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Microfinance:

Does it hold its promises? A survey of recent literature

Aliya Khawari

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ABSTRACT

Poverty alleviation has been the main target of developmental projects world-wide. However, only a few ideas have stirred so much attention in the last two decades as that of the provision of microfinance through specialised institutions. This paper provides a survey of the vast literature that has developed in this field. Though most of the evidence and literature on the subject appears self-praising, nonetheless there is much more to the concept than one can imagine. The establishment of microfinance institutions (MFIs) world-wide for the provision of collateral free loans to the poor through mechanisms and instruments not known to normal commercial banks has set new milestones in the field of financial services. With 900 million households in the less developed countries left without any access to formal financial services, this might just be the key to address market failures in the financial landscape.

JEL Classification: 012, 016

Key words: Microfinance institutions, group lending, sustainability, target groups

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"To argue that banking cannot be done with the poor because they do not have collateral is the same as arguing that men cannot fly because they do not have wings."

Muhammad Yunus [1]

INTRODUCTION

While many factors contribute to poverty, its most obvious manifestation is insufficient household income. Although the world opinion is divided on the issue of how income and wealth should be distributed, the more common belief still holds together that no one should live in extreme poverty. To solve the problem of poverty all over the world, especially in the 'less developed' countries of the world, there are countless NGO's and international aid agencies operating with the aim to help the poor better their standards of living by providing them incentives in the form of small credits and loans to start their own small enterprises (also known as cottage industries) - many of them with poor results.

According to the Asian Development Bank, alone in the Asian and Pacific region, over 900 million people in about 180 million households live in poverty (i.e., those who earn less than $1.00 a day). More than 670 million of these poor people live in the rural areas, most of them rely on secondary occupations as agriculture alone is not enough to provide for their growing needs (Sharma 2001, p. 1). This employment includes a whole range of paid employment, from micro enterprises over services such as carpenters and weavers to self-employed businesses such as food stalls, tailoring and shoe repair. Again the operators of many of these micro-enterprises are women, who suffer disproportionately from poverty (Ibid.).

Poor households are typically excluded from the formal banking system for lack of collateral, but the micro-finance movement exploits new contractual structures and organisational forms that reduce the riskiness and costs of making small, un-collateralized and cheap loans. The concept of special MFIs (Microfinance Institutions) established specifically for the poor of the society is not a very old one. After the Second World War and into the 1970s, development finance was not particularly concerned about poor target groups. However this view shifted after the realisation of the fact that massive amounts of foreign trade invested in large projects did not necessarily lead to the "trickle down effect" which had been expected. This led to the emergence of the *target group orientation*, where donors started a wave of small, diverse projects meant to make credit available to the poor (Schmidt and Zeitinger 1997, p. 1). In Bangladesh (the country with the greatest number of NGOs per square mile) (Feroze 2002) the BRAC[2] was one of the first organisations that

[1] Founder of Grameen Bank, Bangladesh. The quotation is the epigraph to Ghattak and Guinnane 1999, p. 195

[2] *Bangladesh Rehabilitation Assistance Committee* (1970): for relief and rehabilitation work for the people struck by natural disasters which later changed its name to *Bangladesh Rural Advancement Committee* with

adopted this 'target group approach' (Chowdhury and Alam 1997, p. 194). However not all developmental finance visionaries back this approach and some criticise it quite strongly (Schmidt and Zeitinger 1997, p. 2). The critics argue that financing schemes proved extremely costly for donors and, at least in some cases, for the borrowers as well (due to high transaction costs); that they inevitably failed to reach many members of their target groups. Furthermore, these foreign injections of funds did not lead to the creation of institutions which would have been able to play a lasting role in the lives of their beneficiaries (see Schmidt and Zeitinger 1997, p. 1).

Littlefield, Morduch and Hashemi (CGAP 2003, p. 1) have argued that microfinance, and the impact it has, go beyond just business loans. The poor use financial services not only for business investment in their micro enterprises but also to invest in health and education, to manage household emergencies and to meet a wide variety of other cash needs that they might encounter. Furthermore, since many micro-finance programmes have targeted women (who are the poorest of the poor) as clients, they have not only helped empower women who appear more responsible and show a better repayment performance but also shown that women are more likely to invest increased income in the household and family well being (Littlefield, Morduch and Hashemi 2003, p. 7). Microfinance, therefore acts not only as an economic stimulator for small enterprises but also has far reaching social impacts.

The nature of microfinance is complex and in practice often little understood, especially when it comes to problems arising from a conflict of interests between the donors and the many agents acting for them. The mainstream lack of knowledge on *how* and *at whom* are programmes aimed is that many factors are not taken into consideration while launching such programmes in their preparatory assistance phases (PAPs). Furthermore the question which is usually left out of the whole set up is *through whom* to mobilise the credit for the poor who have no access to it. It is therefore extremely important to devise and construct programmes by thinking in three dimensions (taking into account the diverse factors), environments (economical, social and political), role players and stakeholders.

This paper will deal with the concept of microfinance and bring out its important features. It will also illustrate the main paradigms of the microfinance movement and try to draw a balance between theoretical and empirical evidence on the subject. The long standing debate on whether microfinancing should be commercialised with high interest rates on loans to achieve financial sustainability in the long run or whether it should continue to remain subsidised to reach and aid the poorest of the poor who would otherwise be left with no other alternatives for access to financial services, will be dealt with.

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the realisation to take care of the long term needs of the poor that make up more than half of Bangladesh's 140 million people, i.e., households owning less than half an acre of land and selling manual labour for

The paper comprises of four parts. The first part will present a brief overview of microfinance, its definition and what it encompasses. Furthermore it outlines the main objectives of microfinance and what it aims to achieve. The second part will mainly present case studies of the pioneering microfinance institutions in three countries: Bangladesh, Indonesia and Bolivia. These case studies will bring out the key principles and methodologies of the most popular institutes that have contributed to the establishment of 'best practices' in microfinance banking. Statistical data presented on the institutes will help make a comparison between the different types of structures and models of microbanking.

The third part of the paper will deal with all the mechanisms employed by MFIs world wide in exercising credit services. Among these tools it deals also with the informal mechanisms applied by non institutional credit committees or clubs in less developed countries. It will throw light on the advantages and the weak points of the different mechanisms applied to microfinance. It will also explain how MFIs have benefited in applying one or the other such tool.

The fourth part will basically bring out the results achieved through microfinancing, drawn mostly from a study by Hulme and Mosley (1996) (theirs being a near perfect attempt to measure results in a multi-country analysis of MFIs through control groups with consideration to adequate variables). In addition the third part will also deal with the gap that has widened over the years between the advocates and the opponents of microfinance. The conclusion at the end will present the important findings of the paper.

1. Microfinance: An overview

Microfinance is a much researched discipline. Although there is a lot of literature on microfinance, there is hardly any agreement on a universally accepted definition of microfinance. Researchers and microfinance visionaries are divided in their opinions when it comes to microfinance, its range and its targeted recipients. As Sriram and Upadhyayula put it, "It appears that what microfinance means is well understood, but not clearly articulated". (Sriram & Upadhyayula 2002, p. 1)
However, microfinance is generally an umbrella term that refers to the provision of a broad range of financial services such as deposits, loans, payment services, money transfers and insurance to poor and low-income households and their micro-enterprises (Sharma 2001, p. 1). The demand or need for microfinance comes from the disadvantaged sections of the society - who are without access to services of formal sector financial intermediaries - and are typically excluded from the formal banking system for lack of

survival (see Morduch 1999, p. 1602; and Chowdhury & Alam 1997, p. 173) collateral, in short the poor and the very poor. The definitions of these groups vary from country to country.[3] The clientele of the microfinance institutes are normally employed in the informal sector, with closely interlinked household and business activities and earning low income (Central Bank of Philippines 2002).

In a much narrower sense though, microfinance is often referred to as microcredit for tiny informal businesses of microentrepreneurs, the services being mainly delivered by socially oriented non-governmental organisations (NGOs) (Christen, Lyman & Rosenberg 2003, p. 6).

As a whole the range of institutions go beyond the NGOs and include commercial banks, state owned development banks, financial co-operatives and a variety of other licensed and unlicensed non-bank institutions (Christen, Lyman & Rosenberg 2003, p. 6). According to the Asian Development Bank, microfinance services are provided by three types of sources

- formal institutions, such as rural banks and co-operatives
- semiformal institutions, such as non-governmental organisations; and
- informal sources, such as money lenders and shopkeepers.

Institutional microfinance includes microfinance services provided by both formal and semiformal institutions.[4] A microfinance institution is an organisation that provides financial services to the poor. This very broad definition includes a wide range of providers that vary in their legal structure, mission, methodology, and sustainability. However, all share the common characteristic of providing financial services to a clientele poorer and more vulnerable than traditional bank clients.[5] In collaboration with the MFIs there are also a number of other "non governmental self-help promotional institutions" engaged in co-operative enterprises, health care, family planning, education or other social and local activities (Holloh 1998, p. 1). The role of these financial self-help groups is often to channel subsidised credit to individual borrowers or to mobilise internal savings. They vary considerably according to origin, objectives, membership, institutional affiliations and financial experience and have their origin in neighbourhoods or local communities, in religious, social or economic activities (Holloh 1998, pp.1-2).

1.1 Objectives

The governments and policy makers world wide trying to help over one billion people, in households with per capita income of under one dollar a day, to improve their lives are confronted with a complex and difficult task. Most of the poor in the developing countries lack access to the formal financial intermediaries and the problem is especially serious in

[3] For details refer to Hatch, John (1998); Hulme and Mosely (1997) and; Hulme, Moore and Shepherd (2001)

[4] A microfinance program is used to refer to both specialist MFIs and development NGOs with a saving and credit component (Mayoux 2002, p. 47)

[5] Consultative Group to Assist the Poor (CGAP) 2003: http://www.cgap.org/about/faq05.html and the ADB (2000): http://www.adb.org/Documents/Policies/Microfinance/financepolicy.pdf

rural areas where most of the poor live. This limits their ability to acquire assets, start businesses, finance emergency needs and insure themselves against illnesses and disasters (Littlefield, Morduch & Hashemi 2003, pp. 1-2). Their informal alternatives such as family loans, savings or local money lenders are limited by amount, rigidly administered or available only at exorbitant interest rates. MFIs are then supposed to address this very problem directly.

