

# **Response to the Inquiry and Call for Written Evidence by the All Party Parliamentary Group on Microfinance**

**Young Ambassadors for Opportunity**

**12<sup>th</sup> January 2011**

## **1. Executive Summary**

This paper constitutes our response to the Inquiry and Call for Written Evidence by the All Party Parliamentary Group on Microfinance. Young Ambassadors for Opportunity are a fund-raising arm of the Microfinance Institution (“MFI”) Opportunity International (“OI”). We focus on winning support for microfinance amongst students and young professionals and we approach the inquiry from this perspective.

A recurring question posed to us by students and young professionals, and which we believe to be representative of other potential supporters, relates to evidence for the efficacy of microfinance in alleviating poverty. There are studies and anecdotal evidence which support such efficacy, but the evidence does not currently appear to be as rigorous as it could be. As such, our first recommendation is that the UK Government support research to establish the degree to which microfinance is effective in alleviating poverty, the settings in which it is effective and the variants of it that are most effective. Obtaining comprehensive answers to such questions would greatly support efforts to raise funds and support for microfinance – particularly amongst well-informed constituents and particularly in the interconnected world of today where failure to transparently address such challenges can lead to the rapid spread of adverse opinion.

We also recommend a range of channels by which the UK Government could support the awareness-building and fund-raising efforts of microfinance charities.

## **2. The Inquiry**

The All-Party Parliamentary Group on Microfinance, in its inquiry and call for written evidence dated November 2010, seeks to address the question of “the role of microfinance in tackling extreme poverty and, in particular, whether microfinance institutions need to be intentional about improving the welfare of their clients in order to have an impact on poverty alleviation”.

## **3. Young Ambassadors for Opportunity**

Opportunity International is one of the leading Microfinance Institutions globally. Young Ambassadors for Opportunity (“YAO”) is a fundraising arm of OI which focuses on raising awareness of the organisation’s work amongst the students of leading UK universities and young professionals in financial services and other industries, with the ultimate objective of securing ongoing support for fundraising activities. YAO also maintains an awareness of policy research relating to

microfinance in order to contribute to debates on students' behalf and utilise this information in support of its fundraising activities.

#### **4. Microfinance – Background and Current Perspectives**

Throughout the world, at least one billion people live in conditions that can be defined as constituting a 'poverty trap': a set of circumstances whereby opportunities for individuals to increase their level of income and improve their lives through the usual processes of earning, saving, education and participation in the wider market economy are largely absent. Special mechanisms are needed to facilitate escape from such circumstances. One such mechanism is microlending: small loans, typically to women (who appear to play a more pivotal role than men in the long-run success of their families) and secured by cross-guarantees amongst a borrowing group whereby all members suffer sanction if one of them defaults. Microloans aim to support the development of small businesses ("microenterprises") and get borrowers onto the first rungs of the development ladder. They are currently financed through charity, donor funds, private capital and interest income on existing loans, with the latter playing an increasing role as initiatives develop. The structure of microlending initiatives ensures that community relationships and the reputational consequences of default keep credit losses to a very low level and make the overall arrangement viable. Microlending, alongside deposits, insurance and other financial services offered to the world's poor, constitute part of the broader field of microfinance.

##### ***4.1 Current perspectives***

A number of principles are generally considered well-established by participants in the field of microfinance and appear to be robust, though more rigorous studies to support them would be welcome. One such principle is that MFIs will tend to offer lower-cost credit than other lenders to which the poor have access – so-called 'loan sharks' – and experience much lower 'agency costs' and default losses than other financial institutions operating in the same setting. Lower agency costs include lower costs in activities such as acquiring the information necessary to identify suitable borrowers. Indeed, the system of cross-guarantee amongst lending groups largely shifts the task of identifying creditworthy borrowers to the community itself, which will naturally be much better informed about its members than any external party. Lower agency costs and default losses permit MFIs to charge lower interest rates and to reach many more people than traditional financial institutions. The combination of these characteristics – lower interest rates than either loan sharks or traditional financial institutions and broader reach than traditional financial institutions – seems likely to make microlending effective as a tool of poverty relief.

Another generally accepted principle is that the success or failure of a microlending initiative in alleviating poverty is essentially a managerial issue, depending largely on the objectives and approaches of a particular MFI. Deviations from best practice that appear likely to reduce effectiveness may arise where profit is the primary objective, rather than merely being an instrument to make MFIs self-sustaining and capable of growth. Having private profit as the ultimate objective may result in concentrated lending to customers or communities that have been profitable in the past, or to customers who have substantial debts already, as opposed to reaching a greater number of people. Lending for consumption rather than investment may also be an

issue, as may the use of heavy-handed tactics to enforce repayment. All of these issues appear to have prevailed in the Indian state of Andhra Pradesh where predatory microlenders have recently damaged the reputation of the microfinance industry more generally.

