Rethinking Microfinance: Towards relational credit practices for sustainability

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Abstract

Few ideas have been so celebrated or been capable of generating such high and broad worldwide expectations like microfinance. The aim of this essay is to critically sketch the current mainstream microfinance movement and to shed light on its broken promises and emerging contradictions. The paper claims that modern microfinance could increase its internal as well as external sustainability as a development tool by rediscovering some of the key principles underpinning *relational credit practices* as historically testified by a number of bank cooperatives, popular banks and mutual-loan guarantee societies. In conclusion the paper suggests principles to re-imagine the future of microfinance innovating from the past.

Key-words:
1. Microfinance
2. Development
3. Sustainability
4. Relational credit practices

Introduction

Over the last thirty years microfinance institutions (MFIs) have been celebrated as the most powerful and potentially self-sustaining institutional devices for triggering bottom-up processes of development and poverty reduction (Andreoni, 2013a). Microfinance consists in the provision of a wide spectrum of micro-financial services, mainly microcredit, microsaving and microinsurance, to those segments of the populations that are excluded from mainstream commercial banks as a result of their lack of collaterals. Very often MFIs rely upon alternative financial techniques such as various forms of group lending or dynamic incentives as well as tailored

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credit processes that allow them to overcome adverse selection and moral hazard problems (Andreoni and Pelligra, 2009).

Over the last fifteen years the 'mainstreamization' of microfinance has been increasingly transforming the original key features of this global movement. The aim of this essay is to critically sketch the current mainstream microfinance movement and to shed light on its broken promises and emerging contradictions (Dichter and Harper, 2007; Bateman and Chang, 2012). The first step will be to frame modern microfinance in the specific historical-political moment in which it was re-discovered and to show how this rediscovery involved a profound misunderstanding of the nature of microfinance and its limits, both in terms of its overall socio-economic impact and sustainability.

The paper will claim that microfinance today could benefit enormously from rediscovering the institutional models of bank cooperatives, popular banks and mutual-loan guarantee societies and all those financial institutions which in different historical moments and contexts experienced the common philosophy of what we call 'relational credit'(Andreoni and Pelligra, 2009). Specifically, the sustainability of microfinance as an institutional innovation for economic development depends upon its capacity to rediscover a set of principles underpinning relational credit practices. They are: (i) horizontal credit-debt relationships; (ii) high proximity between credit and savings; (iii) strong interlink between credit and production; (iv) scalability from micro to meso institutions by coop-networking.

1. Mainstreaming microfinance: promises or illusions?

Today's microfinance can been seen as the result and, at the same time, one of the main drivers of a new 'developmentalist' discourse which has been emerging gradually since the late 1970s, achieving its most clear manifestation in the *Millenium Development Goals Agenda*. As it has been stressed by Ha-Joon Chang (2010:2), 'development has come to mean poverty reduction, provision of basic needs, individual betterment, sustenance of existing productive structure – that is, anything but 'development' in the traditional sense'. On the contrary, classical development economists such as Albert Hirschman, Gunnar Myrdal and Nicholas Kaldor shared a common idea of development as a circular and cumulative process of structural transformation and increasing productive capabilities (Andreoni and Scazzieri, 2013). A central role in this process was given to the so called 'developmental state', a pragmatic and strategic political actor capable of mastering market forces towards a qualitative transformation of the socio-economic system. Of course, banks were considered central infrastructures and fundamental partners in this process of structural change through increasing productive and technological capabilities.

With the rise of the Neoliberal ideology and the retreat of the State, during the 1980s multilateral organization such as the World Bank, aid agencies such as USAID and policy makers started relying on NGOs, especially microcredit institutions, for promoting development and poverty reduction. These last two words came to be used interchangeably and microfinance, as well as other institutions in the social economy, were elevated to being the most effective and market friendly strategies for the achievement of these goals. This new 'developmental discourse' in which the word *micro* was preferred to the *macro,* found an important support also in the United Nations Agencies, although for different reasons. As Mahbub ul Haq has said, after years in which people were placed at the margin of the development discourse, it was felt necessary 'to put people at the centre of development'. Moreover, as Sen (1997:7) clearly stressed, the great appeal of this new 'alternative paradigm' derived from the rejection of a 'blood, sweat and tears' (to use Churchill's rousing phrase) vision of development'. Microfinance institutions were immediately recognized, along with others such as fair trade coops, social enterprises etc., as the perfect institutional devices for enabling people's agency and cooperation and the expansion of individual freedom and capabilities.