1.1.1 Poverty alleviation

The first and foremost objective of microfinance has been outlined to be *poverty reduction*. It is generally believed that microfinance programmes will raise incomes and broaden financial markets by principally providing credit, among other services, to small scale entrepreneurs (Aghion & Morduch 2000, p. 402). It is a question of much debate who constitute 'the poor'. The contested issue is whether poverty is attached or defined mainly through material needs or weather it is about a much broader set of needs that permit well being (or at least a reduction in ill-being). In the words of Amartya Sen, "The point is not the irrelevance of economic variables such as personal incomes, but their severe inadequacy in measuring many of the casual influences on the quality of life and survival chances of people" (Sen 1995 *cited in* Chowdhury & Alam 1997, pp. 172-173). If material needs were to be taken into consideration then the measurement of income and consumption variables alone will be the deciding factors. Though on the one hand this method makes it possible to compare and analyse the capacity of different people to meet their immediate material needs as is defended by many[6], on the other hand it introduces a bias to the measurement of poverty for its inability to capture many forms of deprivation experienced by the very poor and hence heavily criticised for such shortcomings (see Chambers 1995 *cited in* Hulme and Mosley 1996, pp. 105-106).[7] Now the significant process by which financial services are conceived as reducing poverty is by the provision of income generating loans. According to Muhammad Yunus of Grameen Bank a successful circle can be set up: "low income, credit, investment, more income, more credit, more investment, more income" (IDSS 1994 *cited in* Hulme & Mosely 1997, p. 101). Since the poor are excluded from the formal banking system for reasons like small loan sizes and lack of collateral, the microfinance campaign has initiated new forms of institutions and organisational structures that make it feasible for the poor to get cheaper and uncollateralized loans. This is achieved through different mechanisms and lending methods like group lending or individual progressive lending, that will be discussed later.

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[6] Greeley (1994, p. 57), for example has strongly defended the use of income poverty measures: 'an absolute and objective poverty line in a form of information that empowers the poverty reduction agenda and encourages appropriate resources allocation.'

[7] Chambers (1995, p. 173) recorded that other dimensions of poverty and deprivation like vulnerability to a sudden dramatic decrease in consumption levels, ill health and physical weakness, social inferiority, powerlessness, humiliation and isolation are significant in their own right and are also analytical components for the understanding of income poverty.

1.1.2 Women empowerment

Although it is not always an outlined objective of microfinance, it is one of the self-evident objectives since microfinance programmes have generally and mostly targeted women as clients.[8] This could be explained by the fact that microfinance aims to help the poor and that most of the poor are women. Cheston and Kuhn write:

"In its 1995 Human Development Report, the UNDP reported that 70 % of the 1.3 billion people living on less than 1$ per day are women . According to the World Bank's gender statistics database, women have a higher unemployment rate than men in virtually every country. In general women also make up the majority of the lower paid, unorganised informal sector of most economies. These statistics are used to justify giving priority to increasing women's access to financial services on the grounds that women are relatively more disadvantaged than men." (Cheston and Kuhn 2002, p. 8)

Most of the 14.2 million of the worlds poorest women now have access to the financial services of specialised MFIs to invest in micro-businesses that they own and operate themselves (Cheston and Kuhn 2002, p. 4). Although access to credit alone will not automatically lead to women empowerment, it is hoped that putting capital into women's hands will give them more independence and confidence and hence more say in matters once they financially contribute to the family's income (Ibid.).

In reality, this objective goes to serve the first objective of 'poverty alleviation' in the most effective way, due to the fact that women tend to spend more of their increased income on their households, children's education and the family's welfare. Hence helping women to improve their incomes means improving the welfare of the family (UNCDF 2002). Furthermore evidence from the data of many MFIs clearly indicates that women prove to be more financially responsible with much better repayment rates.[9] The phenomenon is most outstanding in Bangladesh which is traditionally viewed as culturally conservative and male dominated. Of the five million borrowers that the MFIs serve in Bangladesh, the majority are women (Morduch 1999, p. 1571). The Grameen Bank alone, serves over two million borrowers, 95 percent of whom are women with repayment rates as high as 99 percent (Hashemi and Morshed 1997, p. 218; though figures have been updated from Yunus 2004). Likewise statistics from Latin America, Africa and elsewhere in Asia show that MFIs have women as a greater percentage of their clients.[10] However, the empowerment paradigm has its critics contesting it, among many other reasons; like the feminisation of household debt, feminisation of costs of microfinance delivery, feminised debt substituting instead of legal and political reform and feminisation of costs of structural

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[8] see Littlefield, Morduch and Hashemi (2003) and Cheston and Kuhn (2002)

[9] Hashemi and Morshed (1997); Littlefield, Morduch and Hashemi (2003) and Cheston and Kuhn (2002), prove from studies of MFI's that women have better repayment rates

[10] According to the 2002 Statistics of ACCION (Americans for Community Co-operation in Other Nations), 65% of their and their partner programs clients in Latin America and 77% in Africa were women with total (historical 1992-2002) repayment rates of 97 percent http://www.accion.org/media_media_kit.asp

adjustment programmes; mainly for the exploitation of women to have access to loans by men.[11]

1.1.3 Financial sustainability, outreach and impact: The triangle of microfinance

Sustainability is permanence. The private sector mostly shrinks away from microfinance because of the high risk that is tied to it. This high risk is due to many factors, like the high transaction costs of obtaining information about the creditworthiness of poor clients, high mortality rate of the micro and small enterprises (MSEs), the asymmetries of information between banks and the smallest borrowers and the general belief that banking for the poor is not a profitable activity.[12] Most microfinance programs are therefore developed using public funds and most, if not all MFIs that reach large number of its clients below the poverty line require state or donor transfers to subsidise their costs. Such disbursements of public funds are only justified if the discounted social welfare of public investment in microfinance over a longer period of time are more than its social costs and the opportunity costs of the resources used (Zeller & Meyer 2002, p. 5). Unsustainable microfinance organisations tend to inflict costs on the poor in the future far greater than the gains enjoyed by the poor in the present. Sustainability effects outreach because permanency tends to lead to structures of incentives and constraints that prompt all the groups of stakeholders to act in ways that increase the difference between social benefit and social cost (Navajas et al. 2002, p. 154). Sustainability is not an end in itself but rather a means to the end of improved social welfare (Rhyne 1998, *cited in* Navajas et al. 2002, p. 154).

The provision of financial services to the poor is an arduous task because the poor usually live in the rural and remote areas often without basic institutional infrastructure. Furthermore, given the billions of poor of the world, for these financial services to be available over a longer period of time they have to be profitable or at least self reliant and independent from foreign grants (Sharif 1997, p. 62). Thus, financial sustainability and maximum outreach[13] are the key objectives. There is a wide literature on the trade offs between financial sustainability and the outreach aspect arguing that increasing the number of people reached will undermine and endanger the existence of MFIs themselves. This has been explained due to the facts that increasing the outreach of microcredit programs will attract the wrong kind of borrower[14] who are bad credit risks for the MFIs and secondly, with the rise in the number of clients and the amount of loans, the operating costs[15] for making the loans will rise as well (von Pischke 1996, p. 226). These costs may then

[11] see Mayoux (2002, p. 8), a report on the need for remodelling the models and agendas on microfinance based on evidence from MF programs in Africa

[12] see Navajas et al. (2002) and EBRD Publication (2003)

[13] Outreach is measured by the number of borrowers covered by the credit funds (von Pischke 1995 cited in Sharif 1997, p. 62)

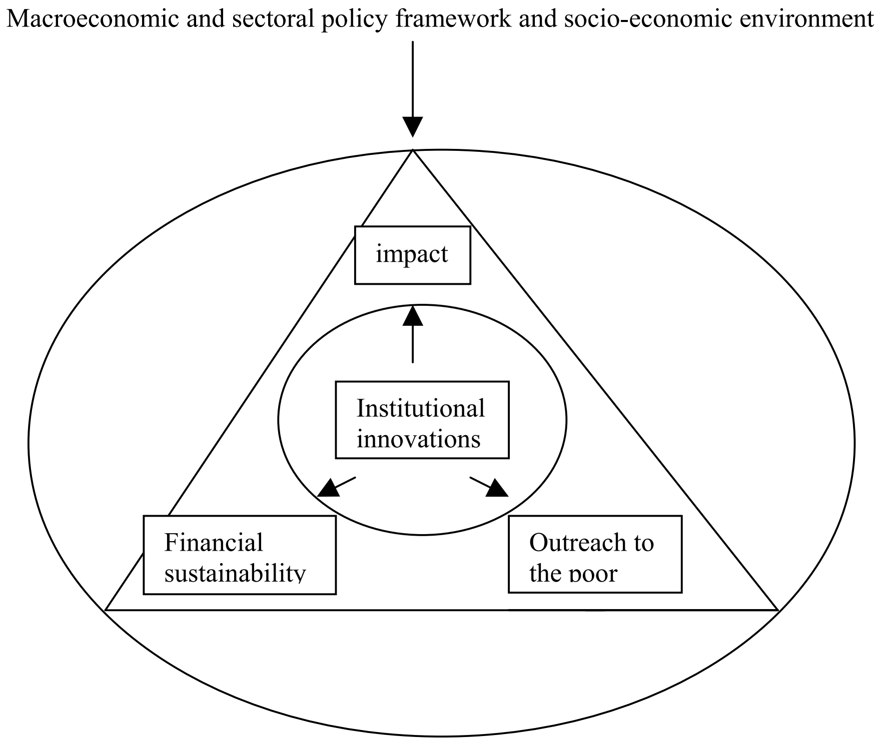
[14] Borrowers who are either dishonest and attracted due to the 'promise of easy money' or are borrowers with poor employment prospects and very few assets (von Pischke 1996, pp. 225-227)

[15] Cost of operation includes salaries and administrative costs, depreciation of fixed assets, the cost of loan and principal lost to default (World Bank 1995 *cited in* Sharif 1997, p. 70)

become permanent in case there is a need to establish branch offices for credit extensions to widely scattered populations. Von Pischke (1996) suggests that successful microcredit lenders are able to balance the demands placed upon them by increasing outreach through greater attention to financial management, thus helping then to attain financial sustainability eventually.

