netherlands platform for microfinance

Microfinance today – a position paper of NPM (October 2011)

The microfinance sector has developed significantly in recent years. With positive and negative effects. Millions of poor people now have access to financial services. However, over indebtness and exceptionally high profits are not in the interests of the poor. MFIs have to aim for both financial and social return. The sector needs more regulation and supervision and the client (the poor) protection and assistance.

1. NPM

Using the lemma 'The Dutch Microfinance Offer' the Dutch donors and investors united in the NPM in 2003. The members of the NPM stand for an integer, transparent and accountable microfinance sector with both financial and a social return. The members of the Netherlands Platform for Microfinance are active in around 90 countries. The total amount of funds that they have invested has grown to an amount of around 1.6 billion Euros per year. The larger part of these funds are provided in debt to microfinance institutions. The other part of the funds are provided in seed capital, grants, guarantees and equity.

The platform has sixteen members, including social investors, commercial banks, co-financing organizations and the Ministry of Foreign Affairs.

2. History

Microcredit as a mean to combating poverty has existed for over thirty years. It is a more structural contribution to combating poverty than financial gifts. Development organizations provided the needed funds to provide microcredit through donations or soft loans. The poor proved creditworthy; the repayment rate was generally above 95%. From the second half of the nineties the number of MFIs increased rapidly. More and more people were reached and apart from the traditional microcredit other financial services were developed and offered, such as saving products, consumption credits, insurance and micro pension services. The sector moved from microcredit to microfinance.

Initially, a precondition was that the loaned money is used for developing an economic activity. Access to financial services is the backbone of economic development. Without a well functioning financial system it is not possible to create good conditions for long term sustainable economic growth and with that economic independency. Now, financial services are not only used for economic activities, but also to allow people to manage cash flows of households, which allows them to increase their standard of living and makes them less vulnerable to unexpected situations.

In parallel to the development of the sector, legislation was created in a large number of developing countries. This legislation permitted the MFIs to become regulated financial institutions. Attracted by the economic and social success more and more commercial investors such as banks, investment funds and public funds became interested to lend or invest in microfinance, particularly in these regulated institutions.

3. Commercializing

It was commonly understood that in order to meet the growing demand for microfinance, a larger and more professional sector was needed. MFIs should become financially independent and no longer be dependent on grants and should be able to attract additional (commercial) capital.

3.1 Growth

The involvement of commercial stakeholders has definitely brought about numerous advantages. During the past ten years the sector grew 39% yearly on average up to a global volume of more than € 45 billion in 2008[1]. The number of clients reached by microfinance is 190 million worldwide[2]. Microfinance entered also in new geographical zones such as Central and Eastern Europe and parts of Asia. In Middle and South America more MFIs were created in each country/region which brought about competition, often inducing lower interest rates for loans to the MFIs and lower rates for the clients of MFIs. In addition, the commercialization implied in many cases more professionalism in terms of governance, efficiency and risk management. Negative consequences of commercialization are for example increased chances of over indebtedness and too much emphasis on financial efficiency.

3.2 Over indebtedness

The aim of financial independence forces MFIs to grow, to increase business volume and to serve more clients. These objectives are achieved by imposing growth goals to loan officers and management which are often linked to bonuses and incentives. This resulted frequently in careless lending, and less attention to payment capacity of clients. In an increasing number of countries we observe clients' debt problems, borrowing more than they can repay.

3.3 Too much emphasis on financial results

Too much emphasis on financial return induced a more efficient functioning of MFIs. However, this efficiency, for instance having lower costs as a result, is not always rewarded to the client, for example by charging lower interest rates. Sometimes the cost reduction is used for profit increase to comply with the efficiency requirements imposed by funders or to pay high bonuses to managers. These developments can be acceptable up to a certain level but have, in some cases, led to excesses.

[1] source: Microfinance Information Exchange

[2] source: State of the MicroCredit Summit Campaign report 2011. Data based on a sample of 3300 MFIs registered at (MSC) from which it received annual data on the number of clients.

As well, the increasing 'mission drift' can have the consequence that the original goal, namely increasing the access to financial services for everybody, hence also for the poor, is not pursued anymore. 'Mission drift' is the provision of (bigger) loans to more prosperous clients neglecting the provision of (smaller) loans to poorer clients. Financing bigger clients gives more financial profit. However, providing bigger loans to more prosperous clients can also produce advantages for other clients. For instance, it implies risk diversification and cost limitation which provides prospects for cross subsidizing.