Since the early 1990s, on the basis of these promises the microfinance sector has been increasingly pumped with private and public donors funds, multilateral organization aid and, especially in the last decade, private investment. Astonishingly, as many have documented, these choices were made without any clear understanding of the strengths and weaknesses of the microfinance sector, without any reliable empirical evidence about the impact that MFIs had been able to achieve up to that point (Roodman and Morduch 2009; Duflo et al., 2013) and, finally with a new ideologically driven vision of microfinance, 'the commercial microfinance model'. Now, to understand the present state of microfinance, it is necessary to analyze how and why the 'commercial microfinance model' had generated so many contradictions. In doing that, I will focus on three different dimensions: the institutional transformation of MFIs, the impact on their microclients and the impact on the socio-economic context in which they operate.

2. The commercial model: the 'internal' sustainability

The commercial microfinance model was launched in the wake of a new *mantra* clearly reported in the *Pink Book* (2004), the CGAP guidelines for MFIs: 'microfinance can pay for itself, and must do so if it is to reach very large numbers of people. Unless microfinance providers charge enough to cover their costs, they will always be limited by scarce and uncertain supply of subsidies from donors and governments'. The basic idea behind the 'commercial microfinance model' is that microfinance can be a *win-win* strategy for poverty reduction. In order to get a win-win result, MFIs have to become financially self-sustainable and in the medium-long term have to reach a certain level of profitability. It is claimed that only in this way will MFIs be able to attract and channel private funds into the sector and to reach on a stable basis the huge demand of microfinance services in developing countries (breadth outreach). To become financially self-sustainable (not simply operationally self-sufficient) MFIs have to achieve a critical mass of microclients which would permit them to benefit from economies of scale and, thus, to reduce the high unit costs associated to microservices. The interest rates, as well as the provision of costly complementary non-financial services has to follow the same logic, in other words, quantity has to be preferred to quality.

However, as many case studies demonstrate, the commercial microfinance model does not stimulate the accomplishment of a more fundamental goal, which is increasing operational efficiency by innovating processes and products (Balkenhol 2007; Andreoni, Sassatelli and Vichi, 2013). In fact, being financially self-sufficient does not imply that the MFI is operating at the maximum possible level of efficiency. Very often their financial sustainability is only the result of the lack of competition in their sector, namely the possibility to apply usurious interest rates. For this reason, instead of blindly pursuing financial sustainability at the cost of social performance, the central problem to tackle here should be 'how much innovation and increasing efficiency can modify the nature of the trade-offs and increase the range of possible options' (Simanowitz 2007:63). Now, how are microclients affected by this profound process of institutional transformation?

3. The impact at the micro-level: the microclients

It is evident that evaluating the impact of microfinance requires a multidisciplinary approach and the application of different methodologies (Andreoni, 2013b). A recent paper by Roodman and Morduch (2009), has attempted an interesting critical assessment of the most-noted econometric studies on the impact of microcredit on households. They found that after thirty years 'we have little solid evidence that [microfinance] improves the lives of clients in measurable ways', although at the same time on these basis they cannot 'conclude that microcredit harms' (2009:3-4).

A promising alternative methodology in the assessment of the microfinance impact, as shown in the recent book *Portfolios of the Poor* (2009), is to collect systemic information on the financial practices of the poor. By collecting more than 250 financial diaries in three different contexts (Latin America, Africa and South Asia) this research has shown how:

a. Firstly and paradoxically, the condition of poverty obliges a person to use more intensively than others a wide spectrum of formal and informal financial services. This intense financial life is just a response to the poorest or vulnerable are living on a small, irregular and uncertain income.
b. Secondly, their lives are much more riskier and uncertain, which means that each emergency without appropriate micro insurances, savings or other instruments for raising lump sums can easily degenerate into something worse.
c. Thirdly, different needs require different financial products so the poor select who are the best lenders according to the specific situations. Sometimes 'they can even borrow to have something to save' (idem:23); being willing to pay for saving in security; paying a high interest rate on very short duration loans, etc.

