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In Microfinance, Clients Must Come First

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In Microfinance, Clients *Must* Come First



In the debate over whether microfinance works, few microfinance institutions articulate what, exactly, their ultimate goals are and how, exactly, they will achieve them. The authors cut through the confusion by mapping a clear theory of change for microfinance. If the goal of microfinance is to alleviate poverty, they say, then MFIs should focus on helping their clients build successful enterprises, rather than on making more and bigger loans.

by SRIKANT M. DATAR, MARC J. EPSTEIN, & KRISTI YUTHAS

MICROFINANCE MAY BE ONE OF THE WORLD'S MOST powerful new solutions to poverty, as well as to the wars, diseases, and suffering that poverty ignites.

If it works.

Supporters of microfinance contend that small loans fuel economic self-sufficiency. They point to the billions of dollars that microfinance institutions (MFIs) such as Grameen Bank, Acción International, and Opportunity International (OI) have given to millions of small-time, impoverished entrepreneurs. They cite research showing that microloans increase household consumption,¹ give women more clout in their communities, encourage the use of contraceptives, and improve the nutrition of young children.²

Critics, in contrast, contend that the world's most vulnerable people are often in no position to take on the risks of entrepreneurship. They point to evidence showing that stable jobs in large industries, not volatile small businesses, lift people out of indigence (see "Microfinance Misses Its Mark" in the spring 2007 issue of the *Stanford Social Innovation Review*). They cite research showing that microfinance clients have been known to scrimp on food, sell their furniture, borrow from loan sharks, and take second jobs to pay off their loans;³ that husbands, sons, and fathers-in-law often take control of women's loans;⁴ and

that, overall, microfinance fails to find its way to the world's poorest people.⁵

These two camps disagree partly because studies of microfinance are, indeed, inconclusive. MFIs vary so much in their missions, strategies, and tactics that assessing their overall impact – or comparing them to each other – is not yet possible. At a more prosaic level, MFIs usually operate in places where it is difficult to conduct research – places that are geographically isolated, politically unstable, technologically backward, and educationally disadvantaged.

But the largest barrier to understanding whether microfinance works is that few MFIs have clearly articulated what it would mean for microfinance to work – let alone how it could



Microloans have launched businesses as diverse as concrete casters in India (top left), clothes shops in China (top right), grocery stores in Bangladesh (above), and shoe factories in Botswana (bottom right).

work, for whom it could work, where it could work, or when it could work. In other words, few MFIs have explicitly formulated their theory of change – that is, an explanation of how their activities could lead to their desired outcomes. Without a clear theory of change, these MFIs invest resources, launch programs, and track outcomes that have little to do with their ultimate goals.

For most MFIs, that ultimate goal is to alleviate poverty. Many MFIs do not explicitly state this. Instead, they say that their goal is to give poor people access to credit. But their donors, staff, and beneficiaries draw the last two links in the chain of logic: Access to credit will help beneficiaries establish profitable businesses that will, in turn, make them economically self-sufficient. We call these organizations institution-centered MFIs, because their theory of change – often implicit – is that building financial institutions for poor clients will eventually help lift these clients out of

PHOTOGRAPHS (CLOCKWISE FROM TOP LEFT) BY MARK SAPPENFIELD/CHRISTIAN SCIENCE MONITOR/GETTY IMAGES; PHILIPPE LISSAC/GODONG/CORBIS; BRUNO MORANDI/THE IMAGE BANK/GETTY IMAGES; AND DAVID REED/CORBIS

poverty. In keeping with this theory of change, institution-centered MFIs aim to serve as many clients as possible by offering a few basic, high-quality, low-cost services. They assume that their clients will be able to use these services to improve their businesses and, in turn, their socioeconomic standing. And like banks, they track financial outcomes such as loan repayment rates, loan sizes, and number of clients.

Yet few MFIs elaborate exactly how their beneficiaries will create those successful businesses. This is an egregious oversight, as the vast majority of microfinance clients have no prior business or banking experience and little formal education. We have even heard about female clients who were not sure whether they were allowed inside banks.

