SUGGESTIONS FOR DESIGNING A MICRO CREDIT MODEL

1. Foreword

As it happens in periods of crisis, commentators have been analyzing what went on and why in the microfinance market. It is well known what happened: microfinance industry has collapsed in some Countries and it has been struggling in some others and its future could even be at stake. The reasons explaining the situation are multifaceted and intricate.[1]

In our perception of the market trend, the crisis that stroke microfinance sector has been specific to a single MFI and not systemic like the crisis blown up three years ago. Indeed looking at glance the situations in the related Countries, the crisis have been due to “improper” individual MFI management (policy, misconduct, greedy, delinquency), contrary to what happened three years ago when the financial crisis had a *dominoeffect*.

All the discussions and comments on the current trend in microfinance have a common denominator: the difficulty to manage the blend between social and commercial objectives in a risky market.

Let’s situate apart the different points of views, whether a bad management practice or insatiability of the lenders or political interferences made it happen in India, Bosnia, Nicaragua, Pakistan, Bangladesh, Morocco and elsewhere. One thing seems to be sure: in microfinance industry nothing will be as before and insiders have been frequently wondering on the effectiveness of the genuine credit model for poverty alleviation.

In this understanding we have noticed that the proposed remedies didn’t take so much into account the changes and the challengescurrently emerging in the microfinance markets.

The role of microfinance to fight povertycan’t be outlined without having a look at industry’s background because there could be the risk of misleadingconclusions. In other words we do mean that the current approach to fight poverty’s problemscould mislead, unless we define which type of microfinance organizations should bein charge for. The importance and maybe the needof this preliminary clarificationstrongly ariselooking at microfinanceindustry in some Countries.

On one hand, MFI has been facing difficulties to be a tool to improve people own human capital (schooling, health care, etc) till situationswhere the impact of microfinance on addressing the poor households has been a disaster. On the other hand, an increased number of MFI have been orienting for only-for-profit and consequently they have been seeking more financial resources to expand business.

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[1] A. Graziosi - Microfinance bad practice and Politics
http://www.microfinanceassociation.org/page.aspx?id=71&nId=106

Under the circumstances the two MFI's souls – social and commercial approach - entered into collision; hence the microfinance practitioners have been confronting with a dilemma and choose which side to stay. There is also a third choice, namely the option to pursue in the same "hub" both above objectives and accordingly try to manage the mixture in a way to meet stakeholders' (GVT, Donors, Investors) satisfaction. However recent studies on the matter have concluded that *"social performance of MFI cannot be taken for granted…..and the risk of mission drift is real*(quote from MicroSave, www.microsave.org*)*

2. Background

Since year 2000 when UN launched the Millennium Development Goals and then declared 2005 International Year of Microcreditan every increasing emphasis has been placed on microfinance as a tool to fight poverty.

In this contextit is of upmost importance to highlightthe fact that microfinancecan contribute to defeat poverty on condition that the other components of the poverty strategy are in place and coordinated each other.We have noticed that the commentators rarely stressed the importance of this condition.

Unless doing that, we risk to assign tomicrofinance an overstated role because each one and everybody is aware that fighting poverty ask fora massive intervention that call in cause a systemic economic policy approach.

In this understanding, it is too much to say that micro credit can be a remedy for some 2.5 billions poor people (the total demand for credit having been estimated at US $ 300 billions), unless we don't make it clear that micro credit should go together with other economic and social policies, instruments and means. In other words, it should be a part of a comprehensive policy including education, infrastructures, healthcare, etc. This means that when it fails, all the other components fail too.

2.1 When lenders, donors, governments deal with micro credit matters in emerging economies a holistic approach could be advisable because a targeted intervention at single MFI level can't get the expected results without addressing other linked issues at macro and meso level.

