers and maintain the stability of the financial system. Regulation imposes its own costs, as institutions must enact new processes to comply with supervisory requirements. These costs are not trivial and may have important effects on the borrowers who microcredit lenders are able to serve. Cross-country evidence on prudential regulations shows that regulation decreases outreach (Cull et al., 2008)[16] as institutions fulfilling the costs of compliance compensate by lending larger sums (which may be riskier for borrowers) and targeting wealthier clients. The increased costs of compliance can also raise barriers to entry, limiting the entrance of new providers.

Many in the microfinance industry have pushed for institutions to adopt measures for self-regulation. The Smart Campaign, for example, promotes Client Protection Principles that include avoidance of over-indebtedness, transparent and responsible pricing, appropriate collections practices, ethical staff behavior, mechanisms for grievances, and privacy of client data. The Alliance for Financial Inclusion (AFI) has a Financial Integrity Working Group, a platform where practitioners can share country-specific information on promoting financial integrity and inclusion. In the area of government regulation, the Consultative Group to Assist the Poor (CGAP) developed the Microfinance Consensus Guidelines(Christen, 2003)[17], which outline areas of general industry and expert agreement on best practices in microfinance regulation. These principles will be a success if their implementation is as good in practice as the words are on paper.

Key questions for the sector to consider include: What types of regulation and supervision best balance protection and inclusion, and in what contexts? What roles do market discipline and supervision by investors play? Regulation that does not directly target microfinance also plays an important role in addressing fair protection issues that affect financial access. Laws that prevent women from owning property, require a spousal co-signature for borrowing, or make the acquisition of a birth certificate or identity card difficult and expensive inhibit access to credit (Gershman and Morduch, 2011)[18] even though they do not regulate the industry itself.

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[16]Cull, R., A. Demirgüç-Kunt, and J. Morduch (2008**), "**Does Microfinance Regulation Curtail Profitability and Outreach?**,"** NYU Wagner Research Paper No. 2011-06.

[17]Christen, R.P., T. Lyman, and R. Rosenberg (2003), "Microfinance Consensus Guidelines," CGAP.

[18] Gershman, J. and J. Morduch (2011), "Credit is Not a Right," Financial Access Initiative.