Through our fieldwork and research in Ghana, Malawi, Zambia, and Nicaragua, we have started to formulate a different theory of change for microfinance – a theory that addresses the unique needs of poor clients. We call this approach client-centered microfinance. (See figures on p. 42 and p. 43 for the logic models of institution-centered and client-centered MFIs.) Rather than nurturing only the success of the MFI, client-centered microfinance also nurtures the profitability of borrowers' businesses – and, in turn, clients' economic and social well-being. To do this, MFIs must provide far greater services than traditional financial institutions do. They must offer not only finan-

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When microlenders nurture their clients' businesses, such as this produce stand in Peshawar, Pakistan, both lender and client prosper.

cial products and services, but also financial education, management training, value chain support, and social services. They should track how their clients use their loans and how they allocate their profits. They should monitor poverty alleviation using measures of not just income, but also health, nutrition, housing, and education.

Although client-centered microfinance practices are not widespread, and no single MFI, to our knowledge, currently implements all of the practices we recommend, early evidence suggests that client-centered microfinance would more readily alleviate

poverty than institution-centered microfinance.⁶ At the same time, economic pressures and the growing importance of financial sustainability are pushing many MFIs to become even more institution-centered. Yet if the goal of microfinance is to alleviate poverty, MFIs should adjust their theories of change to a more client-centered approach.

Institution-Centered Microfinance

Microfinance refers to financial services – most commonly loans, savings, and insurance – delivered in small denominations to poor clients who lack the collateral, credit history, or other assets to enter the formal financial system. The MFI industry has long viewed its primary role as delivering loans to poor clients (see sidebar on p. 41 on the growth of microsavings). If clients are able to pay back their loans and take out new ones, the story goes, they must be getting economic and social benefits from them. Indeed, MFIs routinely report repayment rates of over 95 percent. And today, there are 100 million people receiving microcredit loans from more than 3,000 institutions.⁷

Yet these metrics can hide how poorly an MFI's clients are faring. MFIs often lend to groups, and so they do not report when individual clients within the group default. From the institution's perspective, this makes sense: There is no default if the rest of the group repays the loan. But from the clients' perspective, one person's default means more suffering for everyone. Other group members are forced to make up the difference – often with great hardship. And the debtor, in turn, faces the wrath and sometimes violence of the other members. Some debtors have even resorted to suicide, as several highly publicized cases in

PHOTOGRAPH BY ROGER WOOD/CORBIS

Bangladesh reveal.⁸ And so high loan repayment rates don't necessarily indicate wealthier, happier clients.

Pressure to post high repayment rates also leads many MFIs to neglect the truly poor. For instance, the Mexican government designed the Solidaridad program to make loans to the poorest farmers in the country. Yet a recent study found that less than half of the loans went to the poorest 40 percent of the population. And more than 10 percent of the loans went to the wealthiest 20 percent of the population.⁹ A recent study of MFIs in 49 developing countries shows why: The banks serving the poorest borrowers had the highest average costs.¹⁰

Another common indicator of an MFI's health is the average size of its loans. Yet a study in Bangladesh found that the larger the line of credit, the more families borrowed, rather than saving some of their credit for future use. These families also continued to borrow from informal sources, thereby plunging them into excessive indebtedness.¹¹

Adopting the practices of commercial banks can allow MFIs to serve more clients and therefore can increase their social impact. But the pressure to instill more financial discipline often shifts organizations' focus away from their original mission. As a result, many firms can recite their portfolio at risk (PAR) percentages to two decimal places, but few have even rough estimates of the percentages of their clients who eventually move out of poverty.

Services for Microentrepreneurs

Leaving poverty does not depend on repaying one's loans. Leaving poverty depends on creating a successful business. Yet too few MFIs focus on helping their clients use their loans to create successful businesses. Some that have shifted to a client-centered approach appear to have had more success.

Beyond financial services, most MFIs offer basic loan repayment training. Generally the training is limited to emphasizing the importance of repaying the loan and of applying the loan to the business, rather than spending it on personal needs. Yet clients often face health emergencies and family crises, and also want to spend some of the loan proceeds on education. And so MFIs need to give clients more training in financial literacy and money management so that they can better meet both their busi-

The Rise of Microsavings

For much of the world's poor, saving money entails stuffing it under sleeping mats, hiding it in kitchen jars, or paying moneylenders a hefty fee for their deposit services. Yet without safe, cheap ways to stash their cash, poor people's precarious wealth is even more vulnerable to theft, loss, and the demands of family members and friends.