The interventions addressing any MFI should be conceived and designed bytaking into account the following three levels, which are interacting each other:

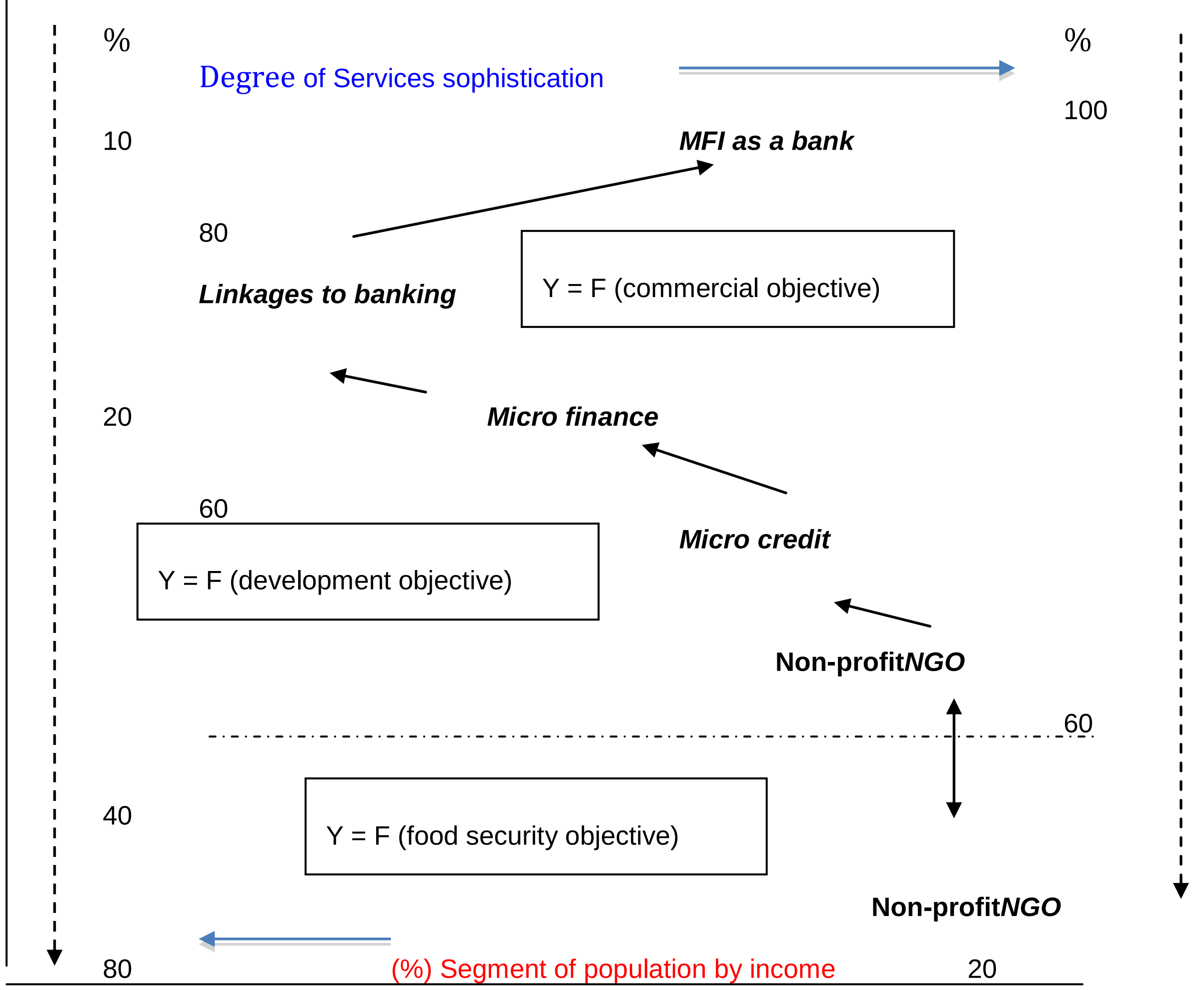
Macro level: a) Regulatory and supervision framework, **b**) Credit policies for a conducive environment, **c**) Land reform, **d**) Property rights, **e**) Markets liberalization*,* **f**) *Sector's* analysis.

Meso level: g) Partnership, **h)** Capacity building & institutional strengthening, **I)** Guarantee schemes, **j)** Credit Bureau, **k)** Capacity building & Institutional strengthening, **l)** Linkages between banks and MFI, **m)** Value chain finance.