Others have extended this balance of sustainability and outreach to the total impact of the microfinance on the welfare of the poor in general (see Zeller & Meyer 2002, pp. 3-11). The inclusion of the impact aspect into the policy objective of microfinancing is justified on the belief that any further institutional innovation and expansion of microfinance will be dependent on public intervention and financial support. These mostly require public investments which in turn raises the issue of pay-off, in other words impact in terms of economic growth, poverty relief and food insecurity (Zeller & Meyer 2002, p. 7). This forms a critical triangle and brings us back to the argument that the social benefits of microfinancing must be greater than its social costs. This triangle of microfinance showing the three objectives of impact, financial sustainability and outreach is represented in figure 1.1.

Figure 1.1 The critical triangle of microfinance



Source: Zeller and Meyer 2002, p. 6

Usually MFIs emphasise on one of these objectives, though all want to contribute to all three (Ibid.). Hence there may be a trade off between outreach and sustainability or between impact and sustainability and so on.[16] However, to a certain extent, these objectives are also complementary as argued above. The triangle in figure 1.1 comprises of an inner and an outer circle. The smaller inner circle represents all the infrastructure innovations that can be introduced to improve financial sustainability (like application of cost reducing information systems), the impact (such as designing demand oriented and low cost complimentary services for the poor) and the outreach to the poor (such as more effective targeting and lending mechanisms that attract the right kind of clients). The bigger outer circle is the external environment where all kinds of socio-economic factors along with macroeconomic and sectoral policies influence the performance of MFIs either directly or indirectly (Zeller & Meyer 2002, pp. 5-6).

2. Case studies: Pioneers in microfinancing

The microfinance revolution (Robinson 2001) that started in the 1970's has come a long way. Though poverty has not been solved, a lot of poor people now have access to financial services. Many of the MFIs are small, operate in few locations, serve a small and particular type of clients and are often unable to mobilise enough savings to acquire sustainability, thus making them vulnerable and dependent on the whims of donors (Zeller& Meyer 2002, p. 2; and Morduch 1999, p. 1571). Others have grown over time serving millions and their institutional innovations have made it possible to make them sustainable. Bangladesh, Indonesia and Bolivia, among a few others, have proved to be the haven for such successful and sustainable MFIs.[17] Many of the MFIs in these countries started as an experimental venture in the 1970s, like the Grameen Bank of Bangladesh (Hashemi & Morshed 1997, p. 217), or as part of initiative entities set up by NGOs and leaders of business communities in the mid 80s, like the PRODEM of Bolivia that gave rise to BancoSol, the first private commercial bank in the world dedicated exclusively to microenterprise (ACCION, 2003). Other commercial banks introduced microfinance products and services to low income clients in order to increase client outreach and profits, like the Bank Rakyat of Indonesia.[18] Still other examples include the famous "village banks", incorporated for the first time by the Foundation for International Community Assistance (FINCA) in Costa Rica in 1985,[19] in the meanwhile the method of village banking is being used world-wide in at least eighty other organisations (FINCA 2001). A

[16] for example impact of loans could be raised through complementary services - such as business or marketing services or training of borrowers-but supplying them increases operating costs, thereby endangering financial sustainability if borrowers or public transfers are unable to maintain/ pay off the costs (Sharma & Buchenrieder 2002, p. 223)
[17] see: Morduch (1999) and Zeller and Meyer (2002)
[18] BRI was established in the year 1895, but *successful microbanking system* was introduced only in 1984 transformed from a failed, subsidised credit program from the early 1970s, to a nation-wide commercial financial institution that profitably provides microfinance services (Maurer 1999, p. 6)
[19] The 'village banking method' was first introduced in 1984 by John Hatch, an economist on international development (FINCAs WebPages): http://www.villagebanking.org/about/history.php3

similar and more or less indigenous village or rural banking system exists in Indonesia,[20] the Bank Kredit Desa system (BKD Program), where each unit is owned by the individual village and operated by selected residents of the village.

MFIs have helped transform the dogma about lending to the poor; often viewed as being a profitless activity with high risks; and have developed alternative models with varying doctrines and target groups. Furthermore, the norm that only heavily subsidised credit provided by the government banks (with far lower repayment rates) are the only solution to the supply of credit for the poor, no longer holds (Morduch 1999, p. 1573). To illustrate the different mix of the mechanisms applied and in use in the pioneering MFIs, the five institutions mentioned above are described in the coming sections.

2.1 Grameen Bank - Bangladesh

The idea of Grameen Bank originated in rural Chittagong, Bangladesh through a university professor, Muhammad Yunus in 1976 as an experiment. Much of the motivation behind the idea was the need for credit by the poor borrowers of the area which would eventually free them from the clutches of the informal moneylenders (because the poorest of the poor had no access to commercial credit) (Jain & Mansuri 2003, p. 254). Yunus started a project giving out collateral free loans from his own pocket to the poor villagers for income generating activities like weaving bamboo stools and making pots (Morduch 1999, p. 1575). The model was shaped on the idea of group lending, the group being formed voluntarily by the villagers. Aided by high repayment rates, the project grew to neighbouring villages and areas and today has 1,195 branches, working in 43,681 villages, with the number of borrowers totalling to 3.12 million, 95 per cent of whom are women (Yunus 2004).

The group comprises of five persons selected by the members themselves from among their peer group. This self selection serves as a screening and monitoring mechanism replacing the need for collateral and keeping transaction costs low.[21] Realising that women are particularly vulnerable, and at the same time careful investors with high repayment rates, Grameen has moved gradually towards lending mainly to women. With financial transactions being carried out within the village rather than the branch office, women who hardly leave the village have been the major profiteers (Hashemi & Morshed 1997, p. 220). Furthermore the social environmental conditions in which Grameen operates, is conductive to repayment of loans resulting from pressure from peers since all in the group are held responsible for loan repayment. The lending mechanism used is the credit rotation (locally

[20] BKD units were first set up in 1898 and though some analysts state that the concept is based on a Dutch village banking system (Ravicz 1998, p. 76), attempts of replicating the same method outside of Indonesia have not been so successful (Morduch 1999, p. 1578)

[21] Hashemi & Morshed (1997, p. 220) argue that this self selection screens out the non-poor in that the small loans and identification of the banks with the poor discourage the wealthier strata of the society from joining and also keep out those who would not be able to make repayments in that their peers can better judge who is reliable and who is not

called Kamethi or Samity, to be discussed in later chapters), with lending first to the initial two persons in the group, then to the next two and then to the fifth. Clients from eight such groups come together weekly so that the bank staff get to see forty clients at a time. Should one of the members default in a group, subsequent loans to the other group members would be denied. In this way the system cashes in on the local information depending on the informal insurance relationships and threats, that range from social isolation to physical requital (Besley & Coate 1995, p. 2).

This system of joint liability and collective responsibility seems to be working exceptionally well with recovery rates standing at 99% in the beginning of 2004 (Yunus 2004). Most loans are for one year with an interest rate of 20% for income generating loans[22] ranging from US$ 75 to US$ 100. All the members of the group are expected to save. Weekly personal saving deposits (of 1 Taka, Bangladeshi currency) make up a part of the *group fund* that is deducted at the time of the first disbursement of the loan (forced savings, usually a fixed percentage of the loan value). When the amount of saving reaches 600 Taka, the group of five is obliged to purchase Grameen Bank shares, which would provide security against default and also serve as sources of additional loans, for consumption or investment, the terms and conditions of which are determined by the group members themselves (Hashemi & Morshed 1997, pp. 219-220). The timely repayment of the loans is a pre-requisite to bigger and different types of loans, acting as an incentive to repayment.

The performance of Grameen over the decades has been very impressive with total revenue generated in 2003 estimated as US $ 60.98 million. Income from interest on loans to the borrowers accounted for 77 per cent of the revenue. Total expenditure was US $ 49.91 million. Profit for the year 2003 was US $ 11.07 million. The bank claims to finance 100 per cent of its outstanding loan from its own fund and its depositors savings. Over 75 per cent of the deposits come from bank's own borrowers (Grameen Bank 2003). According to Yunus, the founder of Grameen, the bank today needs no funds from the donors and "......the growing amount of deposits will be more than enough to run and expand it's (Grameen's) credit programme and repay its existing loans" (Yunus 2004, Report on the Grameen Bank homepage). This would mean that Grameen is financially sustainable. However, although Grameen has been relatively open with its data and provides a full set of accounts in its annual reports, many argue that the outcomes appear so positive and encouraging because of the discrepancy of all accounting definitions (Morduch 1999, p. 1589). For example, Grameen calculates overdue rates as:

$$\text{Overdue rates} = \frac{\text{the value of loans overdue for more than one year}}{\text{current portfolio}}$$

[22] Grameen Bank differentiates in interest rates depending on the type of loan; like housing loans, student loans, loans for Struggling Members (beggars, with 0% interest rates). All interests are simple interest, calculated on declining balance method (Yunus 2004).

Now the problem is that the current portfolio tends to be much larger than the portfolio that existed when the overdue loans were first made. With the portfolio expanding 27 times between 1985 and 1986, reported default rates are considerably lower than standard calculation of arrears (which instead immediately captures the share of the portfolio 'at risk'). The adjusted rates replace the denominator with the size of the portfolio at the time that the loans were made. Doing this can make a big difference as presented in the chart below:

Table 1: Grameen Bank: Selected financial indicators (in millions of US $)

	1985	1990	1992	1994	1996	1985-1996 (average)
Overdue rates (%)						
Reported overdue rate	2.8	3.3	2.5	0.8	13.9	1.6*
Adjusted overdue rate	3.8	6.2	1.9	15.0	-	7.8*
Profits						
Reported profits	0.02	0.09	-0.15	-0.56	0.46	1.5**
Adjusted profits	-0.33	-1.51	-3.06	-0.93	-2.28	-17.8**

Source: Morduch 1999, p. 1590

Notes: * Average for 1985-94, weighted by portfolio size, ** Sum for 1985-1996

Overall, overdues averaged 7.8 % between 1985-1996, rather than the reported 1.6%. The rate is still impressive relative to the performance of the government banks , but it is high enough to start creating financial difficulties. Similarly there is a significant difference between reported and adjusted profits. Till recently, the writing off of losses by the bank had been slow and the adjusted rates ensure that in each year the bank writes off a modest 3.5 % of its portfolio (still considerably less than 7.8% average overdue rate). The result is a two digit loss figure instead of the $1.5 million in profit as reported. Similarly, the grants provided by the donors make up part of the income in the profit calculations (Morduch 1999, pp. 1590-1591). Hence, Grameen cannot only rely on income from investments and lending without having to incur losses. It seems that still, it does work on this basis as long as it grows on the deposit and investment side.