To help poor people protect their assets, a few microfinance institutions (MFIs) have started offering deposit services, or microsavings. Where the poor lack access to credit, savings represents the only way to amass the cash needed for large expenditures such as school fees, home improvements, or funeral expenses. And even for microentrepreneurs who do have access to credit, savings may be the most cost-effective way to fund large purchases. As is the case for corporations, microentrepreneurs with small profit margins or low inventory turnover are often better off using equity funding, whereas those with higher profit margins and higher inventory turnover are often better off using debt funding.

In many areas, savings are highly regulated, and MFIs are required to become for-profit corporations to meet strict capitalization minimums. When NGOs become regulated banks, they can offer a full set of banking services, including savings, loans, and insurance. Many of these institutions look exactly like banks with teller windows, loan officers, and branch managers, except that they focus on serving the poor rather than the more affluent business community.

Managing small-deposit accounts for poor clients can be quite costly because of significant transaction costs. Nevertheless, many MFIs are now providing these enormously valuable services to the poor. —*S.D., M.E., & K.Y.*

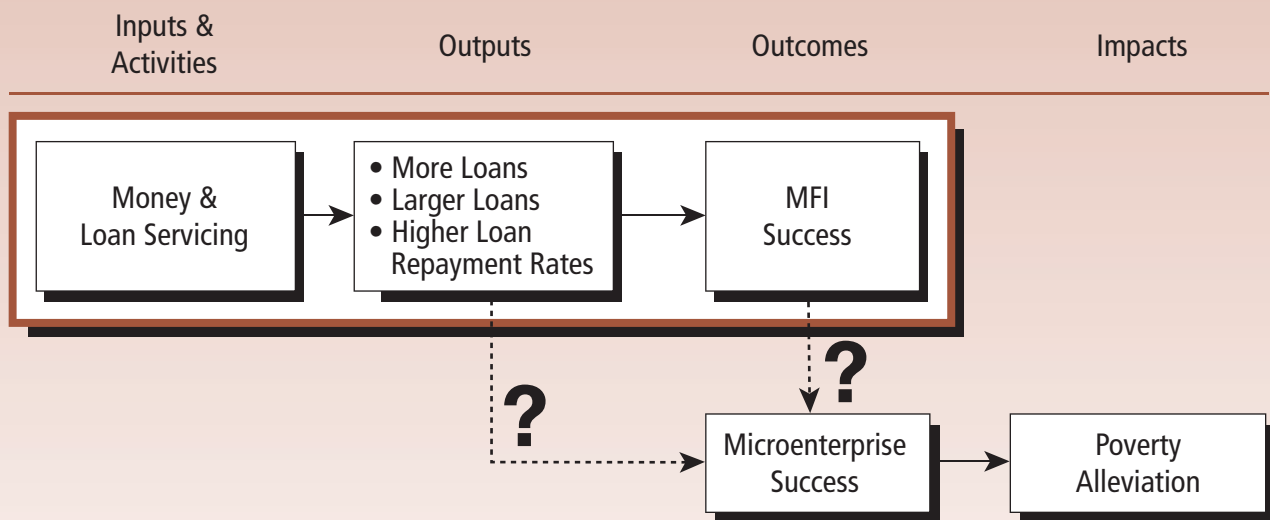
ness and personal needs. At present, MFIs do very little of this.

Moreover, mastering loan management does not lead to generating profits. Just because clients use a loan to stock more inventory, for example, does not mean that they will be able to sell the goods at a profit. And just because they sell goods at a profit does not mean that they can generate enough profits to support household needs, business reinvestments, and loan repayments – sometimes at interest rates as high as 60 percent per year. Yet that is exactly what most MFIs and clients presume.

There are exceptions. Opportunity International, an Oak Brook, Ill.-based MFI with operations in 30 countries, gives business training to its clients. In Peru, the Foundation for International Community Assistance (FINCA), a Washington, D.C.-based MFI, teaches its clients how to identify their customers, market their products, and perform basic accounting. A recent study found that FINCA clients who received business training increased their profits, reinvested more profits into their businesses, and maintained better records than did clients who did not receive the training.¹²

Institution-Centered Microfinance

When organizations create logic models – such as these for institution- and client-centered microfinance – they map what they are investing (their inputs and activities), what tangible results their inputs and activities will yield (their outputs), and what changes in individuals, organizations, communities, policies, or governments their investments will bring about (their outcomes and impacts). Charting the logic model for institution-centered microfinance reveals that this model does not clearly lead to poverty alleviation. In contrast, the logic model for client-centered microfinance offers a feasible plan for enriching the poor.