Micro level: n) Information technology, **o**) Guarantee schemes to back up micro borrowing, **p)** Strategic management and business planning, **q)** Product innovation's, Management best practice, **r)** Reporting and auditing, **s)** Leasing, **t)** Factoring**, u)** Capital restructuring**, v)** Scoring, **z**) Factoring, **w)** Leasing.[2]

2.2 Field reality has demonstrated over the yearsthat micro lenders shifted the activities from neglected people to small businessmen and in so doing changed their genuine missions and became organizations profit oriented.

Figure 1 - Mixing services/market in emerging and transitional economies



Source. A. Graziosi, Social enterprise in microfinance industry, Microfinance Gateway, 09/08

[2] A. Graziosi - Microfinance in Africa: re--thinking the role of the actors, Microfinance Gateway, January 2007 http://www.microfinancegateway.com/content/article/detail/37748

This shouldn't be a bad move, on condition to carry out the task with common sense and respecting the rules of a credit game, namely lending out money on sound basis. Practically, this does mean to distinguish between grant and credit and when and how the money lent out should or shouldn't be paid back and at what conditions.
The reality in frequent cases has shown that these rules haven't been respected for whatever reasons. The results have been a failure in terms of wasted resources, ineffectiveness of the credit model and lack of credibility for the people responsible for.

2.3 Saying that microfinance is still in adolescence status is partially true because a real picture illustrates a variegated reality at both regional and even at country level where the industry has been facing teething problems along with a mature growth challenges. The situation has been depicted in Figure 1, which may be read either as a trend or actual situation in a given country.

From the Figure 1 it emerges that although any single MFI is social oriented the degree of achieving a social mission could be quite different whether the MFI is in one or another segment.

2.4 Borrowing from our field experience we may say that we can't look at the micro credit movement (currently microfinance) as a whole because the movement is represented by an heterogeneous group of organizations and institutions with different missions, objectives, interests, expectations;hencethere is a need to categorize the micro lenders into homogenous groups. [3]

2.5 In this context a *methodological approach*deserves an explanationin the light of the fact that a range of organizations provide credit to both "unbankable" people and enterprises profit oriented,all of them representing micro finance movement.

3. Basel IIIas a reference for regulating microfinance

In brief, we do fully agree to have microfinance involved in poverty reduction: it was its genuine mission!However which type of MFI to refer to? How to achieve that? We mean that it is necessary a definition of microfinance and map out the milestones for the interventions; in other words this does mean to spell out which MFI shall be in charge and which credit model to be adopted.

