THE MICROFINANCE INDUSTRY

Sigurdur Gudjonsson
Faculty of Business and Management, University of Akureyri, Akureyri, Iceland
sigurdurg@unak.is

Abstract: *In this paper the microfinance industry will be described, both as it is today and with historical perspectives. Brief history of past failure of subsidized loans is mentioned. Different but important contributions from Stiglitz and Yunnus are explained and then the microfinance industry´s growth and current state will be described. Finally, different microfinance institutions types are explained. The microfinance industry is peculiar and deserves to be researched and focused upon for several reasons. The most important is that it aims towards poverty reduction by reaching out to the poor and provide them with capital. Noteworthy, that is to be done in a sustainable way, which allows the industry to thrive and expand. Indeed it has expanded greatly over the last few years. While the microfinance industry expands the importance of understanding the industry becomes ever more important. Researches on corporate governance for microfinance institutions have been carried out but more researches are needed, in particular for the social goal called outreach. Because the microfinance institutions have both social goals and financial goals, the microfinance industry is different from most other industries where profit maximization is the main and often the only goal. The corporate governance findings for microfinance industry may therefore be different and may not be easily transferred to other industries.*

Keywords: *Microfinance; corporate governance; outreach; sustainability.*

JEL classification: *M14.*

1. Introduction

If the market would work properly the principle of diminishing marginal returns, introduced by the 18th and 19th century economists such as Turgot, Stuart and Ricardo, would work. Then the poor with little capital would become able to earn higher return on their investment than those who have a lot of capital, hence by the market the capital would be pushed to those very poor who needs it. However that has not been the case. Traditional banks avoid granting the poor the small loans they need because, first the loans are so small it is hard to profit for providing them and the bank does not have information about the loan taker and second these poor people do often not have any collateral, Armendáriz and Morduch (2007/2010). The two features, adverse selection and moral hazard has resulted in that the poor have not received any loans, which they very much need in order to leave the poverty trap they are stuck in.

The failure of the market, to provide the poor with capital was addressed strongly in the aftermath of the second World War, development programs were created which were often in the form of governmental or institutional subsidized loans and agricultural banks were established, however low repayment rate, unprofitable investments and corruption lead to the results were somewhat disappointing, Adams et al (1984).

More successful attempt to address people lack of access to capital came with the introduction of the microfinance phenomena in the 1970´s. Although it is always hard to say where, when and how it exactly started, it is a fair beginning to introduce on the one hand Stiglitz theories, particularly where he addresses joint liability and on the other hand Yunnus establishment of the Garmeen Bank in 1976.
Providing the poor with unsubsidized capital can indeed be a challenging task even to those who are actually willing and able to make loans. In their seminal paper Stiglitz and Weiss (1981) address the problem of credit rationing which takes place in the loan market even though it is in equilibrium, due to imperfect information. This issue is addressed further in the literature by Stiglitz (1991) who points out that one solution might be peer monitoring, whereby the risk is transferred from the bank to the loan taker and increases his welfare at the same time. In peer monitoring or group lending, the loan taker does not have to provide collateral in order to receive a microfinance loan, but instead he or she (most microfinance borrowers are women) belongs to a group who are together hold responsible for repayment of their loans; and if they repay the loan they receive a higher amount of borrowing next time, but if the loan is not repaid, no member of the group will obtain another loan. By this means it is possible to provide a loan where transaction costs are high and at the same time no collateral is provided. It is important to note, however, that many microfinance programs do not rely on group lending, and some microfinance programs offer individual loans with collateral, just as commercial banks do.
The most famous player in the microfinance field is probably the receiver of Nobel Peace Prize, Mohammad Yunus, founder of the Garmeen Bank of Bangladesh, who started to lend small amounts of money to women in Bangladesh so they could begin entrepreneurial activities; and this became a sort of benchmark for microfinance institutions (MFIs). Yunnus began by lending his own money to poor women, these women repaid their loans without having collateral, Yunus (2007), In substitute for collateral Yunus used the loan taker´s network´s connection to make sure for repayment i.e. group lending with joint liability to repay the loan. In addition to joint liability, Garmeens lending method also presented new methods in the form of dynamic incentives for the loan taker to repay since if all of them repaid they could get higher amount next time and in order to keep the business risk to minimum a very frequent repayment was introduced.
At the turn of the 21th century microfinance industry had become a growing industry, however great numbers of MFIs were not sustainable and received considerable amount of capital in form of subsidization. But their social performance was on the other hand quite impressive, institutions that are mainly concerned with social issues have entered in to microfinance field, institutions such as Catholic Relief Services, CARE and Freedom from Hunger, Armendáriz and Morduch (2007/2010). The recent trend is in similar manner, the microfinance industry is growing and furthermore, MFIs performances may be improving as well. The growth and the current state of the microfinance industry will be discussed next.