Other MFIs offer enterprise-specific training. The Tanaoba Lais Manekat (TLM) not only helps poor cattle farmers in East Nusa Tenggara, Indonesia, buy cows, it also teaches them best practices in cattle husbandry and offers them support services, such as vaccinations. In another program in East Nusa Tenggara, TLM teaches seaweed farmers both business development techniques and better seaweed cultivation methods. Some 87 percent of TLM clients in the seaweed cultivation program state that their profits and savings have increased since they joined the program.

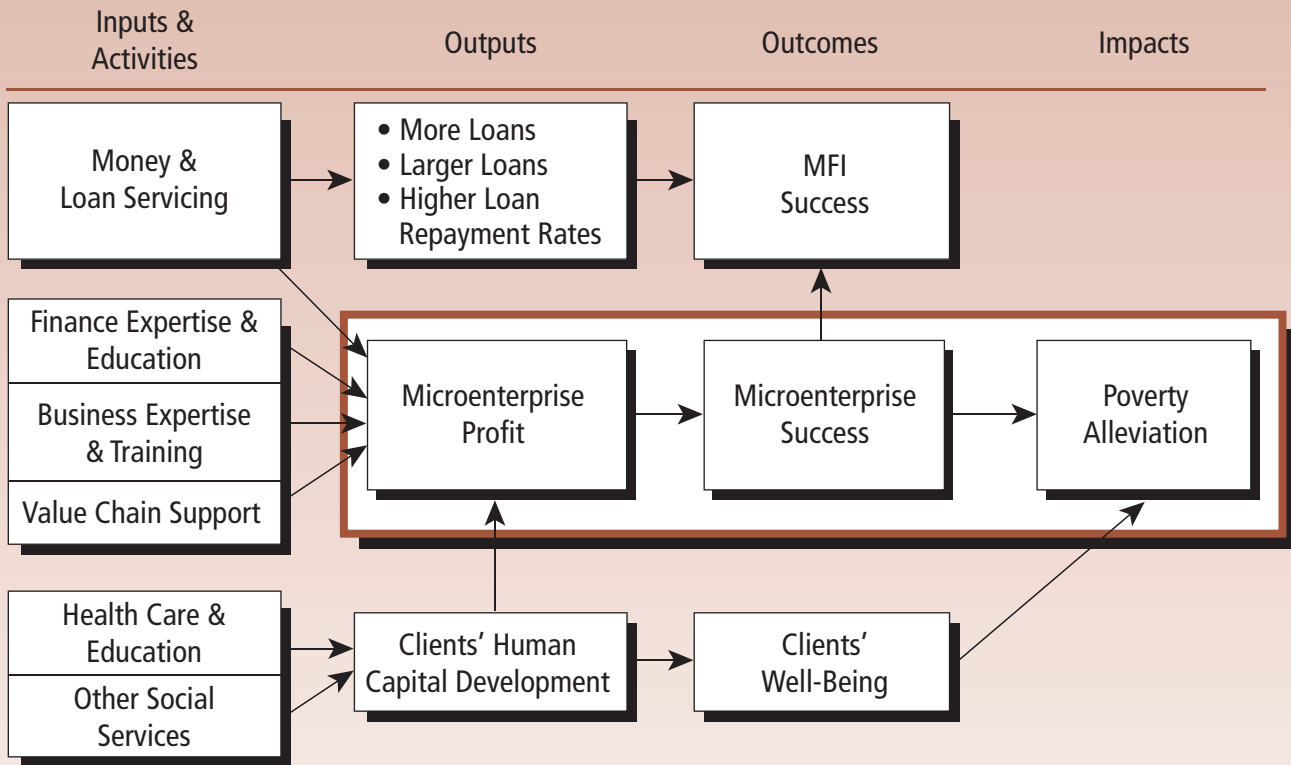
To make businesses even more productive, some MFIs have targeted the health and happiness of the clients themselves, offering training in areas such as nutrition, health care, and domestic problem solving. These social services not only help clients profit from their loans, but also aid in the development of human capital – an important contributor to the alleviation of poverty.