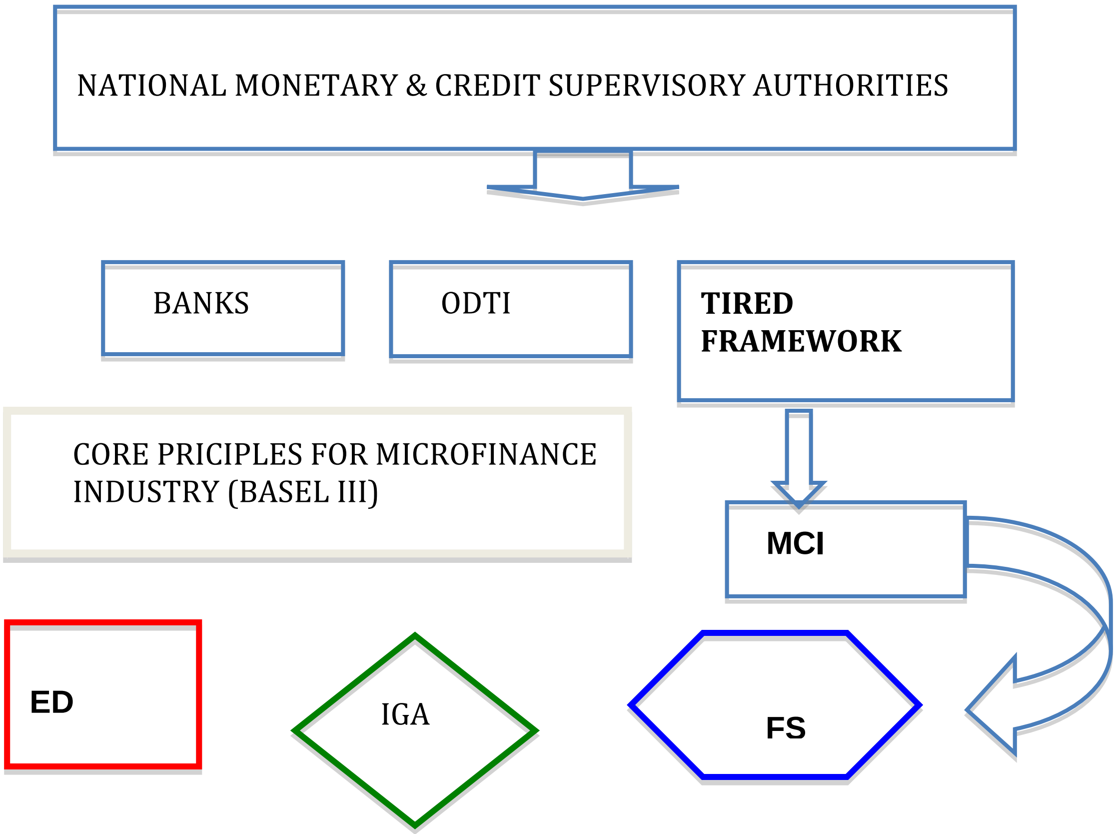
On the matter we particularly refer to Microfinance activities that the Consultative Group has defined as *the provision of financial services in limited amounts to low-income persons and small, informal businesses, which are*

[3] A. Graziosi - A new approach in evaluating micro finance institutions' performance, Sept/2002 http://www.alternative-finance.org.uk/cgi-bin/summary.pl?id=241&language=E

offered by a variety of formal financial institutions, including banks and non-banks, either as their core business or part of a diversified portfolio.[4]
The document defines three groups of institutions: Banks (B), Other Deposit Taking Institutions (ODTI) and Microcredit institutions (MCI). We share this approach because eventually microfinance isn't no longer considered as a distinct market but a component of the entire financial market, which comprises many circuits. Among other considerations, such approach favorsthe achievement of a country financial inclusion, which is an objective of the Basle III regulatory framework.

The group Microcredit institutions (MCI), namely institutions that lend for limited amount without being authorized to collect deposit, shall have a different supervisory treatment and the Consultative Group left to the countries' supervisory authority the modalities and instrumentsto intervene.

Figure 2 – Proposed MCI classification under Basel III



Source: Our elaboration

Although all the financial circuits should be under a unique umbrella, when we are going to evaluate an individual MFI, should we use the same yardsticks for ODTI and MCI? Moreover, are all MCI homogenous? Obviously, we have to

[4] Basel Committee on Banking Supervision – Microfinance activities and the core principles for effective banking supervision, February 2010

use different parameters because we can’t measure credit risk, market risk, liquidity ratios and whatever MFI’s performance with the same indicators for ODTI and MCI.

Moreover, we do have to consider that MCI group includes both profit and non-profit organizations. This is a crucial point. In the current trend of microfinance industry, all MFI have social objectives as a common denominator but different approaches to attain them.

4. Basel III an avenue to consider for designing a credit model

After so many industry’sbacklashes, in an apparent uncertainty, insiders have been frequently questioning on the effectiveness of the genuine credit model for poverty alleviation. A burning question has been emerging: should we have in the same “hub” for poverty reduction and enterprise development? Which is the suitable solution?

We do fully agree to have microfinance involved in poverty reduction: it was its genuine mission!However which type of MFI to refer to? How to achieve that? Commentators, practitioners and visionaries have been discussing these very hard questions to provide microfinance industry with a re-start. In Countries where the damages of the crisis have been devastating, policy makers have been making efforts to give an appropriate response to crisis by introducing new regulatory and supervision frameworks.

Here we would like to contribute by referring to the above-proposedcategorization, whichbesides being a guide for regulation and supervision purpose mayrepresent a very good orientation when designing a new MFI credit model.