3.4 Towards an equilibrium and efficiency

The question is what, in the opinion of the NPM members, are 'reasonable' profits, reasonable 'returns on equity' (ROE) and reasonable salary and bonus structures. Producing a reasonable profit, through which further growth can be attained, is required for an MFI to continue to exist. Only those MFIs are able to continue attracting required capital in the form of loans or equity. The NPM members commit themselves to verify that the MFIs, before and during the term of financing, do not apply a 'just for profit' management but pursue reasonable profits and offer access to reasonably (honestly and responsibly) priced financial services.

Besides a more commercial way of working, an MFI also needs sufficient scale to be able to work in a more efficient way. This means that MFIs should have sufficient volume to achieve this. If sufficient volume is available, activities (such as administration and HRM) can be centrally organized, an adequate ICT can be introduced and loan officers can dedicate themselves to serving the clients. The NPM members are committed to stimulate where possible that MFIs merge to achieve this efficiency improvement.

The members endorse that improving access to financial services for everyone can genuinely contribute to combating poverty. To achieve this, well functioning financial institutions aiming at social as well as financial return are needed. Social return, if well incorporated in the organizations, will improve financial return. MFIs should operate with integrity, transparency and responsibly; they should know the client, protect and assist (advise) her, follow an effective and professional management and pursue a reasonable profit.

4. Social Banking

In the area of financial sustainability a lot of very good results were achieved meanwhile. More and more MFIs are able to realize such financial results that continuity is guaranteed, that new services can be developed and that growth can be financed. However, recent events demand, next to avoiding the adverse effects, to focus on improving the social return of MFIs.

4.1 'Client Protection Principles'

To avoid negative impact such as over indebtedness and a lack of transparency, the members of NPM endorsed the so called 'Client Protection Principles', the code for clients' protection developed by CGAP (World Bank department). These principles, six of them, monitor:

- avoiding over indebtedness;
- transparency about the real, effective interest rates charged on loans;
- appropriate collection methods;
- integrity towards clients;
- privacy of client data; and
- the presence of a complaint procedure.

4.2 'Microfinance Transparency'

The members of the NPM actively support the 'Microfinance Transparency' (MFTransparency) initiative that has investigated, up to March 2011, the effective interest rate of products offered by MFIs in 20 countries. Transparency is important because in a transparent market, consumers are able to make borrowing decisions based on accurate, comparable pricing information. Microfinance institutions can set prices based on knowledge of market rates. Policymakers and regulators can operate with an understanding of the pricing dynamics of the markets they supervise. Funders are better able to select partners whose strategies align with their own. Pricing transparency is also a key element in preserving the reputation of the microfinance industry among the general public. MFTransparency, makes comparisons between MFIs and publicizes these on the web to denounce needlessly and excessively high interest rates.

4.3 Stimulating social return

To improve social return, financers upon providing loans or investments increasingly scrutinize the MFI concerned as to whether it has an effective policy for social objectives. The NPM members collaborate in this area with some organizations that develop and stimulate the introduction of Social Performance Management. All NPM members have adopted international standards in their policies and select and assess MFIs before investing in them.

Measuring and stimulating social return requires specialist methods and processes. The 'Progress out of Poverty Index' (PPI) is a recently developed method to measure how poor a population is and if any improvement has been brought about in their financial situation. The NPM members support the development and application by MFIs of tools and methodologies such as the PPI and other methodologies.

Another interesting development is the 'social audit' or 'social rating'. These are methods that socially assess MFIs as well as investors. In these assessments it is, among others, investigated how the social objectives are anchored in the organization and how these are translated into products that are offered. This development also receives the approval of the NPM.

The NPM members have signed the Principles for Investors in Inclusive Finance (PIIF). The principles were developed in response to growing interest and investments into inclusive finance and demand for investor guidance. The PIIF provide a framework for responsible investment in inclusive finance. Inclusive finance includes, but is not limited to, microfinance. It focuses on expanding access to affordable and responsible financial products and services by poor and vulnerable populations. This also includes organizations that are often unable to gain access to financial products and services such as micro- and small-enterprises. A wide range of financial products and services are incorporated within the remit of inclusive finance including savings, credit, insurance, remittances, and payments.

5. Inclusive finance

Universal access, at reasonable cost, to a range of financial services is essential for the poor to increase their livelihood and to protect their family from unexpected emergencies. Many MFIs do not offer a wide range of financial services. Next to credit they should preferably also supply products such as savings, consumption credit, money transfer services, micro insurance (notably against business risks such as crop failure and disability) and micro pensions. Apart from the fact that there is a need and a demand for such products, these also provide the MFI revenues which contribute to a higher profitability.