The Bangladesh Rural Advancement Committee (BRAC) makes the business case for improving the health of microen-

trepreneurs. The nongovernmental organization (NGO) noticed that borrowers had a much harder time repaying their loans when they or their families fell ill. And so BRAC introduced its essential health care program – monthly community meetings about disease prevention, nutrition during pregnancy, local sources of essential vitamins, and other health topics. A health program organizer facilitates the meetings with the help of community health volunteers whom BRAC trains. BRAC volunteers also go door to door to deliver information about sexually transmitted diseases, reproductive health, and domestic violence. Since the program's inception, childhood malnutrition and mortality have declined more among BRAC member households than among nonmember households. The BRAC field staff strongly support the educational programs and believe that there is a strong correlation between clients' participation in the programs and their successful use of credit.¹³

A final client-centered service that MFIs can provide is value chain support – which includes linking clients to customers and

Client-Centered Microfinance



suppliers, conducting regional economic analyses, and standardizing production to enable bulk sales and export. TLM, for example, links seaweed producers in East Nusa Tenggara to domestic and international markets. Likewise, OI is organizing an agricultural cooperative in Granada, Nicaragua, that will deliver cassava to local as well as to U.S. and Canadian markets. Although cassava is one of Nicaragua's leading exportable crops, low local market prices have discouraged farmers in Nicaragua from growing it. OI will help the cooperatives develop techniques that greatly extend the shelf life of the cassava, as well as establish business agreements with U.S. and Canadian distributors.

Client-Friendly Products and Practices

Client-centered microfinanciers need not only provide services after the fact of lending, they should also consider clients' needs on the front end. Meeting clients' needs begins with an analysis of client economics. Too few aca-

demics or practitioners have studied how clients use their loans. For example, MFIs award many of their smallest loans to traders and service providers who use the loans to purchase inventory. But no one seems to know how these clients use their inventory to generate profits. Do they sell it gradually over the six-month loan cycle, or do they replenish their inventory every two days? How do they decide how much to mark up their inventory? Will their markups be enough to cover the loan payments and meet household needs? In some cases, MFIs make inventory loans to clients who are unlikely to use them for inventory. What does a produce vendor with sales of \$20 per day do with a \$200 loan?

When standardized loans are mismatched with client needs, clients may borrow more than they need, pay higher than necessary costs, or make poor choices, like skimping on quality or selling out inventory stocks to meet an unforgiving payment cycle. And so understanding how clients use financial products can help MFIs tailor their financial products.

Technologies for Microfinance

Meeting the needs of clients in rural areas, where a large proportion of the poor reside, has long been an enormous challenge for the MFI industry. In these areas population density is low, and transportation and communication systems are generally poor, making it difficult for MFIs to operate even tiny branch offices. Yet the need for financial services is perhaps even higher in rural areas, where the poor have fewer community members and moneylenders with whom to conduct business. MFIs have worked hard to develop innovative technologies and processes to serve these populations.

Opportunity International in Malawi, Africa (OI in Malawi), has been among the leaders in these technological innovations. Most people in Malawi live in rural areas and do not know how to read. An estimated 90 percent of them do not have a bank account. And Malawi does not have a national identification system, making it difficult to track individual clients and their accounts.

To serve these rural dwellers, OI Malawi has created a mobile banking system that sends specially equipped trucks to the remotest corners of the country. The trucks

carry armored storage for cash, a secure place for a bank teller to conduct business, computer equipment for accessing client accounts and storing transaction information, and ATMs. Clients know the trucks' schedules, and so can travel to central locations to access them. Operating these roving banks is much cheaper than building the typical system of branches, while giving the poor unprecedented access to banking services.

OI Malawi has also adopted smart-card technology, which allows for the secure storage and use of money. Smart cards are similar to debit cards, except that they contain programmable chips that can be used in place of cash. Clients can transfer money from their accounts to the cards, and then use the cards in place of cash at stores, gas stations, and other locations equipped with smart-card readers. Like other debit cards, smart cards can be used in ATMs, allowing customers to conduct transactions when branches are closed, and in local dialects that may not be understood by tellers. Smart cards can also use graphic or voice interfaces for illiterate clients.

Combining these mobile banking and smart-card technologies, OI

Malawi was able to deliver aid to the remote Dowa region during the recent drought. Working with other aid organizations, OI Malawi first issued smart cards to people who needed aid. Then on a monthly basis throughout the hungry season, the mobile bank visited the area, making regularly scheduled stops and delivering money from Concern Worldwide to the aid recipients. Clients had previously received food, but preferred receiving cash so that they could choose which kinds of food, health care, and other services to purchase with their smart cards.