Basel III, namely the “Microfinance activities and the core principles for effective banking supervision” could inspire practitioners, consultants, stakeholders, investors and donors when conceiving a new credit model.

To achieve that it is a necessary to look into MCI group. In our perception of the microfinance movement, the MCI group includes, by and large, three big categories of organizations providing financial services for: Enterprise Development (ED, *accumulation*), Income Generating Activities (IGA, *increase family income*) and Food Security (FS, *distribution of basic food to very poor people*). These organizations deserve different management rules and evaluation criteria.

This is an importantstarting point when investigating on the contribution of microfinance to food security and climate change.

Indeed in the Enterprise Development’s casethe objective is based on the intent to create a return on investment, which contributes to a capital formation. By contrast, income generating (IGA) aims at increasing a family's Income by having social empowerment and self-reliance as a primary goal and business development as a secondary goal. The Food Security category targets the subsistence sector. Under above circumstances the expectations of the financial providers (investors, donors and GVT) should be different because the reasons (declared objectives) behind the interventions are quite different.[5]. For that reason, the three categories of MFI require different management policy and evaluation indicators.

Once this point has been clarified it will make it possible to position the concerned MFI and accordingly to set out resources, objectives, scope, means, credit policy at whatever level of interventions:

- Governments: to regulate and supervise
- Donors:to adapt the support
- Investors: to measure up the risk
- Stakeholders: to set upunambiguous objectives
- MFI: to fund rising.

Accordingly the achievement of the social performance (poverty alleviation and climate change) will be function of the weigh assigned to the variables in the below function; therefore, MFI performance (outcome) will be function of how much social shall be incorporated in the MFI declared objectives.

Social performance = F (ED; IGA; FS)

This approach will be of high importance to find out the expected return's on investment (ROI) that shouldn't necessarily be measured in economic terms only, but include social benefits, which will be decidedly different whether it refer to one or an other category.

Summing up, while dealing with fighting poverty and climate change, it could be advisable to have specific guidelines with regard to the different types of institutions. In this way it will be easier set upstandards management rules as well as evaluation criteria.

The practical effect of such approach will be palpable while assessing over-indebtedness that asks for an early-warning system to detect in time a likelyevent: with an appropriate set of battery indicators an upcoming event may be detected well in advance. Incidentally this is why, among the other

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5 "Proposed guidelines for microfinance industry regulatory framework within Basel 3": http://www.microfinanceassociation.org/search.aspx?search=Proposed+guidelines+for+Microfinance+regulatory+framework&GO=GO