2. The Current State of Microfinance Industry.

The microfinance industry is indeed a growing industry. With just handful of institutions in the 1970´s and early 1980´s, the industry has grown greatly and in 1997 the “State of the Microcredit Summit Campaign” reported 618 institutions reaching over 13 million clients. At the turn of the last century the number of the

institutions had more than doubled, now reaching more than four time as many clients and for the year end 2010, the State of the Microcredit Summit Campaign reported 3.652 MFIs reaching more than 205 million clients, of those more than 137 million are considered “very poor” i.e. living on a less than 1.25$ per day and more than 113 million were women or more than 82%, Maes and Reed (2012). Furthermore in some countries the industry is growing of more than 20% a year. Lascelles and Mendelson (2011).
To conclude about the total dollar amount involved in the microfinance industry is not easy, however in a report issued by the Center for the Study of Financial Innovation, Lascelles and Mendelson (2011) stated that from the 2.000 MFIs which reported to the Microfinance Information eXchange (MIX), the total assets of these MFIs amounted to $72bn. The institutions reporting to MixMarket had 105m borrowers so knowing that there are more than 3.600 MFIs existing with over 200 million clients, the total amount should be considerably higher.
Microfinance institutions are not equally distributed around the globe. More than 95% of all MFIs are in the developing world, little less than half of all these institutions are in Asia & the Pacific, roughly quarter are in Sub-Sahara and a little less than 20% in Latin America, Maes and Reed (2012). Most of the biggest institutions are in the Indian sub-continent. The biggest one ranked by staff size is a non-government organization (NGO) called BRAC in Bangladesh, with 44.306 staff members, more than 5 million borrowers and $646 million as gross loan portfolio. The second one is the famous bank Grameen Bank with 25.283 staff members, 8.3 million borrowers and gross loan portfolio of $939 million and third is the Non-banking financial institution SKS Microfinance in India, with staff size of 22.733, total 7.3 million borrowers and gross loan portfolio of $925 million. These institutions are then followed by ASA (Bangladesh), Compartamos Banco (Mexico), BASIX (India), Bandhan (India), Vietnam Bank for Social Policies (Vietnam), Spandana Sphoorty Financial Ltd (India) and ACLEDA (Cambodia), Villarino 2012 (webpage).
From the “State of the Microcredit summit campaign report 2012 it is possible to see that only 5% of MFI are in the developed world and only 2% are in “North America & Western Europe”. In the MixMarket data set, which I use for my research, not a single MFIs in neither North America nor Western Europe reports their findings to the MixMarket. Following are the numbers of MFIs reporting to MixMarket and their regions, since no institution from North America or Western Europe reported their findings they are not included in the table.

Table 1. The MFIs divided into regions as follow for the year 2011

AFRICA	289
EAST ASIA AND THE PACIFIC	197
EASTERN EUROPE AND CENTRAL ASIA	196
LATIN AMERICA AND THE CARABBE	363
MIDDLE EAST AND NORTH AFRICA	55
SOUTH ASIA	212
TOTAL	1312

It is important to note that Africa is the African countries that are located Sub-Sahara. The countries in North Africa are considered more similar in economical respect to the middle eastern countries, for example the average loan balance is 606$ while it is only 475$ for Sub-Sahara Africa. It is however not complicated to take all Africa together as a continent, since each country from the data set is listed separately, for example those countries that have a MFIs and report to MixMarket from North Africa are from Egypt, Tunisia, Morocco and Sudan. Graphically the brake down is presented in Figure 1.