Finally, it seems clear that microfinance cannot be a complete solution to underdevelopment and there should be no expectation that it can. Underdeveloped countries suffer from a lack of basic infrastructure and adequate public services; an issue that requires solutions other than microfinance. Similarly, there cannot be an economy composed entirely of microenterprises and effective measures are therefore needed to support the development of larger businesses, including past microenterprises which have been successful enough to grow to some scale. Such measures have traditionally included enhancing the regulatory and structural setting, but they could also include arrangements for handing successful customers over from MFIs to other financial institutions and giving them access to the capital markets.

## **5. The YAO Response**

In our unique role as YAO and given our growing penetration within two distinct target groups: (1) students of leading UK universities and, as a developing workstream, (2) young professionals in the City of London, we are well-positioned to express a view on how best to garner support for microfinance amongst these groups and how to address the questions they and other interested parties pose on a consistent basis in relation to the wider microfinance industry.

YAO will provide our recommendations on the following three issues, drawing on our work with the two target groups mentioned above:

1. Policy research in relation to the delivery of microfinance services: what are the most effective means of delivering microfinance services, to what extent are these effective in alleviating poverty, in what settings are they most effective and how can this information be utilised in garnering support for microfinance?
2. Awareness-building: what are the most effective means of promoting microlending and other microfinance activities amongst potential donors and other potential supporters?
3. Fundraising: what are the most effective means of raising funds from potential donors to support the establishment and development of microfinance initiatives?

YAO is not currently in a position to carry out extensive policy research relating to microfinance, but in awareness-raising and fund-raising we have consistently found that the ability to refer to persuasive evidence in support of the effectiveness of microfinance in alleviating poverty is of central importance. It is easier to engage people if the concept can be demonstrated clearly to work, especially where potential supporters are students in fields such as economics or young professionals working in the financial industry. In addition, the queries raised by students and young professionals are likely to be indicative of queries raised by well-informed potential supporters more generally. We will therefore recommend that more rigorous research be conducted in relation to microfinance.

In relation to questions (a), (b), (c) and (f) of the inquiry, this submission addresses all aspects of microfinance, albeit with a greater focus on microlending, and operates

under the assumption that microfinance is of interest primarily as a potential means of alleviating extreme poverty and achieving the Millennium Development Goals. It appears to us that, outside of these potentialities, microfinance would be of no special interest to the UK Government and there would be no case for the UK Government to support it.

## **6. Recommendations**

YAO's recommendations in relation to each of the three areas of policy research, awareness-building and fund-raising outlined above are as follows. Please note that sections 6.2 and 6.3 operate under the premise that the research recommended under section 6.1 demonstrates a considerable effectiveness of microfinance in alleviating extreme poverty, as seems probable given current evidence

### ***6.1 Policy research – a response to questions (d), (e), (g) and (h) of the inquiry***

Based on our extensive interactions with students and young professionals – potential supporters of microfinance and potential future leaders in a variety of relevant fields – it is clear that more robust data than are currently available are required to conclusively demonstrate the extent to which microfinance is effective as a mechanism of poverty relief and to identify the most effective variants of, and settings for, the basic microfinance concepts.

The most reliable data relate to the effectiveness of microlending from the point of view of the lender, rather than that of the recipient. These data appear to show very moderate levels of default and loss, even by the standards of consumer credit in developed countries. Some studies suggest that default losses amount to no more than 5-10%, which is remarkably low considering the economic context in which these loans are extended. With typical annual interest rates on microloans at 20% and costs appropriately controlled, repayment rates of 90-95% or better make it possible for microlenders to operate at a profit. This is vitally important in that it permits capital accumulation by MFIs, making them self-sustaining and permitting them to expand their operations – which is naturally to be desired, at least so long as there is evidence for the wider efficacy of microfinance in poverty relief and so long as profit is seen as an instrument of success and not as an end in itself.

However, questions have been raised by potential supporters over the reliability of loan loss data from Microfinance Institutions. Many MFIs are not required to operate according to the same accounting standards as other institutions and, as a consequence, practices such as delayed recognition of bad loans can result in under-estimation of loss rates. Thus, demonstrating the reliability and transparency of accounting information – at least for the leading MFIs – should be seen as a key objective.

Another aspect of microlending where the data appear reliable is its effect on the status of women in society. Receipt of microloans appears to be positively correlated with contraceptive use, female health and the education of children. If microfinance is to be first and foremost a poverty reduction strategy, the correlation between its use and a broad set of human development indicators represents a strong positive result.

On the issue of poverty relief measured by purely economic indicators, however, studies to demonstrate a positive impact of microfinance could be more rigorous. The reported experience of leading MFIs suggests that there is a significant positive effect but this needs to be demonstrated more robustly and to rely less on anecdotal evidence and in-depth case studies of isolated programmes. Key groups of potential supporters will need further proof that microfinance, and microlending in particular, effectively facilitates entrepreneurship to lift people out of poverty in underdeveloped areas. The diversity of MFIs (now believed to number between 1000 and 2500 globally) and the variation in their approaches may be a complicating factor in performing such analysis.