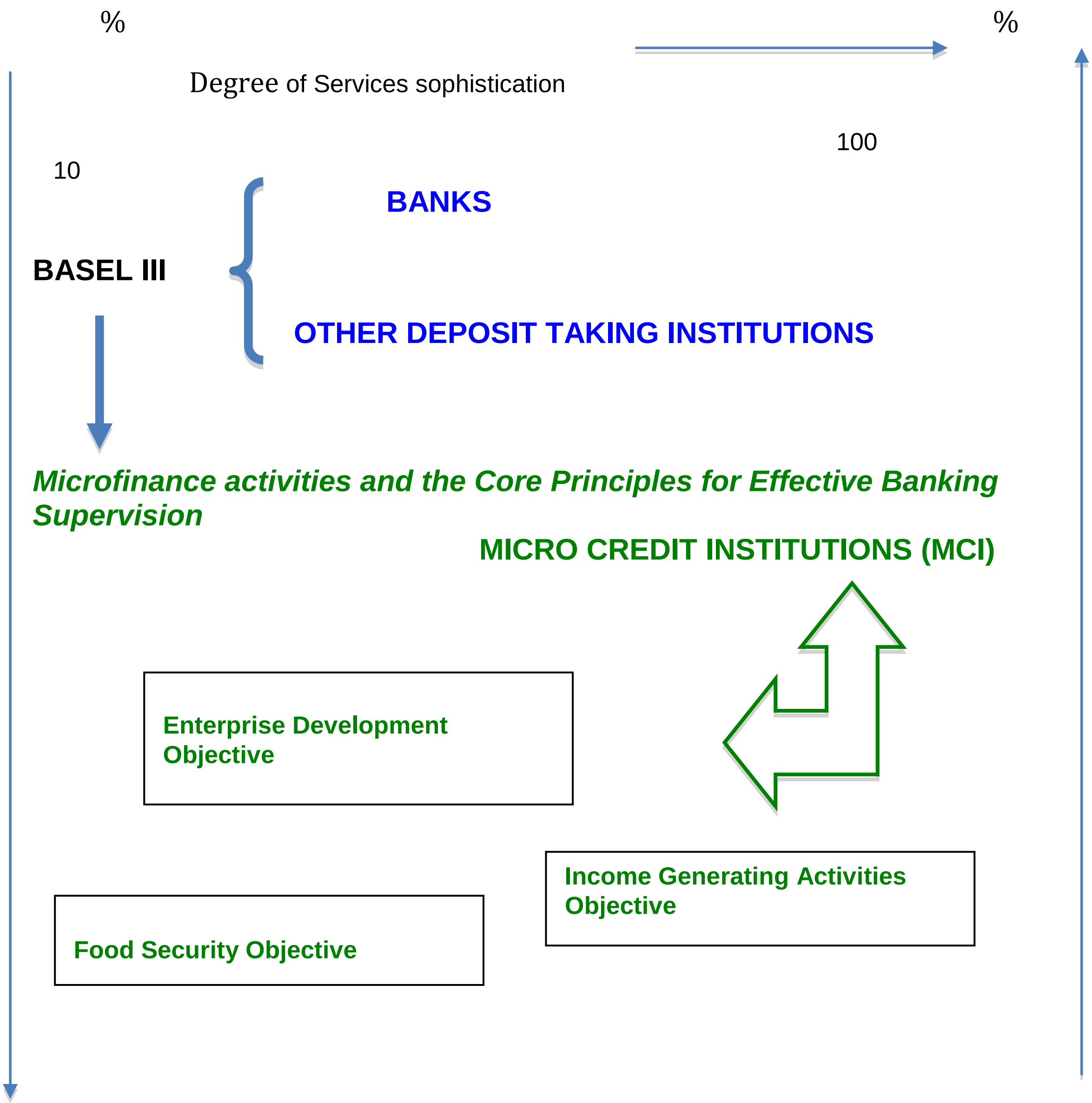
reasons, in some situations, microfinance crisis hasn't been perceived as a likely event.

However putting in place a set of indicators although may alert on an in-coming wave can't stop it; indeed the real problem is preventing the formation of a wave that could devastate in-shore. In other words, the crisis call for a re-thinking of the credit model: here again the importance to find out which type of MFI, how to manage it along with the degree of related risk.

We do believe that conceiving a credit model taking from recommendations worked out in the "Core Principles" – as we have tried to do - could be an inspiring reference.

The above-mentioned document besides being a very good source for introducing a country's regulatory framework,it could also be a very good reference for designing a new credit model. When conceiving a new credit model it is a good step to look into the MCI market's segment.

Figure 3 – Financial institutions as per Basel III regulatory framework



100 (%) Segment of population by income

Source: Our elaboration

In our view the proposed categorization besides being taken as a guide for regulation and supervision purpose, it can be a very good orientation for both positioning MFI in the market and deal with on management and evaluation matters.

It is just in this understanding that here we took on it. In so doing we looked into MCI's market segment and then introduced some definitions in the MCI group, namely by categorizing the different organizations as we have shown in the Figure 3.

This will be a considerable step for transparency in the microfinance industry, which after a "boom" needs to re-define itself. Moreover, this will homogenize a heterogeneous group of financial and non-financial providers into more specific sub-groups, in a context where microfinance means everything and the opposite of it.

Each one and every financial organization, whether Banks or ODTI or MCI will have their niche of the market to serve and every segment of population will have a chance the have anappropriatepartner to meet the financial and non-financial servicesthey need.

Within a universal financial market, profit and non-profit organizations have a place to play their role, on condition to keep away frommystification, uncertainty and misconception.

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