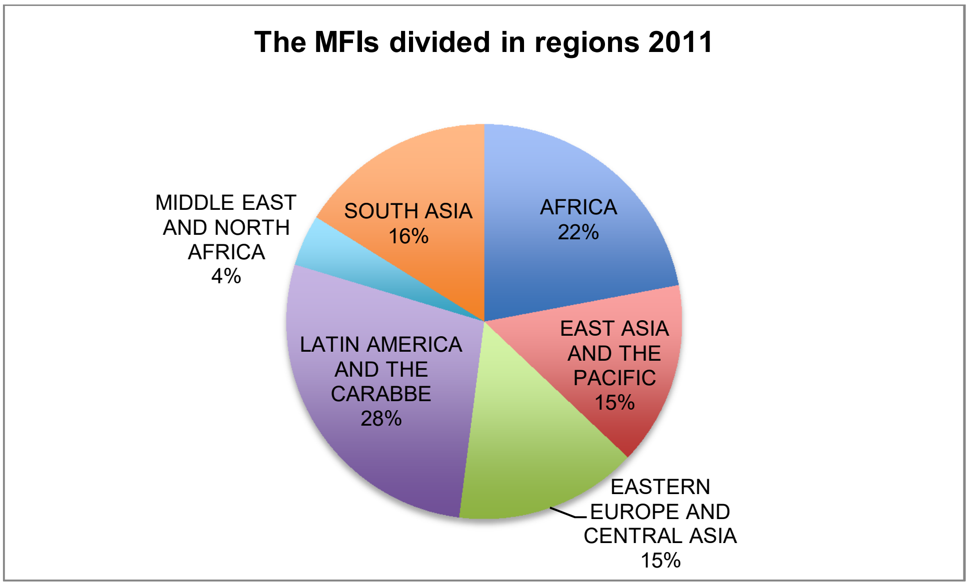

Figure 1. The MFIs divided in regions 2011
(Sources: Descriptive statistics from the MixMarket data set)

The microfinance industry is not only growing, it is also changing. New players are entering, some looking for profit and as Hartarska and Nadolnyak (2011) point out and noteworthy, annual funding for microfinance activities in 2004 was somewhere less than $1.5billion with 90% coming from developed nations´ taxpayers while just few years later in 2008 the same amount was more than $5billion, but now mostly by many private institutional investors via Microfinance Investment Vehicles with intermediate between foreign investors and MFIs.
However, although microfinance industry has grown, according to the World Bank (2012), only half of the world's 7 billion people receive any kind of financial inclusions. The growth of microfinance clients from 13 million clients in 1997 to more than 200 million in 2011 is a step forward but so far the microfinance movement has only reached fraction of the worlds´ poorest people. Reaching out to the poor and provide them with capital is an essential part of decreasing poverty but in order to make sure we do not get ahead of our self, the microfinance movement has to be surly helpful for those who use it and in particular it must be accessible to the poorest part of the population. Researches on the phenomena, if properly carried out should be useful in order to fulfil this agenda.

3. Different Microfinance Types

Although it might be challenging to define microfinance, it is easier to distinguish between different types of MFIs. The MFIs will be categorized into four main types in the same way as in the data set used in this research (called MixMarket). This is a commonly accepted way of dividing these institutions as can be seen in the literature of microfinance by scholar such as Servin et al (2012), Périlleux et al (2012), Galema et al (2012), Bassen (2008), and Mersland (2008). The microfinance institutions are put into four categories, now presented based on the definition used in MixMarket.

The first type of MFIs to be described is the one focused on in this research namely NGO or Non-Governmental Organization. NGOs are usually registered as non-profit organizations and they are usually not regulated by a banking supervisory agency. Their financial services are usually more restricted than other MFIs and they are commonly not allowed to collect deposits, although there are number of exceptions. This particular limitation may severely affect their financial performance. NGOs are usually more focused on their social mission than on their financial performance, Bassen (2008). It is therefore not surprising that among all the different microfinance types, they do perform best on that matter.