In a country like Bangladesh where the majority of the population is poor, institutions like Grameen and others like it (Bangladesh Rural Advancement Committee (BRAC) and the Bangladesh Rural Development Board (BRDB); all using a Grameen style lending model)[23] are believed to have a strong economical and social impact on the lives of the inhabitants. A survey of Grameen, BRAC and BRDB by Pitt and Khandker (1998) in Bangladesh used a sample of 1800 households, in 87 villages. Among other findings, the most profound results of the survey showed that women and their families have benefited from the programs. For example increase in household consumption was observed to be

[23] Morduch (1999, p. 1602); Chowdhury & Alam (1997, p. 171) and Wood & Sharif (1997, pp. 46-49)

more when the borrowers were women and not men and schooling of girls particularly increases in when the borrowers are women and lending from Grameen (Pitt and Khandker 1998, p. 2). However, although Pitt and Khandker interpret the impacts as marginal, average impacts estimated with more limited econometric structure contradict these claims (Morduch 1998, p. 2).

2.2 The BancoSol of Bolivia

BancoSol was created in 1992 as the first licensed commercial bank solely dedicated to provide micro-finance services to micro-entrepreneurs. Its creation was the result of transforming PRODEM, a non-profit microlending NGO, into a regulated financial entity (BancoSol 2004). PRODEM had grown to outstrip the capacity of the local banking system to supply it with lending capital, thus prompting its stakeholders to redefine its status into a commercial bank for hopes that the profit status would help to attract private investment (Schreiner 2002, p. 597). BancoSol has achieved much from the commercialisation of the bank, according to some studies it has captured more than one third of the borrowers in the entire Bolivian banking system.[24]

BancoSol differs from Grameen in many ways and resembles it in some ways. With the transformation of PRODEM into BancoSol the focus shifted to banking instead of social service. Like Grameen it started to establish itself through the extensive use of the group lending mechanism, where the borrower needed no collateral but had to belong to a joint liability credit group. But differs from the Grameen in that loans are made to all group members at the same time, with three to seven members in one group (Morduch 1999, p. 1576). Furthermore in 1995, with the emergence of Caja Los Andes, a profitable competitor that uses individual liability loans, BancoSol has also started lending to wage earners and individuals (who do not wish to form a solidarity group and can offer some other kind of guarantee) (ACCION 2003). Like Grameen, most of its clients are women - mostly market vendors, seamstresses, bakers, candy makers etc.. Third, unlike the Grameen Bank where interest rates are low, BancoSol has relatively high interest rates. Interest rates on loans in 1998-2000, offered to clients with a good performance record were at 45-50%, which is extremely high when compared to Grameen but not so when compared to the typical moneylender , who may charge as much as 10% per month (Morduch 1999, p. 1576).

Fourth, BancoSol is independent of subsidies and self sufficient due to the high interest rates. It makes a decent return on loans. Though the return on equity has drastically fallen in the last years (1.7% at the end of 2002), in 1997 and 1998 it reported a peak return of 29 percent and 36 percent, respectively (MIX 2002). Fifth, both the repayment schedule and

[24] According to the data of 1995, BancoSol together with Caja Los Andes (a micro-lending competitor), shared around 40% of the microlending market (Navajas et al. 2003, p. 748). However according to Morduch (1999, p. 1577), in 1998 Bancosol had 40% of all low income borrowers in Bolivia, having served 81503 clients

the loan durations are both flexible (see Table 2). Unlike Grameen where repayments have to be made every week, BancoSol permits some borrowers to make weekly and other to make monthly payments. Likewise loan duration periods are not fixed to one year as in the case of Grameen, the duration of loans vary from 1-13 months (Morduch 1999, p. 1576)
Last but no least, borrowers in Bolivia are better off than those in Bangladesh and the loans are also larger. BancoSol gives out small loans (as low as $100) to first time borrowers, but the loan size to repeat borrowers is much bigger, with average loan sizes well above $ 1000, compared to the average loan size lying well below $ 150 for the Grameen Bank (Table 2). Hence, while BancoSol, like Grameen, serves the poor as clients, most of its clients are among the 'better off' poor and lie just above the poverty line[25] (Morduch 1999, p. 1576). This could be due to the fact that though by Latin American standards, Bolivia is a poor country, GNP per capita in Bangladesh is significantly lower than Bolivia, with Bolivia at US $ 970 in 1999 and Bangladesh at US $ 360 (World Bank 1999); on the other hand it may also be that through microfinance the poorer clients have moved on to become less poor borrowers (Morduch 1999, p. 1576). However, the clients of BancoSol are among the poorest in Bolivia, as compared to those of other MFIs like those of Caja Los Andes, who were found to have more liquid collateral wealth compared to borrowers of BancoSol (Navajas et al. 2003, p. 750).

BancoSol's rapid expansion and success comes from impressive repayment performance, although it has been widely observed that compared to its competitors, BancoSol offers a relatively standardised loan contract to all takers with quite minimal screening (Navajas et al. 2003, p. 768). However the expansion has been brought to a halt through a combination of intense competition, a deep recession and limited information sharing amongst microlenders (which might lead to membership overlap that would in turn increase the chances of default).[26] Nonetheless BancoSol stands as a success, having achieved financial sustainability and has been successfully replicated in many other Latin American affiliates of ACCION International (Americans for Community Co-operation in Other Nations, an umbrella organisation (NGO) based in Massachusetts. ACCION has many partner micro-lending organisations that help people, mostly poor, to work their own way up the economic ladder).

[25] Where poverty is based on access to a set of basic needs like housing, public services, education and health services (Navajas et al. 2002, p. 159)
[26] See Navajas (2003, p. 748) and Chaudhury & Matin (2002, p. 46)

The following table serves to highlight the basic characteristics of the five MFI's discussed in this chapter.

Table 2: Characteristics of selected leading microfinance programs

	Grameen Bank Bangladesh	BancoSol Bolivia	Bank Rakyat Indonesia Unit Desa	Badan Kredit Desa (BKD) Indonesia	FINCA Village Banks
-Membership	3.12 million	53,812	3 million borrowers; 28 million depositors	765,586	171,000
-Average loan balance -Typical loan term	$134 1 year	$1509 4-12 months	$ 1007 3-24 months	$ 71 3 months	$ 191 4 months
-Percent female members -Mostly rural / urban	95% rural	60% urban	18% mostly rural	50% rural	95% mostly rural
-Group lending contracts -Collateral required	yes No	yes no	no Yes	no no	no No
-Voluntary savings emphasised -Progressive lending	no yes	yes yes	yes yes	no yes	yes yes
-Regular repayment schedules	weekly	flexible	flexible	flexible	weekly
-Target clients for lending	poor*	largely non-poor	non-poor	poor	poor
-Currently financially sustainable	no**	yes	yes	yes	no
-Nominal interest rates on loans (per year)	20%	47.5-50.5%	32-43%	55%	36-48%

Sources: Grameen Bank: figures updated for January 2004, loan size is from December 1996 (Morduch 1999, p. 1574); Bancosol: figures from 2001 from ACCION International, interest rates from Morduch (1999, p. 1574); BRI Unit Desa: figures for 2002 for membership, female members from Microbanking Bulletin, interest rate, loan balance and loan term from Morduch (1999, p. 1574); BKD: Morduch (1999, p. 1574), female members figure is for 1993 (Christen et al. 1995), FINCA: Morduch (1999, p. 1574), membership figures updated from FINCA's Homepage

*The poor comprise of those owning less than half an acre of land or earning less than $1 a day

**Though Grameen Banks founder clearly and publicly claims financial self reliance, it is a matter of how accounting terms are defined and understood

2.3 The Bank Rakyat of Indonesia (BRI)

Bank Rakyat is a century old state owned commercial bank set up mainly for the provision of financial services to the non-urban and remote areas along with a special aim to encourage the farmers and support the agricultural sector (Maurer 1999, p. 6). Though the bank serves all market segments in the banking industry, here the concern is only with the unit desa[27] system - the microbanking services for low income borrowers (not necessarily

[27] Desa in local language means *village,* which is a little misleading because the unit desas are located at the sub-district capital towns and not at the villages (Maurer 1999, p. 6)

the very poor) - of the bank. With the provision of small loans and saving services in both rural and urban areas, the unit desa has more clients than any other bank in Indonesia (Robinson 2001, p. 58). The establishment of the unit desas came about in the 1970s with the massive effort of the government to lend to rich farmers to attain national rice self sufficiency. However, despite government subsidies and low interest rates the program (called BIMAS)[28] failed and could only be saved with a massive restructuring of the unit desas as an independent profit-centre of the Rakyat Bank in 1984 (Maurer 1999, p. 6).
Like BancosSol, the unit desa system of Bank Rakyat is self sufficient. However the unit desa system uses a different lending technology and does not lend to groups, unlike Grameen and BancoSol. What differentiates the unit desa system from all other programs however, is the requirement of collateral[29] by the bank for the issuance of loans to individual borrowers (Morduch 1999, p. 1577). In this way the very poorest borrowers are automatically excluded; thus the bank lends to the "better off" poor and the non-poor households with an average loan size of US $ 1007 in 1996 (see Table 2). Neither does the unit desa of the BRI specifically target women as borrowers like the Grameen or BancoSol. Although women have made up a significant part of the borrowers the number has declined over the years (see Christen et al. 1995, p. 29). Only 18% of all borrowers were women in 2002 (see table 2).
Nonetheless, operations remain small scale and the flexible definition of collateral gives the staff a little leeway to increase loan sizes for reliable borrowers who may not be able to fully back loans with assets (Ibid.). Despite this 'flexibility' in the definition of collateral repayment rates for the bank have been quoted at 98.34 percent in 2002 (BRI 2002) and this rate has been maintained even during the financial crises in Indonesia. Repayment rates for BRI were as high as 97.8 percent in March 1998 (McGuire 1998, p. 10).
The focus of the bank on achieving an extensive branch network in Indonesia with an average of five staff members each has not only helped it reduce costs immensely but also to serve over 3 million borrowers. In addition to the 320 branches at district level, BRI has 3600 units at the sub-district level as well as village service posts (Maurer 1999, p. 9). Another feature that the unit desa system has concentrated on almost since its establishment (restructuring) in 1984, is the introduction of SIMPEDES (rural savings product). Whereas Grameen and BancoSol have only recently started to mobilise savings more aggressively (Morduch 1999, p. 1607), this saving instrument of BRI units helped the program to break even within two years, to be profitable since 1986 and free of subsidy since 1987 (Robinson 2001, p. 63). As Table 2 shows, the number of depositors at BRI for the year 2002 stood at 28 million (Microbanking Bulletin 2002). Like BancoSol, BRI borrowers start off with smaller loans that increase over time depending on repayment

[28] Stands for *bimbingan massal*, meaning mass guidance: it was the Indonesian governments subsidised agricultural credit program operated through BRI from 1970-85 (Robinson 2001, p. 270)
[29] The question raised here is what differentiates it from the normal banks then? Though collateral is needed, the unit desas however are different from ordinary banks in that they lend out smaller loans and have vast network of branches even in rural areas with mostly low income residents.

performance. Interest rates in general are set at 34%. However, as an incentive to timely payment, loans repaid on time have an interest rate of 24% (15% in real terms).

