History matters in microfinance

By Hans Dieter Seibel

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Is microfinance a special solution for poor people in poor countries?

Microfinance is not a recent development, and neither is the development of regulation and supervision of microfinance institutions (MFIs). Every now developed country has its own history of microfinance. It is important to recognize this because it presents a view different from that of many in the microfinance community who associate microfinance with credit NGOs and believe that microfinance was invented in Bangladesh some 20-odd years ago. Attributing the origin of microfinance to recent initiatives misses not only the historical depth and scale of microfinance, but also centuries of experience, which means: learning from trial and error, failure and success. The beginnings in Europe were all informal and small-scale, including informal savings clubs, among them the *box clubs* in England during the 18th century.

The case of Ireland, 1720-1950: How self-help and legal backing created a mass microfinance movement, until a cap on interest rates brought it down

The birth of microfinance in Europe dates back to tremendous increases in poverty since the 16th century. In Ireland, loan funds emerged in the 1720s, using peer monitoring to enforce the repayment in weekly instalments of initially interest-free loans from donated resources. After a century of slow growth, a boom was initiated by two events: (a) a special law in 1823, which turned the charities into financial intermediaries by allowing them to charge interest on loans, enabling them at the same time to collect interest-bearing deposits; and (b) the establishment of a Loan Fund Board in 1836 for their regulation and supervision. Around 1840, around 300 funds had emerged as self-reliant and sustainable institutions, generating their own resources through deposit collection and providing small loans to the poor. Financing their expansion from profits and deposits, their outreach eventually covered 20% of households in Ireland. The funds offered three times higher deposit rates than commercial banks and started cutting into their core business. This brought the commercial bankers onto the barricades. They used their clout to stop the growth of the Loan Funds: through financial repression, by getting the government to put a cap on interest rates in 1843. The Loan Funds lost thus their competitive advantage, which caused their gradual decline during the second half of the 19th century, until they finally disappeared in the 1950s. This history of the Irish Loan Funds thus comprises three phases: a century of gradual growth as informal institutions; a few decades of rapid expansion as formal institutions in a conducive regulatory environment; and a century of decline due to financial repression.

The case of Germany, 1778-now: How self-help, regulation and supervision created the world's largest microfinance system

Microfinance with the poor in Germany has three roots, all informal at origin: community-based savings funds; and two movements of savings and credit cooperatives, one rural and one urban. The community-owned financial institutions started during the latter part of the 18th century. Having learned from the early Irish charities that charity is not sustainable, the first thrift society was established in Hamburg in 1778 and the first communal savings fund (*Sparkasse*) in 1801. As the movement spread, the influx of savings forced the savings funds (now usually called *savings banks* in English) to expand their credit business, including agricultural lending. The Prussian state responded with regulation, passing the first *Prussian Savings Banks Decree* in 1838.

After the hunger year of 1846/47, Raiffeisen and Schulze-Delitzsch reinvented the wheel of microfinance: the former in rural areas, creating rural savings and credit cooperatives, originally called credit associations (*Darlehnsvereine*), later known as *Raiffeisenkassen* and now *Raiffeisenbanken;* the latter establishing urban savings and credit cooperatives, now called *Volksbanken* (people's banks). With the help of contributions of some wealthy people, Raiffeisen started by establishing a rural charity association in Weyerbusch in 1847, bringing in grain from non-affected areas. Within a few months, this brought down the price of bread by 50 %. This was paralleled by Schulze-Delitzsch's first urban credit association in 1850, who insisted on self-help without charity from the beginning. Raiffeisen had to realize that charity did not lead to sustainable institutions. In response, he established the first rural credit association (*Darlehnskassen-Verein*) in Heddesdorf in 1864, following Schulze-Delitzsch's example. For the next twenty years, the initiative turned into a movement, but growth was slow, reaching not more than 245 rural cooperatives in the mid-1880s. The turn-around came in 1989, when both the rural and the urban networks of credit associations were brought under the law: the Cooperative Act of the German Reich, the first cooperative law in the world. At the same time, joint liability, which had kept back the growth of the system, was replaced by limited liability. Until 1914, the number of rural cooperatives in Germany increased to more than 15,000 and spread to many other countries.[1]

The spectacular success of microfinance in Germany, which pushed moneylenders and most private banks out of business, is due to several factors:

- self-help and self-reliance, based on savings mobilization
- local outreach with lasting *house-banking* relationships
- the evolution of a legal framework: 1838 first Prussian savings banks decree; 1889 first Cooperative Act; 1934 Banking law covering all financial institutions including savings funds (or savings banks) and cooperatives, which are now cooperative banks
- abandoning joint and several liability of cooperative members in favor of limited liability as part of the cooperative act of 1889
- Effective delegated supervision through own apexes, so-called auditing federations, evolving in four stages:
  - 1860s-80s voluntary auditing, emergence of cooperative auditing federations; financial difficulties during the 1880s due to inadequacies in auditing
  - 1889, as part of the new cooperative law, mandatory auditing, but optionally by cooperative auditing federations or freelance auditors, resulting in financial difficulties of cooperatives under freelance auditors during the 1920s
  - 1934 mandatory auditing by separate auditing federations for all banking networks including cooperatives and savings banks; the auditing federations are in turn supervised by the Bank Superintendency
  - 1971 DGRV as national cooperative auditing federation with 11 regional and 6 specialized auditing federations; paralleled by DSGV for savings banks

Results: This has resulted in a financial system in Germany dominated by these former microfinance institutions (*1997 data*), with:

- 39,000 branches (49% cooperative banks, 51% savings banks)
- 75 million customers (40% cooperative banks, 60% savings banks)
- 51.4% of all banking assets (28% cooperative banks, 72% savings banks)
- 64% of all financial intermediation.

The conclusion:

- Microfinance is not a poor solution for poor countries.
- Savings-driven microfinance institutions in cooperative or community ownership are equally feasible in rural and urban areas.

[1] In 1866, Raiffeisen published his first cooperative handbook (Die Darlehnskassen-Vereine), which went through several revised editions until 1887, reflecting the trials and errors of the movement. It has lost little of its actuality and could teach many a microfinance expert a lesson, eg, when and when not to use joint and several liability as a collateral substitute; and how to avoid moral hazard in setting up cattle insurance schemes.

- If properly regulated and supervised, they have great potential in poverty alleviation and development, both in rural and urban areas.

What relevance to developing countries?
What distinguishes a developed country like Germany from many developing countries is not the prevalence of self-help and informal finance at an earlier time. Community- and member-based as well as other informal financial institutions are exceedingly widespread throughout the word. In Nigeria for example, they date back to the 15th and 16th century from where they were carried by slaves as part of their social capital to the Carribbean, where both the institution and the original Yoruba term, susu, are still found today. The major difference seems to be the legal recognition given to informal finance in Germany and the protection of the institutions through prudential regulation and effective supervision. While there are some examples of limited magnitude of upgrading informal finance in developing countries, there is no case where a modern financial system has been build on indigenous institutions. In the microfinance community, the importance of an appropriate legal framework, regulation and supervision is controversial. Has the time to revive come to revive an older controversy?

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