In particular access to savings products enables people to create a buffer, to build capital and to create opportunities for the next generation. 80% of the world's population continues to go without a safe place to store money. The demand for savings products is with many poor people higher than the demand for credit.

Not only a larger number of products are needed but also higher quality products are needed. In case of credit products it is important to offer more than just standard products and instead to have products which fit with the needs of the client. For example, a farmer can only repay its credit after selling the harvest, while a stationers' shop could pay back monthly. In this way, it is avoided that loans are repaid with new loans. Usually MFIs lack a wide range of services due to the fact that the authorities do not allow them to offer these services (a banking license is generally needed). Moreover, the MFIs usually do not have sufficient volume and knowhow for this.

To develop such an inclusive financial service in each developing country would require a widely supported vision and strategy from all involved parties; government, regulatory and supervisory entities, financial institutions, as well as, for instance, the telecommunication sector (concerning mobile banking). For this reason, the NPM members collaborate with entities that support these developments such as MFI networks as well as official authorities.

6. The missing middle

It has emerged from research in Latin America that no more than 5 to 10% of the MFIs clients grow to a small enterprise. The huge majority of micro entrepreneurs remains at the level of micro enterprise and do not grow into small enterprise. An important cause for this is that most MFI clients are entrepreneurs, but not by choice, and would have preferred to be an employee. They are unable to make their business grow.

In addition, it is also true that in case these entrepreneurs are successful and their businesses grow, they will need larger loans and other types of products. Traditionally, the MFIs provide credit to starting entrepreneurs. In many cases, small and medium entrepreneurs are not attended by anybody. Regular banks do not accept them (especially not in rural areas) because they find these entrepreneurs too small and for the MFIs they are too large, the MFIs are not able to follow these clients in their growth. The consequence is that small and medium enterprises (SME) sector cannot develop, which is essential for economic development and thus for poverty reduction.

Even though SME finance is different from microfinance, MFIs are usually the most appropriate institutions to attend to the needs of SMEs. The NPM members are committed to stimulate and support MFIs in these areas.

7. Enabling environment and Governance

The NPM members, together with the partner MFIs, stimulate that a sound structure for the sector will be developed through the legal and regulatory framework. This structure includes instructions concerning management quality, supervision and reporting and prescriptions for transparency, protection of clients and quality requirements for products and services. Regulations concerning the supply of a broader financial services package through MFIs and relevant fiscal structures form part of the necessary legislation and a good functioning structure for the sector. Furthermore, the existence of credit bureaus is essential. An adequately functioning credit bureau can play an important role avoiding over indebtedness, in addition to the measures that can be implemented by each MFI itself to avoid over indebtedness.

8. Conclusion

The developments in the microfinance sector, particularly during the last ten years, have taken place in fast sequence. From microcredit to microfinance to inclusive finance; from attending thousands to attending millions of people; from a sector influenced primarily by donors to a sector with a number of other actors such as banks, other commercial and social investors and national supervisors.

The NPM members are convinced that inclusive finance is a force that can be effective in poverty reduction. However, the members are also concerned about some developments in the sector.

The NPM members note that a more commercial way of working will be essential for MFIs, and that cooperation with commercial investors is necessary to provide sufficient capital for MFI funding. The role NPM members see for themselves is to ensure that there is sufficient balance between financial and social return. The members of NPM distance themselves from MFIs only oriented towards financial return. Apart from a more commercial way of working and the cooperation between development organizations and commercial investors, the NPM members would also like to play a role in stimulating a more efficient way of working, for instance, by stimulating cooperation between MFIs. The members support MFIs in their growth to more mature, financially independent, entities that are able to continue to exist entirely without grants after this phase.

The NPM members recognize that achieving social return is not a matter of course and that specialist methods and processes are needed to measure and improve the social return. To improve the financial services the NPM members endorse the 'Client Protection Principles' and they support the 'MFTransparency' initiative and several other initiatives such as those of 'social ratings'. They have also committed to the Principle for Investors in Inclusive Finance. Furthermore, the members are active to make Social Performance Management a standard for selection, assessment and monitoring partner MFIs.

Moreover, the NPM members endeavor that MFIs can offer a wider range of financial services, such as savings and insurance and that the quality of the offered products will improve. Furthermore, they regard it their role to stimulate MFIs to attend the 'missing middle', the SME sector.

In addition, cooperation is sought with, for instance, national regulatory and supervisory entities (who have the role to supervise that these services are supplied diligently and in a responsible manner) and with organizations supporting MFIs (such as sectoral lobby organizations).