Unlike Grameen and similar to BancoSol, BRI is a commercial and not a social organisation. Microfinance is an instrument that it uses to earn profit, it does not provide clients with training or guidance (Robinson 2001, pp. 58-59). On their loans to poor and low income households, alone in 1995 the unit desa of the BRI made a profit of US $175. Even more outstanding is the fact that the unit desa system repayment rates and profits have outdone the performance of the loans made to corporate clients by other parts of the bank (Morduch 1999, p. 1578).

2.4 The Bank Kredit Desa of Indonesia

The Bank Kredit Desa system (BKD)[30] is a sister institution of BRI and has existed in its present form since 1952 (although it was first established in 1898) and is less well known. 4806 active kredit desas were reported in 1996 operating mostly in rural Indonesia with each bank unit owned by the village and operated by three of the members of the village, usually the village heads or chiefs (Ravicz 1998, p. 76; and Morduch 1999, p. 1578). Small capital grants from the provincial governments helped establish the kredit desas. This initial grant, required and voluntary savings and the retained earnings make up the loan capital of the kredit desas (Ravicz 1998, p. 76).

The kredit desas give out loans to individuals like the BRI's unit desa and its operations are financially self reliant. In 1994, the program had a client base of 0.7 million borrowers, to whom loans worth US$ 30 million were disbursed and the profit of $ 4.73 million was reported (Morduch 1999, p. 1578). Like the Grameen Bank, the kredit desas target and lend to the poorest households and most of the borrowers are women. Loan sizes at $ 71 are comparatively smaller than those given out by Grameen and significantly smaller than those issued by BancoSol or BRI (Table 2). At the same time the interest rates at which the loans are given out (55% nominal annual interest rate and a 46% real rate in 1993) are much higher than those of BRI. This could be explained due to the fact that the BRI is the supervisory body of the BKDs and their business is defined by the BRI with monthly supervisory visits to the village kredit desas to review their performance. Therefore the small loan sizes and the high interest rates prevent any competition between the unit desas of BRI and BKD (Ravicz 1998, p. 81).[31] Borrowers of kredit desas in need of bigger loans can then move on to become BRI clients given that they have a good repayment background. The duration or term of the BKD loans generally range from 10 -12 weeks with repayments taking place weekly (Morduch 1999, p. 1578).

[30] Also called Badan Kredit Desa (BKD) (Ravicz 1998, p. 76)

[31] This however gives rise to difficulties for BKD to compete with its competitors like the Badan Kredit Kecamatan (BKK), who provide small, non-collateralised loans and often operate in the same villages (Ravicz 1998, p. 81)

Like at Grameen and BancoSol, no collateral is required for the issuance of loans. An interesting feature of the BKD system is that the distribution of funds is delegated to and managed by the village heads (also termed as management commission) (Morduch 1999, p. 1578). This is specifically true and works well in Indonesia due to the distinct system of authority that runs down from Jakarta to the villages. This reliance on the system of local heads is of advantage in that it usually makes an effective use of the local information in the same way as the other MFIs utilising group lending, while at the same time, maintaining an individual lending approach. Borrowers thought to be the worst credit risks are in this way singled out by the commissions (Ibid.).
Following in the footsteps of BRIs unit desa system, BKDs introduced voluntary saving products in 1991 which have grown slowly but consistently since then. At the end of 1996 total savings under the program stood at US $ 9.8 million (Ravicz 1998, p. 79). . No interest is paid on forced savings[32]. However, BKDs offer almost the same interest rates on small voluntary savings as BRI and other MFIs. The other rural local banks offer twice the rate of interest on savings (Ravicz 1998, p. 77).
On the one hand the structure of BKDs make them vulnerable to systematic credit risk due to the dependence of their loan portfolio's concentration in a single village. But on the other hand, this structure appears to be most suitable to provide financial services to extremely remote and thinly populated areas at relatively low fixed costs. Fixed costs are low because BKDs operate from already existing village facilities and the staff are paid completely on commission. BRI supervision costs, too, are bound to the BKDs annual loan volume (Ravicz 1998, p 76).

2.5 The Village Banks (FINCA)

The kredit desas of Indonesia are not the only examples of village banks. A more viable and world-wide applicable village banking system has resulted out of the initiatives of John Hatch and his co-workers, from The Foundation for International Community Assistance (FINCA), a non profit NGO, for the first time in 1985 in Latin America (FINCA 2001). Most of the attempts by NGOs to apply the system in different continents have had more success than those of others like the Kredit desas of Indonesia (Morduch 1999, pp. 1578-1579). FINCA currently co-ordinates a network of programs located in the Americas (Mexico, Honduras, Guatemala, the Dominican Republic, El Salvador, Haiti, Nicaragua, Ecuador, Peru, and the United States), Africa (Uganda, Malawi, Tanzania, South Africa, Zambia, Burkina Faso and Mali), Central Asia and the newly independent states of the former Soviet Union (Kyrgyzstan, Armenia, Azerbaijan, Georgia, Kosovo and Russia) serving over 171,000 borrowers (FINCA 2001).[33]

[32] Forced savings are a fixed percentage of the loans (deducted usually at the time of issuance of the loan) and theoretically can be claimed back after the repayment of the loan. More often though at BKDs these forced savings are hardly returned and in this way serve as a fee for the bank (Ravicz 1998, p. 79)
[33] NGOs like CARE, Catholic Relief Services, Freedom from Hunger and Save the Children work with the village banking model in many countries (Morduch 1999, p. 1579)

The village banks are community-based credit and savings associations set up by the NGOs together with local groups that typically consist of 25 to 50 low-income women who administer and manage all loan decisions and selection of members independently. That the clients are from amongst the very poor and mainly women makes the village banks similar to Grameen. Village banks grant loans for four-month cycles. Unlike Grameen or BancoSol, loans are made to individual members. The loans are then repaid in weekly instalments of capital, interest, and savings. Starting loans basically lie around US $ 50 and the initial loans are made by a sponsor agency like the NGOs. After the first cycle, loan amounts are based on savings; the more a member saves, the more she may borrow.[34] Typically clients are expected to have saved about 20% of the loan value to have subsequent loans (Morduch 1999, p. 1579). This 20% of the loan value is deposited in the village bank's internal account, which the members manage collectively, deciding how to use or re-invest. At the beginning of the next cycle, individual members receive a new loan, equal to the original loan plus the amount of savings they have accumulated.

Similar to the Kredit Desas of Indonesia, the village banks exploit the local information most effectively without having to sacrifice borrower individuality. Likewise interest rates on the loans are high lying in the same range as that of Unit Desas of BRI (with a nominal interest rate of 4% per month in 1998, thus an annual interest rate of 36-48%) (Morduch 1999, p. 1579) but lower than the BKD's (Table 2). Though village banks of FINCA operate on almost all continents, they have yet to attain financial sustainability and require substantial subsidies to cover capital costs and can only meet 70% of their total costs on average (Ibid.). This is mostly because the village banks had to make a trade off between outreach and scale, with the aim of reaching areas that are especially difficult to serve (e.g. rural Mali and Burkina Faso) (Morduch 1999, p. 1579).

3. Microfinance mechanisms

The five MFIs discussed in the last part summarise briefly the different methods used for the common goal of lending to low-income households. It has been the aim of microfinance theorists and policy makers for the establishment of institutes or networks with a system that would utilise the societal assets of the borrowers in the absence of physical possessions. Mostly group lending has been emphasised to serve this purpose, however it is by far not he only instrument that differentiates micro-credit contracts from the standard loan contracts.

It is true that the group lending models have had a lot of success in serving borrowers who are just starting micro businesses with the only employee being him/herself. However, the model is quite limiting for clients who intend to move upwards and seek bigger loans. It is because of these limitations that the most famous of group lending MFIs like the BancoSol

[34] The Virtual Library of Microfinance : On FINCA http://www.gdrc.org/icm/finca/finca-top.html

have started turning to individual lending as well (Aghion & Morduch 2000, p. 402)[35]. The five institutions discussed previously also use dynamic incentives, regular repayment schedules and collateral substitutes to aid the maintenance of high repayment rates. Repayment schedules among the programs also vary significantly. Only two of the programs use group lending techniques (table 2) but all tend to lend in increasing amounts over time ('progressive' lending), all bid for terms better than the alternative sources of credit and all aim to do away with borrowers in default. This section discusses the various methodologies known for screening and the diversity of technologies applied for repayments. The mechanisms discussed in 4.1 and 4.2 will deal with mechanisms relevant to group borrowing.

3.1 Peer selection

Collaterals are normally pledged as a means of separating good risks from bad risks. In the case of low-income or poor borrowers who have no collateral to offer, group lending is an effective substitute to separate good borrowers from bad borrowers in that it deals with adverse selection and brings similar types of groups together. Group lending draws on local information networks to achieve the equivalent of gathering direct information on borrowers (Ghatak & Guinnane 1999, p. 197).