The second microfinance institution to be described is the Microfinance bank that is licensed financial intermediary regulated by a state banking supervisory agency. Microfinance banks often provide several kinds of financial services such as deposits, lending and money transfer. Microfinance banks are perhaps the closest to traditional banks of all the microfinance institutions. The third microfinance type mentioned is Cooperative/Credit Union (c/c) which is a non-profit, member-based financial intermediary. These institutions usually offer several types of financial services such as lending as well as deposit where the aim is to benefit its members. The Cooperative/Credit Union´s may be regulated differently than traditional financial institutions such as banks. The fourth and final type of MFIs described here is NBFI or Non-Banking and Financial Institutions. NBFI usually provide similar services to their customers as banks do. The main difference lies in their different capital requirements and limitations on certain financial service offerings.

It is important to be able to distinguish between different microfinance types and their different characteristics. These institutions are different legal entities which results in their different behavior and performances. By having access to the breakdown of how the MFIs are defined it is possible to focus with more accuracy on their different characteristics such as their emphasis on sustainability and outreach.

The NGOs are normally the smallest of the entities while the MFIs banks are the largest, however things are not that simple. The largest MFI in the world by staff size is BRAC in Bangladesh. They have more than five million borrowers, and gross loan portfolio of more than $646 million, yet this institution is classified as NGO. They do also have deposit accounts for their customers. At the same time the second largest MFI, Grameen Bank, also in Bangladesh, is classified as MFI bank and the third largest, called SKS Microfinance in India is NBFI. In other words, the classification itself does not tell the whole story, for example, a large NGO might be very different from a small such institution and might in fact be much closer to a large commercial bank than to a small scale NGO. However it is possible to see certain trend in the characteristics of these institutions, the NGOs being perhaps the closest to the original MFIs that were established in the 1970s.

Those MFIs that are used in this research are from MixMarket. The NGOs are greatest in numbers of all the institutions. The breakdown for the year 2011 is presented in Table 2.

Table 2. The breakdown for the year 2011

NGOs	456
NFBI	403
Banks	138
c/c	218
Different	97
Total	**1312**

This categorization looks graphically like this:

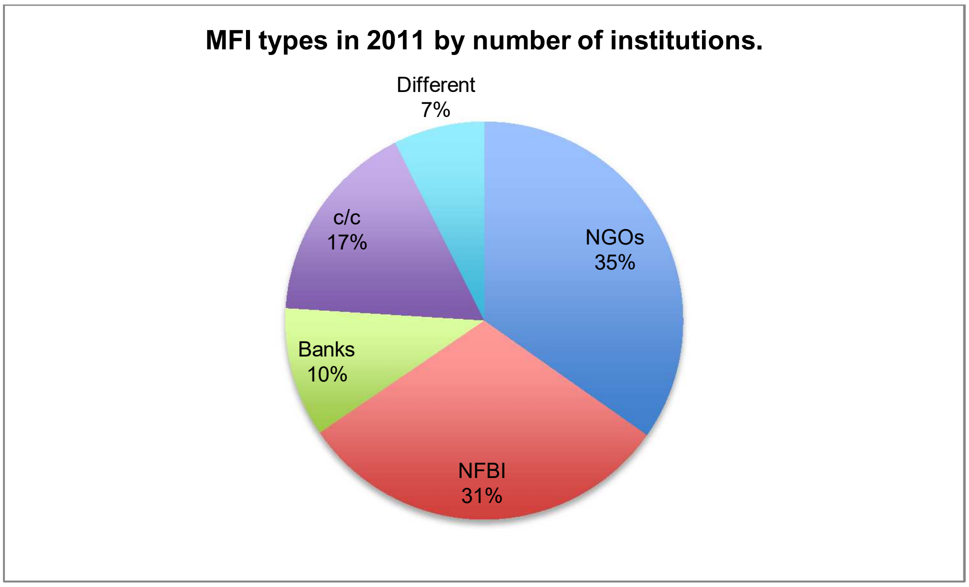

Figure 2. MFI types in 2011 by number of institutions
(Sources: Descriptive statistics from the MixMarket data set)

Although the NGOs are the most common MFIs within the MixMarket data set, the size in term of gross loan portfolio is different. On average NGOs have 16.6 million USD as gross loan portfolio (even less if large outliers are removed), while NBFI has 44.5 million USD, Banks 395 million USD and cooperatives and credit unions have 20.2 million USD as gross loan portfolio. Graphically it looks like in Figure 3.
If we take the sum of the total gross loan portfolio in order to understand which organizations are largest viewed only in relation to my data set, which should, however give some idea about the industry as a whole, then the total gross loan portfolio for all NGOs in 2011 were 7.490 million USD, 17.900 million USD for NBFI, 54.100 million for MFIs banks and 4.380 million USD for C/C which looks graphically like this:

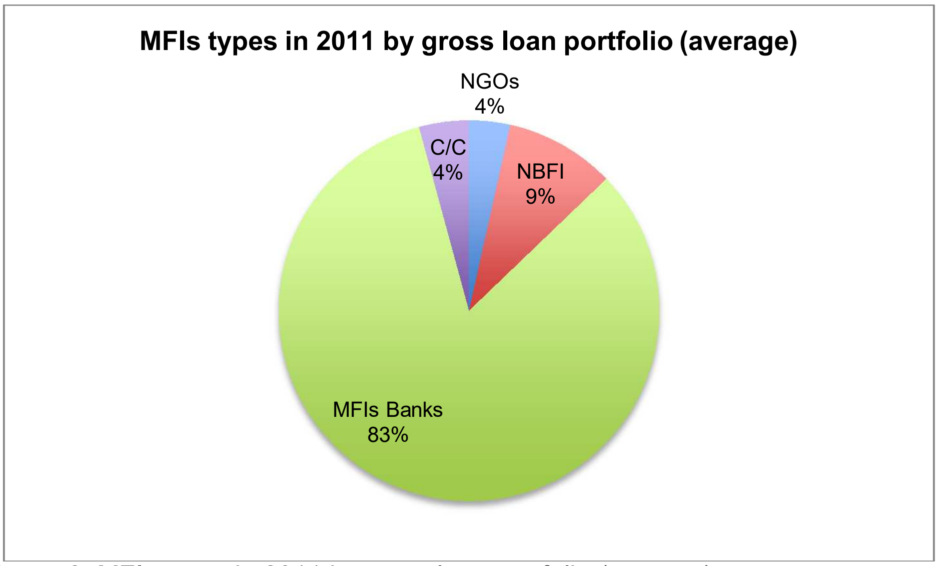

Figure 3. MFIs types in 2011 by gross loan portfolio (average).
(Sources: Descriptive statistics from the MixMarket data set)

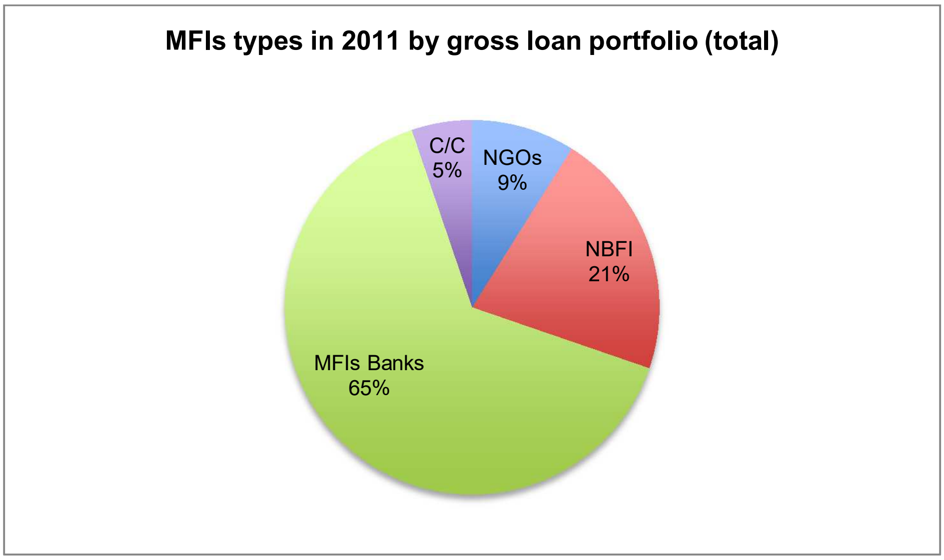

Figure 4. MFIs types in 2011 by gross loan portfolio (total).
(Sources: Descriptive statistics from the MixMarket data set)

In short, although most of MFIs are either NGOs or NBFI, then the MFIs banks are by far largest MFIs when we look at gross loan portfolio.

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