The Microfinance Information Exchange (“MIX”) has been established as a platform through which MFIs can exchange information and analysis on the effectiveness of their programmes and best practice. As such it represents a useful tool and should be developed further. However, MIX does not as yet constitute a rigorous or standardised dataset upon which research can be based

YAO has identified additional important questions relating to microlending where the data permit little comment. These include points raised by critics of the microfinance industry. For example:

- Does microlending tend to help only some segments of the community; the ‘entrepreneurial poor’ as they might be called? Is this effect offset by the higher levels of entrepreneurialism that have been suggested to exist in poor societies compared to rich ones? Is it offset by spillover effects such as the creation of jobs and income by microenterprises?
- To what extent is it possible for the poor to distinguish between MFIs which have poverty reduction as their underlying objective and organisations which may present themselves in a similar fashion, but have private profit as their ultimate objective and are willing to engage in abusive practices to achieve this goal?
- What effect would regulation of interest rates, lending criteria, repayment schedules or the capitalisation of MFIs have on the industry?
- What effect will the entry of international investors, motivated primarily by the desire to achieve a return on investment, have on the effectiveness of microfinance in alleviating poverty?

Given all of the above, we recommend that more rigorous and comprehensive data be gathered to underpin conclusive research relating to microfinance. Collecting such data and analysing it appropriately would make it possible to establish the extent to which microlending is effective as a general tool of poverty relief, the settings in which it is most effective, and the managerial practices which enable it to achieve its full potential.

Data collected and analysed should focus on:

- The credit risk associated with microfinance loans in different contexts and the extent to which it is possible for MFIs to make profits that permit them to be self-sustaining and capable of growth
- The level of profit, if any, at which microfinance ceases to improve the economic prospects of the borrowers and their communities
- The extent to which microcredit reduces poverty and improves the development trajectory of communities, particularly when compared to traditional financial services institutions or reliance on ‘loan sharks’

- The long-run development of enterprises established using microcredit
- The extent to which the benefits of microcredit diffuse beyond the direct recipients of loans
- The differential effects of various managerial objectives and practices on the effectiveness of microlending in alleviating poverty
- The effects, beneficial or otherwise, of regulation or legal restrictions on the effectiveness of microlending
- The effects of involvement by profit-motivated international investors on the effectiveness of microlending
- The ways in which microcredit synergises with, supports, or is dependent on other efforts to alleviate poverty and support development, including efforts to develop infrastructure and public services and measures to support larger enterprises
- The effects of microcredit on the status of women and their children in different settings

The UK Government should support such research to the greatest extent possible. This goal might be achieved through:

- Direct financing of research on microfinance carried out by UK universities, charities and MFIs
- Fostering of research links between these parties

## ***6.2 Awareness-Building – a response to questions (i) and (j) of the inquiry***

We recommend that the UK Government support the awareness-building activities of microfinance charities by:

- Reviewing and endorsing the work of appropriate microfinance charities, potentially by developing a system of recognition for microfinance charities that meet appropriate standards so as to distinguish them from other small-scale lenders that do not meet standards of best practice
- Facilitating microfinance charities in using this Governmental recognition to support their fundraising activities
- Undertaking joint awareness-building efforts between microfinance charities and Governmental bodies, in particular the Department for International Development (“DFID”)
- Facilitating partnerships between microfinance charities and private-sector organisations in order to extend the reach and impact of efforts to promote microfinance
- Supporting efforts to identify and reach segments of the population who do not currently have a strong awareness of microfinance
- Promoting awareness of microfinance in UK schools
- Supporting the development of networks that propagate awareness of microfinance, such as the networks currently being established by YAO amongst the student community
- Giving appropriate attention to the efforts of microfinance charities and the potential of this tool in UK Government publications relating to international development

### **6.3 Fund-raising – a response to questions (i) and (j) of the inquiry**

We recommend that the UK Government support the fund-raising activities of microfinance charities by:

- Directly financing appropriate microfinance charities
- Directly financing the fundraising activities of microfinance charities – this in particular may generate significant positive results in that every amount spent on fundraising has the potential to yield a multiple of that amount in terms of financing from other sources
- Facilitating the efforts of microfinance charities to raise funds from the private sector
- Facilitating relationships between microfinance charities and international development institutions that may result in funding being provided to the charities
- Offering targeted incentives to the private sector, and in particular to corporates active in low-income countries, to support microfinance charities both financially and through the provision of facilities and expertise

## **7. YAO Strategy**

YAO plans to continue building its network amongst students in leading UK Universities and amongst young professionals in the City of London. This activity is expected to be self-sustaining in that individuals brought on-board through our initial efforts may continue to support and publicise microfinance as they move through their University and professional careers and may eventually become professionally involved in the field. However, it will also require ongoing effort and commitment as cohorts of students move through University and new potential supporters take their place.

To support this activity YAO intends to establish collaborations with other parties, such as the Global Poverty Project, in order to expand the range of publicity tools available, the impact of these tools and the range of outlets available.

YAO also intends to leverage policy research conducted by other parties in relation to microfinance in order to support its activities and we expect that, as this research becomes more rigorous, it will become proportionately easier to gain support. We likewise intend to act as a vehicle to ensure that the queries and challenges raised by our constituents are reflected in the wider debate on microfinance.

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