Ghatak (1999) in his elaborate econometric work, has shown that the grouping process is a helpful means in raising repayment rates, lowering interest rates and fostering social well-being. He is of the perception that price differentiation (of loans) achieved through group lending contracts can never be matched through individual lending contracts. Furthermore, he states that risky borrowers who will end up with risky partners (if they find partners at all) will be less willing to accept an increase in the extent of joint liability than safe borrowers for the same reduction in the interest rates. This implies that the degree of joint liability can be used as a screening instrument to induce borrowers to self-select loans that differ in terms of individual and joint liability (Ghatak 1999, pp. 31-35).

This view has been shared by Aghion and Gollier (2000) in a parallel work on peer group formation[36]. According to Aghion and Gollier, the peer group model helps in the induction of low interest rates. In addition this model gets rid of credit rationing. This is done by reducing costs normally incurred for the verification of the borrowers past performance status. It is also effective in cases where borrowers are uninformed about their potential

[35] Even the Grameen Bank has been said to explore the new grounds for lending technologies other than group lending, for its wealthier and more established borrowers (Aghion & Morduch 2000, p. 402). See also Grameen Bank: Microfinance-Credit lending models (1998): http://www.grameen-info.org/mcredit/cmodel.html.This however has been a rare appearance in the literature on Grameen

[36] Ghatak (1999) focuses more on peer group formation under perfect information, whereas Aghion and Gollier address the urban like scenario, where migration is frequent and information is scarce. However, both derive the same conclusion that peer group lending improves efficiency and lowers interest rates

partners. The collateral effect, called cross subsidisation, caused by the peer group formation helps reduce the interest rates on the loan[37].

3.2 Peer monitoring

The fact that joint liability can reduce the moral hazard of the borrowers has been explained by the fact that it serves as an incentive for the group members curative steps against and / or towards a peer member who might misuse her/his loan because of joint liability (Ghatak & Guinanne 1999, p. 202). Thus the group lending model tends to serve as a monitoring instrument among peers or in other words tends to harness social collateral[38]. In the case of non-payment borrowers with individual lending contracts have to fear only the penalties imposed by the bank. In contrast to this in group lending, in case of default the borrower will also be confronted with the wrath of his or her peers. The implicit social costs for the defaulting member may be very high, especially in communities with a high social cohesion (Besley & Coate 1995, p. 2)

For the borrowers of joint liability agreements 'strategic defaults' (that the borrowers are unwilling, rather than unable to pay their loans) can be ruled out. This is due to two reasons. Compared to commercial banks in developing countries, the borrowers are better able to monitor one another, given the geographical proximity and the exchange (trade links) that exits between them. Second the execution of social sanctions from other borrowers against strategic defaulters serves as a far superior enforcement technology for debt repayments (Aghion 1999, p. 81). Thus in this way the peer monitoring costs, critical for the optimal peer group design, can be transferred onto the borrowers. It has been observed that the advantages of group lending is maximised when groups are neither very small nor too big. Groups should not be too small because of joint responsibility, meaning the insurance of the loan is spread on multiple individuals; and the cost of the loan to several members reduces the cost per individual. Groups should not be too big because of the free-riding effect (Ibid.). The free-riding effect is created when each member does not have as much incentive in generating his return as he would if he alone were liable for his loan. The sharing of returns reduces the incentives for efforts, so the individual members will tend to make too little effort (Koo Che 2002, p. 3)

3.3 Dynamic incentives

Another important mechanism for assuring high repayment rates dynamic incentives. Normally programs start with lending out small amounts to first time borrowers and upon satisfactory repayment, the loan sizes are gradually increased (also called progressive

[37] This is because the joint responsibility for the loan obliges the group members to repay not only their own share of the loan but also of their defaulting peers, otherwise the entire group is denied any future finances. Hence pressure from peers often is an instrument to high repayment rates (Aghion &Gollier 2000, p. 632)

[38] Theories of peer monitoring had been mostly initiated by Stiglitz (1990) and Varian (1990) as sited in Ghatak and Guinnane 1999, p. 202

lending)[39]. Progressive lending has the unique advantage of testing the borrowers with small loans, allowing lenders to develop relationships in time and so sort out potential defaulters before the loan scale is expanded (Ghosh & Ray 1997, p. 493).

An essential element of these incentives is the threat not to refinance a borrower who defaults on debt obligations. Together with progressive lending, this is a way to get over the information asymmetry problems and enhance efficiency (Aghion & Morduch 2000, p. 408).

It is of utmost importance that the interest rates are kept low because the MFIs plus point is their provision of financial services at rates more appealing than their competitor's in the market. This applies to Bank Rakyat and BancoSol in practice, who charge higher interest rates than most other MFIs like Grameen, but still keep their rates quite below those charged by the traditional moneylenders. Seeing the potential profitability of the BancoSol model, competition in the micro-credit market has intensified in Bolivia, significantly reducing the number of BancoSol's clients (Navajas et al. 2003, pp. 748-750). With time, competition might reduce the effectiveness of the dynamic incentives against moral hazard, as it has been observed in the case of BancoSol and also Bank Rakyat. But since there are only a handful of MFIs who are profitable, this threat is yet to be felt by most of them. The need for a centralised credit rating agency grows stronger with competition (Morduch 1999, p. 1583).

Dynamic incentives tend to function much better in areas where mobility is low. This is why it is mostly ideal for rural areas, because mobility in urban areas is comparatively high. It is much more difficult to monitor and get hold of any defaulters who would then try to establish a credit line with a different agent/ program in the community by moving away (Sumar 2002, p. 8). Banks have had lesser problems to attain repayments in their rural programs than in their urban ones and this is yet another reason why microfinancing is less popular with men than women, who are tied to one geographical area (Morduch 1999, p. 1583; and Sumar 2002, p. 8). This goes to explain why some MFIs like the Bangladesh Rural Advancement Committee (BRAC) shifted their focus to women, even though they did not start out mainly like that (see Matin & Hulme 2003, pp. 651-653). According to Morduch, since women have fewer alternative borrowing possibilities than men, dynamic incentives will be strengthened. He bases this assumption on a study by Rahman (1999), describing complementary cultural forces based on women's "culturally patterned behaviour." (Morduch 1999, p. 1584).

Furthermore, another challenge arises if the lending relationship should come to an end in the near future. The borrowers will then have the incentive not to pay in the final period. Reckoning this, the lender will not want to lend in the last period, which will induce the borrowers to default in the next to the last period. This will lead to a spiral that would eventually mean the end of the entire process. Hence dynamic incentives would then serve

[39] (Hulme & Mosley 1996, pp. 50-54)

the purpose of repayment when the end date of the programs are unknown (Morduch 1999, p. 1583; and Sumar 2002, p. 8).

3.4 Regular repayment schedules

One of the main features of microfinance that differentiates it from a standard business loan offered by commercial banks is the use of regular repayment schedules. The repayments begin as soon as the loans are given out to the borrowers and proceed regularly thereafter. In contrast to commercial bank's standard loan contracts, MFIs have established a new way of loan repayments, usually on a weekly basis as in the case of Grameen Bank. This is done by adding up the principal and the interest due in total and dividing it by 50 [which roughly represents the number of weeks in a year] (Aghion & Morduch 2000, p. 414).

This repayment system helps screen out undisciplined borrowers and thus represents an early warning system for loan officers and peer group members alike. In addition, since repayment starts before the borrower's project or investment actually brings in returns or profit, the borrowers would then need to have a supplementary source of income to rely on. Thus, insisting on weekly repayments means that the bank is effectively lending partly against the households steady, diversified income stream, not just the risky project (Morduch 1999, p. 1585). However, this clearly indicates that there exist an incompatibility between the borrowers need (especially those having seasonal occupations) and the microfinance scheme. As a result of this, the extremely poor who have their supplementary incomes tied directly to uncontrollable factors such as the weather, would then have complications in repaying if their entire group is dependant on the same factors.

3.5 Other collateral substitutes

Some MFIs like the BRI have the pre-condition of a collateral, whereas many others have come up with substitutes. Programs like the Grameen, for example, asks borrowers to contribute to an 'emergency fund'. This fund is established through a payment of about 0.5 percent of every unit borrowed by the borrowers. This fund is meant to serve as an insurance against potential default, death or disability and similar circumstances. A 'group fund' account is established in addition to this emergency account. At the time of the first loan disbursement a compulsory deduction of 5 percent (also termed as group tax) is made for this group fund (Hashemi & Morshed 1997, p. 219). Almost half of the fund can be placed at the disposal of the group members, provided that there is unanimous consent, however typically it is disbursed among the group as zero interest loans. Earlier the members of Grameen had no right to withdraw this fund with the expiration of their contracts. But for about a decade now these funds can be withdrawn when leaving the Bank, of course only after the Bank has deducted what the borrower owes it (Morduch 1999, p. 1585).

In comparison the BRI is among the few MFIs that require collateral. Not surprisingly, this has helped the BRI to succeeded in generating good repayment rates and attain financial sustainability. However, its advocates emphasise instead the role of dynamic incentives in generating repayments (Robinson 1992 *cited in* Morduch 1999, p. 1586). Because of the complex nature of the whole mechanism, it is quite difficult to determine which incentives actually play the most significant role in achieving high repayment roles. Even though collateral for loans is hardly ever collected[40], according to bank officials, nonetheless its importance as an incentive for the return of loans should not be underestimated (Ibid.).

Others, like the BancoSol have diversified their lending approaches over time. Though initially BancoSol emphasised the importance of the solidarity groups for high repayment rates, the need for different loan structures arose with the prosperity of its clients at varying rates (Navajas et al. 2003, p. 752). By the end of 1998, more than a quarter of BancoSol's portfolio had some kind of guarantee other than the solidarity group (Morduch 1999, p. 1586).

3.6 Rotating Savings and Credit Associations (ROSCAs) and Accumulating Savings and Credit Associations (ASCAs)

Rotating savings and credit associations can be found all over the world and go by different names in different regions and countries[41]. It is surprising that NGOs around the world have paid little attention to the lending technologies of their informal competitors that operate efficiently without any (financial) costs. The MFIs have much to learn from the ROSCAs and their mechanisms (Wood & Sharif 1997, p. 372; and Rutherford 1997, pp. 368-369).