As a result of these dynamics poor households end up managing a complex web of financial relationships (or better connections in an uncertain context) with others – family, neighbors, moneylenders, saving clubs etc. – in order to respond to their everyday needs. At this point, it seems evident how the poor need and can benefit from financial services, even if having access to them simply results in a reduction of their vulnerability and morbidity rather than economic development.

The crucial issue here is to understand what is the most effective institutional tool for providing these services. From what we have observed above, the commercial microfinance model is not the best candidate for a series of reasons. Among them the application of relatively higher interest rates; the preference accorded to individual lending methodologies which reproduce in relational terms, a vertical credit-debt relationship; the oversupply of financial services even when the poor will not benefit from them or have not shown a sufficient debt capacity; and finally, the huge reduction in the provision of complementary non-financial services such as the establishment of market linkages for inputs and outputs, the building of common infrastructures, business and technical training etc., all elements which are crucial for making credit more productive.

4. The impact at the macro level: the 'external' sustainability

Scholars addressing the 'macro-limitations' of microfinance as a tool for triggering sustainable economic development have stressed three fundamental issues (Bateman and Chang, 2012):

a. The micro scale of the investments and firms seems to limit the possibility of benefit from economies of scale in production;
b. The investment in very simple 'no tech / no-capital' microenterprises seems to do not facilitate the accumulation of productive capabilities in key manufacturing activities in the local economy;
c. The inherent fallacy of composition affecting microfinance schemes.

This last point deserves particular attention as it calls in cause the external sustainability of microfinance. As Pollin (2007:2) was among the first to note, microenterprises 'need a vibrant, well-functioning domestic market itself that encompasses enough people with enough money to buy what these enterprises have to sell. Finally, micro business benefit greatly from an expanding supply of decent wage-paying jobs in their local economies'. In other words, even if the microfinance sector were able to finance new 'small tech/small capital' enterprises, relying only on supply side measures would not be enough. The reason for this, as Allyin Young (1928) clearly explained in his classical paper on increasing returns, is that 'the extent of the market', which is nothing more than the market demand for final and intermediate goods, is a fundamental driver for the growth of the economic system and its advancement in terms of division of labour. This reflection is supported in a recent paper by Chowdury (2009:7) in which exponential expansion of microfinance 'seems to have created a mistaken belief among advocates of microfinance that supply creates its own demand a la Say's law. The reality is that the supply of credit and other complementary supply-side factors cannot drive the growth of viable business if the market itself does not expand rapidly'.

5. Rediscovering relational credit practices for sustainability

In order to reimagine a microfinance model for the future we need to rediscover the innovative financial practices successfully undertaken in the old days by various types of financial institutions (Andreoni and Pelligra, 2009; Andreoni, 2013a). In particular, looking at the history of the Mons Pietatis, the most important institutional innovation of the Italian Renaissance or at the first credit cooperatives, popular banks and mutual loan guarantee societies which spread in all Europe over the XIX century, we discover that all these experiences were initially created for providing financial services to a multitude of micro and small economic actors such as artisans, farmers, micro and small local entrepreneurs, etc. Now, one might assume that these institutions were inspired by the same vision as the modern microfinance movement. However, saying that their vision was simply a *micro*-finance one would be very reductive. In fact the profound innovation of the old microfinance movement, which is disappearing in modern microfinance, is a *relational-finance vision* rooted in specific *relational-credit practices*. As we will see sketching out some stylized facts taken from the history of these institutions, the concept of relational credit does not refer simply to the adoption of group lending methodologies with joint liability (i.e the social collateral argument) but involves different patterns of financial and non-financial relations among people in a certain context. Let's start by looking in a comparative perspective at the historical emergence of credit cooperatives and popular banks. By analyzing these experiences we will delineate the principles behind the concept of relational credit practices.