OI Malawi has also established banking kiosks in the country's far-flung market villages. In sparsely populated regions all over the globe, the poor regularly travel to these marketplaces for business and socializing. Not only can vendors safely deposit their earnings at the kiosks, but customers can also withdraw at the times and in the amounts they need.

Client-centered microfinance practices, such as those adopted by OI Malawi, may seem too costly for many MFIs. But by reducing costs through effective and creative technologies, MFIs can free funds to give the services clients need to grow profitable businesses.

—S.D., M.E., & K.Y.

Prizma, an NGO in Bosnia and Herzegovina, is one organization that has adjusted its practices to accommodate its clients. Like poor people everywhere, Prizma's rural clients often face family crises and intermittent income, which make it difficult for clients to pay back their loans consistently. To accommodate this reality, Prizma adjusted its incentive system so that loan officers were no longer under pressure to maintain zero arrears. Loan officers now take into consideration a client's circumstances and renegotiate repayment terms when clients experience financial setbacks.¹⁴

In this and many other cases, the loan officer makes or breaks borrowers' experience (for a related article, see "Luck of the Draw" in the spring 2007 issue of the *Stanford Social Innovation Review*). In addition to being the face of the MFI, the loan officer can give clients the information and support they need to thrive in business and at home. During early discussions of the loan process, the loan officer can help determine the appropriate loan amount and how the client will earn enough to repay. In other words, loan officers should spend less time chasing defaulting clients and more time avoiding defaults in the first

place. To do this, loan officers need not only financial expertise, but also the knowledge and skills that will help them identify target clients, encourage them to learn about the MFI's financial services, evaluate their needs, assess their character and capacity for repayment, and interact with them with the appropriate language and cultural nuance.

MFI's should also consider the burdens their clients bear when accessing financial services. Tangible costs include those of obtaining information about the services, applying for the loan, getting transportation to make loan payments, and tracking the debt. Intangible costs include the stress of getting temporary loans from other sources, the familial discord that arises from shifts in balances of power, and the time spent learning about lending – and away from business, family, and other activities. OI in Malawi recognizes these difficulties, and allows groups to shift from a weekly payment and meeting schedule to a biweekly or monthly schedule once they have proven their ability to repay the loans. The organization also holds its training sessions on a monthly basis, which reduces clients' traveling time.

A final way that MFIs can better serve their clients is to measure whether their loans are actually moving people out of poverty. Grameen Bank does this with its poverty index. The index includes socioeconomic indicators such as whether school-age children are attending school and whether family members are free from treatable health problems. Such metrics can show whether loan officers, branches, and MFIs are achieving their social goals. They can also be used as a basis for rewards and resource allocation decisions.

Expanding the Niche

MFI's have all but ignored how clients use loans and other resources to build profitable businesses. Many of them hold the view that giving poor people access to financial services alone will relieve poverty. Others know that increasing access to financial services is not enough to alleviate indigence, but think that providing other services and products is too far from their mission or too challenging and costly. The background of their senior staff members is often banking, and so they rightly believe that their core competence is banking services, not health and human services. And so most MFIs leave education, training, value chain support, and so forth to other organizations, and instead stick to their institution-centered niches.

If MFIs are serious about alleviating poverty, though, they must provide more training, support, and products tailored to poor clients. The success of microenterprises is critical both to alleviate poverty and to drive financial returns to the MFI. When microenterprises fail to make profits, clients must reduce their consumption, sell valuable assets, take on more debt from other sources, or default on their loans. MFIs also suffer, losing revenue and posting unfavorable returns.

Although the ranks of microentrepreneurs are swelling,

MFIs must remember that their clients are often in business by necessity, rather than by choice. Most microfinance clients have no training, education, or role models in business, and therefore are unlikely to cultivate successful microenterprises on their own. They are not entrepreneurs in the traditional sense. If their communities had jobs and if their family situations permitted it, they would be employed. Yet the large-scale, labor-intensive enterprises that generate stable employment will not arrive in most developing countries any time soon.

To make microfinance work for more people, more often, in more places, MFIs need to think clearly about how their practices will bring about the changes they seek. This may mean making fewer microfinance loans and incurring more costs to support the loans they've already made. The benefit, of course, is the building of sustainable businesses. The challenge is finding ways to provide these additional services efficiently. In our current research, we are designing and testing these client-centered practices. We hope that our results will ultimately lead to the broader application of effective and cost-efficient client-centered microfinance programs. □

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