ROSCAs are basically groups of people who decide to pool their money, make regular contributions, and then give money to members on a rotating basis.[42] Mostly women are participants of ROSCAs, however, men too take part in it. Structures of these informal organisations are extremely diverse as are the aims of the members. In general however, each woman has another member "guarantee" her loan, so that if the first woman is not able to pay, her guarantor assumes the debt (Mayoux 1995, p. 59).

There is typically an agreed procedure for deciding the order for taking the pool of money. But in some ROSCAs, members may request special consideration for emergencies and go before their turn. This is how it works: lets say there are 25 members who meet weekly and each contributes $2 to their ROSCA. At each meeting one of them is chosen via lottery and given the total amount of money collected, in this case $50. Once a member has received

[40] If the threat of collection is believable, there should be few instances when collateral is actually collected (Morduch 1999, p. 1586)

[41] Examples include indigenous institutions like *esusu/ tontine* (West Africa), *chitti/ Kamethi* (India and Pakistan) *arisan* (Indonesia), *susu* (Caribbean) and *juntas or panderas* (Latin America) (Mayoux 1995, p. 59). For a detail list of local names for ROSCA's around the world see GDRC link: http://www.gdrc.org/icm/rosca/rosca-names.html

[42] Rutherford in his study of ROSCAs in Bangladesh (samities) observed that the neighbourhoods indulging in such credits associations were mostly from 'lower middle class or poor' (Rutherford 1997, p. 355)

the amount, her/his name will not be entered into in the lottery again, though she/he will go on depositing her/his $2 every week. After 25 weeks when all the members have had their share of the fund, the ROSCA ends. Usually a new one is then started, often with more members or bigger amounts.

ROSCAs are one of the two broad categories of user-owned savings and credit schemes. The other category is called ASCAs (accumulating savings and credit associations). In this category the fund built up from members contributions or savings is not rotated among the members as soon as it is collected as in the case of ROSCA. But it accumulates through regular contributions and is at the disposal of members (sometimes also non-members) to draw on as they wish. However anyone who uses the funds of ASCA has to pay a small interest on the loan, which is then distributed to the contributing members as a dividend at the end of the ASCAs life (Rutherford 1997, p. 353). ASCAs are quite similar to the village banks of FINCA. In fact the village banking system of FINCA is just another name for ASCAs, that have existed long before the village banks came into existence (Matin et al. 1999, p. 16).

ROSCAs are indigenous and perhaps the most efficient form of financial intermediation known as they convert small savings into loans instantaneously without any paperwork or storage costs. Furthermore they are flexible and can be adjusted to any group size or kind. There have been efforts to establish microfinance programs based on the ROSCA's models in Africa and Asia. In Kenya, organisations based on the ASCA model function profitably without donor funds where other MFIs have failed to serve their purpose due to high operating costs and slow client intakes. In 2001, they had 29000 clients (Mule et al. 2001)[43]. Many small MFIs with 'self-help groups' in India, Bangladesh and Pakistan Work with the same model. In southern India the professional management of ROSCAs (called 'chit funds') reached extreme levels of sophistication such that their activities are regulated by the parliament, "Chit Funds Act, 1982" (Rutherford 1997, p. 366; and see also Tankha 2002).

3.7 Empirical research agenda

While reviewing most of the existing literature on microfinance, the institutions, their diverse structures, the tools and mechanisms employed, the actual running of their operations, their social and economical impacts; all seem to function somehow like advertisements. A significant part of the theoretical approaches are sustained with anecdotes from a particular set of programs rather than empirical regularities. The expansion of the microfinance theory can gain much from better research which would in turn enhance the ongoing policy dialogues. This is easier said than done. Because there is a lack of a comparable framework where the performance of the different mechanisms of the

[43] In 1996, USAID/Jamaica provided assistance to establish a microfinance program modelled on a traditional Jamaican form of ROSCA (rotating savings and credit association), known as the “Partner.”(Blank 1998, pp. 1-3). See also Seibel and Marx 1987

microfinancing can be quantified or measured to determine their efficiency. MFIs usually use one lending model, it would help for example if it were possible to compare the different models with samples within a single program like individual lending contracts to some borrowers and group lending to the others, weekly repayments for some, monthly or quarterly schedules for others.
Morduch stresses the need for well designed experiments because "...a collection of studies instead presents regression in which repayment rates are explained by proxies for forces behind particular mechanisms. The variations thus arise from features of the economic environment that effect the efficiency of particular program features" (1999, p. 1586). The results from existing evidence is often varied and may not necessarily have the same interpretation because information flows, markets and the enforcement mechanisms are effected by a whole range of other factors and not just the type of credit contract. Particularly relevant, among other environmental conditions and factors, is the political economy context that might promote or restrain the development of MFIs (Michealowa 2003, p. 76) Narrowing the gap between theory and evidence will be an important move toward improving and evaluating programs (Morduch 1999, p. 1587).

4. Does microfinance work?

The idea of microfinance has fascinated many who broadcast its successes widely, especially donors who often pledge billions of dollars to support the idea decade after decade. True that it has introduced and developed innovative financial intermediation to sectors of the society, namely the poor and low income, who would otherwise have little or no access to financial services. In addition, it also stops the exploitation of the poor at the hand of local moneylenders. True that it provides small loans for the promotion of small enterprises instead of giving charity. But how great is the ultimate impact of microfinance on poor households? Are the benefits of microfinancing really more than its costs? Is microfinancing financially self-sufficient and sustainable at all?
This part will mainly deal with the significant aspects of microfinance in achieving its objectives and also discuss the difference of opinions and the divide that has emerged over time between the advocates and the critics of microfinance. It will also outline the important findings of studies which have played an important role in adequately measuring the results microfinancing has achieved.

4.1 The microfinance schism

The idea that allures most of the supporters of microfinance is based on the fact that the institutions that adopt the rationale of good banking will automatically also serve the task of poverty reduction or alleviation. This has been termed as the win-win proposition (Morduch 2000, p. 617). According to this argument, MFIs that are financially sustainable and shun or avoid subsidies in the long run will have more outreach and serve their purpose better because there would be no limitations imposed on them from the donor side[44]. The key paradigm being that low income households need to have approach to credit and not 'cheap credit'. Hence high interest rates do not come at the cost of outreach. In the light of this argument, poverty can thus be reduced without costs to governments or donors and may even bring in profits (Ibid.).

Other practitioners however are not so easily convinced. The fact remains that most poverty alleviation programs are subsidised. For example an extensive survey of all MFIs targeting the poorest clients in 1998 revealed that they yield revenues that would only cover 70 percent of their total costs (Microbanking Bulletin 1998, pp. 18-23). Subsidy rates do not necessarily fall with the age or scale of the institutes, in fact some donors believe that little more than 5 percent of the programs will be financially sustainable ever (Morduch 2000, p. 618)[45]. The critics argue that the win-win logic is much more complicated in nature than it seems, with success depending on aspects that have been mostly ignored like the occupations of the borrowers or the use of the loans. They argue that so far, comparisons have been inadequate and that assumptions are too quickly generalised without reliable evidence. In addition, the loan size consideration is also complementary for the comparison of outreach, however rough and indirect it may be. For example, BKD's success with its clients despite the small loan size is also dependant on the type of occupations that the borrowers have, which in this case would be petty traders, small restaurant owners or tailor shops. These small entrepreneurs engage in activities with high margins and quick turnaround investments that enables them to make repayments with interest rates as high as 55 percent on short term loans (Table 2). However, other programs lending to borrowers engaged in moderate return sectors like livestock, agriculture and handicraft have to consider long term financing, which would prove too costly to the borrower if interest rates are too high.

4.2 Empirical evidence

While innumerable studies have been made, only a handful have used appropriate control frameworks and sizeable samples that meet the agenda of answering the questions of *financial sustainability, impact* and *outreach* to the poorest and the trade offs in pursuing the goals simultaneously. Two such studies are worth mentioning. Morduch (1998), presents cross sectional study drawn mainly from Pitt and Khandker's (1998) survey of 1800 households in Bangladesh served mainly by three main MFIs namely: Grameen Bank, the BRAC and the BRDB. The study also included a control group of households from areas that were not served by any MFIs. The study summarises important findings on comparisons of consumption level, school enrolment of children in the control groups, the

[44] Assuming that donors usually have the say in how a program should be run

[45] It should be noted that private commercial banks or credit unions like the Indonesian BKDs are not included in this rough speculation but just the concerned NGO programs (Morduch 2000, p. 627)

supply of labour and also takes the seasonality aspect into consideration. Among others, the most important assertion of the survey is the impact of the loans on the poor, showing that access to credit does not result in the alleviation of (income) poverty as is popularly believed but rather has an impact on the reduction of vulnerability (Morduch 1998, pp. 29-31). The study however is limiting in that it takes only a single country, namely Bangladesh, into consideration.

A much comprehensive analysis is presented by Hulme and Mosley (1996). Their work is based on the examination of 13 different MFIs in seven countries with different structures and all having the objective of poverty reduction. It takes into account the effects of design, management and policy environments on the financial sustainability of the institutions and its impact on poverty.[46] The study compares two control groups of 150 each, with one group comprising of borrowers and the other of non-borrowers, with similar incomes, asset holdings and access to infrastructure. The impact variable was then measured over a 5 year period from 1989-1993. The important findings of the study has been summed up below.