The first credit cooperatives based on the Hermann Schulze Delitzsch and Fredrich Raiffeisen models were born during the 19th century in Germany and spread with different names and institutional forms such as credit unions and saving banks in all continental Europe, Japan, Canada, and America, in this last case with the Morris Plan banks. The Credit Cooperatives *a là Rafaissen* were mostly concentrated in the rural areas, while the cooperatives *a là Schulze*, which in Italy came to be known as Popular Banks, operated in urban areas. In general, the Credit Cooperatives' members, regardless of their income, had the chance to become members of the bank, although initially very often as savers more than as borrowers. Moreover, all members usually came from the same local parish, ran their businesses in the same markets and had learned their job working in the same workshops. As for the governance, credit cooperatives were owned and controlled by their own members according to the rule of 'one head one vote', which guaranteed, during the frequent meetings a democratic participation of all bank members. During these meetings, the members used to define the interest rates, to evaluate the credit/trust-worthiness and debt capacity of potential borrowers, the amount of savings deposited by the members, and sometimes, ended in coordinating joint initiatives for example by establishing market linkages for inputs and outputs. Many of their financial relationships were so heavily intertwined with their different productive activities that we can more insightfully look at them as material credit-debt relationships. With this respect it is also interesting to notice that those cooperatives operating in rural areas developed specific financial products which better responded to the specific needs of agricultural activities, namely long term loans; while those banks working with artisans and merchants in urban areas provided small and short-term loans as a response to the fact that in these activities the financial turnover is faster and there is a continuous need of working capital. Moreover, while the member-owners of rural cooperatives had an unlimited joint liability, popular banks in growing cities adopted a personal limited liability. This choice was clearly an effective strategy considering how people's mobility and anonymity is higher in urban contexts than in rural ones. As a result, in the rural credit cooperatives the deposits were longer term, the interest rates were almost constant, the bank's liquidity was quite low, and, finally, members ended to perceive the bank as "an extension of their own business" (Prinz 2002).

The adoption of a so peculiar model of ownership and governance had crucial implications on bank cooperatives members, their patterns of financial and non-financial relations, and the broader context.

Firstly, the financial relations were embedded in a dense network of horizontal personal relations. Since all the members had the opportunity to be at the same time, or in different moments in time, borrowers, savers, bankers and entrepreneurs meant that their system of interaction was articulated in a *horizontal relational structure*. The institutional arrangements of these cooperative banks were shaped by this relational context. Even those more marginalized people in the community who were not able to have access to large amounts of credit, were not excluded from the bank and their small savings were channeled in more productive 'small tech/small capital' activities.

Secondly, the fact that all the financial resources saved were reinvested in the same community enabled the maintenance of a high level of *'proximity' between credit and savings*. In other words, what is saved is reinvested in a circular process. This property is particularly important as it responds to the need, mentioned above, for a coordinated increase in supply-side and demand-side factors.

Thirdly, an important part of the credit was oriented *towards productive activities and re-production of the credit system*. In other words, the financial activities were functionally linked to productive activities and financial products and services were designed according to the specific needs and features of the borrowers and their micro and small enterprises.

Finally, after WW2, by adopting small institutional adjustments and relying on *coop-networking* strategies, many of these banks have been able to contribute massively to the process of development and structural change of many of today's most successful European Regions. For example, in Emilia Romagna and Trentino Alto Adige, where there has been a historically strong credit cooperative movement, we find today the highest ratio of bank branches to people, the highest level of financial inclusion, the highest presence of micro and small enterprises, and the lowest level of usury. Not only have these financial institutions shown a high degree of resilience, but also a high capacity for reinventing themselves and collaborating with other actors (Andreoni, Sassatelli and Vichi, 2013). The story of Confidi, the Italian mutual loan-guarantee societies is a good example of this. Adapting the principles illustrated above, these institutions whose members are SMEs operating in different sectors, especially in the manufacturing, have been developing interesting practices of relational credit. Instead of recycling their own savings into investments which would have required creating a bank, they have constituted guarantee funds which can be used by all members every time they apply for a loan in a cooperative or commercial bank. As a result, those enterprises affiliated to these confidi can benefit from a higher chance of receiving credit, and generally pay a lower interest rate since part of the investment risk is covered by the business community, not the bank.

Of course, many others institutional formulae have been designed according to the specific socio economic context in which they have emerged. However, those financial institutions which have been developing relational credit practices not only have provided the poor with microfinance services but also have contributed in a broader sense to a sustainable path of economic development.

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