4.2.1 Financial sustainability and best practices

Table 3 shows the financial performance and the poverty impact results of the 13 MFIs studied. The institutions having more tendency towards financial sustainability (Group A in Table 3) had lower arrears rates and subsidy dependent indices than those that were less financially sustainable. Furthermore, design features such as the availability of voluntary saving facilities, higher interest rates, the frequency of loan collection, and the existence of material incentives to borrowers and lending staff to maximise repayments, appeared to correspond more with financial sustainability (Hulme and Mosley 1996, pp. 56-57).[47]

[46] It is important to mention that the definition of poverty adopted by the authors for their research analysis, was a manifold one. The income poverty as well as the vulnerability and other forms of deprivation, including physical weakness and mental disability, social inferiority, powerlessness and isolation, were taken into consideration (Hulme & Mosley 1996, p. 106)

[47] Such design features have been termed as the "best practices" and are widely circulated by the Consultative Group to Assist the Poorest (CGAP, donor consortium housed within the World Bank), the US Agency of International Development, the UNDP and other key donors (Morduch 2000, p. 617)

Table 3: Overview of 13 microfinance institutions

								Average increase in borrower income as % of control group *	
	Number of borrowers (1991)	Subsidy dependence index	6-months arrears rate (1992)	Voluntary savings	Frequency of loan collection	Incentives to pay**	Proportion of borrowers below poverty line (%)	Whole sample	Individuals below poverty line only
Group A									
Bolivia BancoSol	51 000	135	0.6	Yes	Monthly	1	29	270	101
Indonesia BRI unit desa	1 800 000	9	3.0	Yes	Weekly	2	7	544	112
	499 000	32	2.1	Yes	Weekly	2	38	216	110
Indonesia BKK	158 000	35	13.7	Yes	Weekly	2	29	-	-
Indonesia KURK	1 050 000	142	4.5	No	Weekly	1	vast majority	131	126
Grameen Bank	598 000	199	3.0	No	Weekly	1	vast majority	143	134
Bangladesh BRAC	25 000	199	0.0	No	Weekly	1	vast majority	138	133
Bangladesh TRDEP	702 000	226	4.0	Yes	Monthly	1	52	157	123
Sri Lanka PTCCS	2 400	217	8.9	Yes	Weekly	1	-	133	103
Kenya KREP Juhudi									
	542 822	**132.7**	**4.4**	**-**	**-**	**-**	**-**	**276.5**	**117.8**
Average Group A									
Group B									
	12 000 000	133	42.0	Yes	Annual	0	44	202	133
India RRBs	1 700	267	20.2	No	Monthly	0	0	125	-
Kenya KIE-ISP	223	1884	43.4	No	Weekly	1	vast majority	117	101
Malawi Mudzi Fund	400 062	398	27.8	No	Annual	0	9	175	103
Malawi SACA									
	3 100 496	**670.5**	**33.4**	**-**	**-**	**-**	**-**	**154.8**	**112.3**
Average group B									

Source: CGAP 1996, p. 2 [48]

* Year prior to survey ** Incentives to repay: 0= none, 1= larger repeat loans only available if repayment performance is satisfactory, 2= as 1, plus staff pay and borrower interest rates related to repayment performance

4.2.2 Financial sustainability and poverty reduction

According to the analysis, the relationship between poverty reduction and financial sustainability is a little ambiguous. Such that, the income impact of institutions in Group A were found to be greater than those in Group B. However, the range of the proportion of clients under the poverty line is quite vast, with 7 percent at BRI (Group A) and 9 percent at Malawi Saca (Group B) to the vast majority in the Bangladesh organisations (Group A).

[48] The table is a summary of the important findings from Mosley and Hulme, Finance against poverty, Routledge 1996, pp. 110-112

The study summed up that the average income impact of borrower households above or on the poverty line is higher than those below the poverty line, as compared to income changes encountered by a control group. Thus program impact increases, at a decreasing rate, with client income.

4.2.3 Why do less poor borrowers receive more income impact?

The study defended the assertion that higher income borrowers experience a greater income impact. This is because clients above the poverty line are more willing to take risks and invest in technology for the efficiency or advancement of their activities that would in turn most probably increase income flows. On the other hand, very poor borrowers tend to take out small, subsistence protecting loans and rarely invest in new technology, fixed capital or hiring of labour (as depicted in Table 4). Rather than having a positive impact on the income of the very poor households, these loans in some cases serve the opposite and even lower the income and the borrowers often find themselves engulfed in debts (Mosley and Hulme 1996, p. 98).

Table 4: Borrowers samples

Loan use per $ 100 borrowed by income category

	Household Income Category	
Loan Use	Less than 80% of Poverty Line	Higher than 80% of Poverty Line
Consumption	69	14
Purchase of working capital	15	30
Hiring of labour outside the household	5	12
Purchase of fixed capital (not embodying technology)	10	32
Purchase of fixed capital (embodying new technology)	6	12
Average Loan Size	59	143

Source: CGAP 1996, p. 3[49]

Though the overall positive impact of the loans were enjoyed by the better off clients, still some of the very poor borrowers managed to attain a considerable rise in income from their loans. It is interesting to note that the very poor who did manage to increase their incomes, borrowed for relatively low risk capital investments such as small irrigation, high yielding seeds in rain-fed areas and new carpet weaving looms (Mosley and Hulme 1996, p. 100).

4.2.4 Why do financially sustainable institutions produce better income impact?

The impact of Group A institutions (especially BancoSol, BKK and the K-REP) were well above the ones with the worst record for financial sustainability. Other than the adoption of

[49] The table summarises the findings of Mosley and Hulme, Finance against poverty, Routledge 1996, pp. 91-101

the "best practices" features, the authors put forth a number of possible explanations of how these features enable clients with a better potential to generate higher returns to self select themselves into a program:

a) Financially sustainable institutions have high interest rates that serve as an automatic screener for borrowers with projects with low rates of return (Mosley and Hulme 1996, pp. 30-32).
b) Most sustainable financial institutions have voluntary or compulsory saving schemes, which again asserts screening those out who would not be able to save; furthermore, this serves as a kind of an insurance for households and banks, should projects fail to yield the expected level of return (Mosley and Hulme 1996, pp. 188-190).
c) The provision of services close to the borrowers place of residence or economic activity lowers the transaction costs to the customers, thus raising their rate of return (Mosley and Hulme 1996, p. 189)

4.2.5 Assessing the trade-off

The most important implications of the study could be listed as follows:

a) MFIs are likely to produce a higher income impact by focusing their lending on clients just above the poverty line who would also invest in technology for the efficiency of their activities helping them earn higher returns on their investments.
b) Poverty impact and financial feasibility both can be enhanced if adequate institutional reforms are introduced, like cost recovery interest rates, saving and insurance facilities, intensive collection of loan instalments and incentives to repay.
c) For increasing the depth of outreach to the very poor, products that conform to the requirements of the poor like small emergency loans for consumption or appropriate saving facilities will increase their successful uptake of financial services.

5. Conclusion

The microfinance movement has come a long way and on its way has immensely changed the financial landscape around the world. It has inspired new banking concepts that have given hope to the poor households for the betterment of their livelihoods through their own efforts and labour. In the process of the development of the microfinance ideology, the development of the rhetoric of making profits while reducing poverty simultaneously (win-win situation), however, has moved much faster than the empirical evidence and the claims have yet to be really substantiated.

The most important purpose that the microfinance idea has served is the acknowledgement of the shortcomings of the existing mechanisms of banking and added to the perception of rethinking the poverty paradigm. This in turn has brought about the need for institutional innovation. In particular, the MFIs have proved that despite the absence of collateral and high transaction costs, lending to low income households can be profitable. In addition, experiences with some MFIs, like BRIs unit desas among others, have explicitly shown that the poor are able to save in significant amounts when given the right saving mediums. This can further the cause of reducing constraints to borrowing for the poor by addressing the savings side of the poor households. Bolivia, Indonesia and Bangladesh have proved this although it has taken a lot of effort that ranged from special legal accommodations to strong leadership. Such efforts are usually hard to come by.

The role of NGOs has been immense in the microfinance movement and usually they have had the energy, financial resources and in most cases the dedication to follow and bring about changes in the legislation and influence institutional decision making. Increasingly, NGOs can be expected to take over social tasks [if they have not yet done so] as the state ministries adapt accordingly.

On the other hand if poverty alleviation is to be achieved challenging alternatives have to be tried out. Taking a really serious look at the mechanisms and the management structures of the programs can significantly reduce costs while not necessarily reducing outreach to the poor[50]. Experimentation and evaluation of new structures that take into consideration the diverse factors and the environments (political, economical, social etc.) that can effect the success of a program can aid instead of just replicating existing programs that might or might not function in another set up with a different set of variables and surroundings.

While changes have been brought about, a lot still remains the same. Lending bigger amounts to a few is still cheaper than lending smaller amounts to many more. Though claims are exaggerated, fact remains that many programs are still subsidised. This brings us to seriously ask the question whether subsidised programs are really that bad. For example if institutes like the Grameen Bank serve poor clients and in doing so the benefits outweigh the costs, why not support it through subsidies? If subsidies are cut down most of these programmes (according to some estimates 95%) will go down, leaving the governments with millions of poor, with their subsistence at risk, on their hands. Hence ongoing subsidies to programs can benefit the poor and the governments/ institutions alike. The lack of alternatives to microfinance for serving the destitute to help themselves has yet to be identified.

[50] For example, learning from programs like Pahnal (micro savings institute in Mexico). Pahnal not only introduced new mechanisms but also reduced operational costs immensely by setting up branches in post offices (already existing structures) (see Morduch 1999, p. 1606)

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Abbreviations

ACCION	Americans for Community Co-operation in Other Nations
ADB	Asian Development Bank
ASCA	Accumulating Savings and Credit Association
BIMAS	Bimbangan Massal (Indonesia)
BKD	Badan Kredit Desa (Indonesia)
BKK	Badan Kredit Kecamatan (Indonesia)
BRAC	Bangladesh Rural Advancement Committee
BRDB	Bangladesh Rural Development Board
BRI	Bank Rakyat Indonesia
CARE	Catholic Relief Services
CGAP	Consultative Group to Assist the Poor
EBRD	European Bank for Reconstruction and Development
FINCA	Foundation for International Community Assistance
GDRC	Global Development Research Centre
GNP	Gross National Product
KIE-ISP	Kenya Industrial Estates- Informal Sector Programme
KREP	Kenya Rural Enterprise Programme
KURK	Kredit Usaha Raykat Kecil (Indonesia)
MFI	Microfinance Organisation
MIX	Microfinance Information Exchange
MSE	Micro and Small Enterprises
NGO	Non- Government Organisation
PAP	Preparatory Assistance Phase
PRODEM	Fundation papa la Promocion y Desarollo de la Micro Empresa (Bolivia)
PTCCS	Primary Thrift and Credit Co-operative Society (Sri Lanka)
ROSCA	Rotating Savings and Credit Association
RRB	Regional Rural Bank (India)
SACA	Smallholder Agricultural Credit Administration (Malawi)
SIMPEDES	Savings scheme organised by BRI, *q.v.* (Indonesia)
TRDEP	Thana Resource Development and Employment Programme (Bangladesh)
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Programme