Is microdebt good for poor people? A note on the dark side of microfinance

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This note focuses on the 'downside' of microfinance: on the way in which some microfinance activities can damage the prospects of poor people. It is not a polemic that argues that microfinance has failed—there is much evidence, not least from my work with colleagues, that it can help many poor people improve their lives. Rather, it is a reminder that those who provide microfinancial services (referred to here as MFIs, or microfinance institutions, but recognizing that many institutions also provide enterprise development or social development services) need to monitor carefully not only their positive impacts but also their negative effects, look to the future, and not rest on their laurels. The 'microfinance industry' needs to practice more humility about what it has achieved (outside of Bangladesh it has not even scratched the surface of poverty, for example in Kenya less than 70 000 people out of an estimated 9 to 10 million poor people have access to microfinance) and deepen its understanding of the financial service needs of poor people (see Rutherford in this issue).

> Outside Bangladesh the microfinance industry has not even scratched the surface of poverty

Microfinance, microcredit or microdebt?

Most MFIs focus on disbursing loans. Their savings services are designed as a means of collateralizing loans and providing low-cost capital: they are not designed to meet the poor's need for savings mechanisms. Such loans are usually referred to as 'microcredit' and MFIs have created the myth that poor people always manage to repay their loans because of their ability to exploit business opportunities. This is nonsense, and Pischke's dictum that we should call microcredit 'microdebt' can help us be more realistic about the different ways in which loans can impact on the livelihoods of poor people.

> Microcredit should be known as microdebt

Microdebt can create considerable opportunities for people to utilize 'lumps' of money so that they can improve incomes and reduce vulnerability. But not all microdebt produces favourable results, especially for poor people working in low-return activities in saturated markets that are poorly developed and where environmental and economic shocks are common. Because of circumstances beyond their control (sickness, flood, drought, theft and so on), lack of skills and knowledge or taking bad decisions, a proportion of poor borrowers encounter great difficulties in repaying loans. While MFIs suggest that such problems are overcome through 'social support' in some painless way this is often not the case—talk to the dropouts of MFIs! Many (though presently we have little understanding of exactly what proportion) report being threatened by

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Many women commit suicide when they have problems repaying loans

group members and MFI staff or having their possessions (pots and pans, roofing iron) seized. In Bangladesh, MFI debtors have been arrested by the police (this came to light in 1997 when a police vehicle carrying such debtors crashed and the individuals concerned were killed), are threatened with physical violence (Montgomery, 1996), and the press regularly report female suicides resulting from problems of repaying loans. Many poor people are very frightened about getting into debt: this is a rational response to the dangers that arise from indebtedness to MFIs and not a 'misunderstanding'.

Microcredit and microfinance

The emphasis that most MFIs place on microenterprise lending has led to the evolution of a microfinance industry in which services have a poor match with client needs. Clients have to pretend that they want microenterprise loans (when they need to pay school fees, cope with a medical emergency, buy food, etc) and do not have access to the types of microsavings services that they desire (see Rutherford in this issue). In extreme cases, such as the Kenya Women's Finance Trust and several other East African MFIs, clients who wish to stop taking loans and only wish to make savings are 'balanced out' (i.e. have to leave the MFI). Whereas most banking services aimed at individuals find that demand for savings accounts is much greater than for loan accounts the microfinance industry tries to force every saver also to be a borrower. This is often because of product design through which MFI institutional viability is dependent on expanding the loan portfolio while savings products are not designed to cover costs.

MFIs do not work with the poor and the poorest

Effective MFIs—such as those in Bangladesh—provide services that help poor people improve their prospects and reduce their vulnerability. However, the claims that microfinance assists 'the poorest' and 'the poorest of the poor' are unfounded within national contexts. MFIs virtually never work with the poorest—the mentally and physically disabled, the elderly, street children, the destitute and refugees—and many MFIs (for example, virtually all of those in Kenya and Uganda) have high proportions of clients who are non-poor, if one takes official national levels of the poverty line as the criteria. (In Nyeri, Kenya, for example, I was amazed to find that 13 out of 13 group members of a 'poverty-focused' MFI I interviewed in 1999 owned cars!)

All of the group members of a 'poverty-focused' MFI owned cars

The common assumption that microfinance is automatically about working with the poor and poorest needs to be dropped, unless MFIs can provide clear evidence that this is the case. Donors also need to be more circumspect. The grandly named Consultative Group to Assist the Poorest (CGAP) (through disseminating microfinance best practice) has spent its first three years as the Consultative Group to Assist the Not Very Well-Off (CGANVWO) if one examines its portfolio. (To its credit, CGAP is now making serious efforts to incorporate a poverty focus into its work.)

There is no moral requirement that MFIs need to work with the poor. However, if they seek access to aid funds targeted on poverty reduction then they do need to explain what they are doing for poor people, rather than hide behind rhetoric and anecdote.

Microfinance and poverty reduction policy

MFI and donor hype has created the impression that microfinance is a cure for poverty. This is encapsulated in the work of the Microcredit Summit and the thousands of well-intentioned but misguided supporters who believe that microcredit is the answer to the problems of poverty. This is a potentially dangerous line of argument as it distracts attention from the fact that poverty reduction requires action on many fronts—social safety nets for the poorest and most vulnerable, an effective education system, low-cost and reliable health services, governments that can provide social inclusion (and thus maintain law and order) and sound macroeconomic policies, and many other issues.

Microfinance services are only one part of a poverty-reduction strategy

Providing effective microfinance services to poor people is part of a poverty-reduction strategy—but only a part. Those who present microfinance as a magic bullet to reduce poverty provide such a simple message for policy formulation that they encourage it to be simple-minded.

Microfinance in the future

The microcredit breakthroughs of the 1970s and 1980s contributed greatly to the understanding of poverty reduction by illustrating the feasibility of creating MFIs that can approach sustainability and can provide valued financial services to poor people. However, this contribution is now being undermined by unproven claims about microfinance always helping poor people and the exaggeration of the role of microfinance within poverty reduction policies. Worse still, the microfinance industry has ossified! It promotes group-based microenterprise loan products and is obstructing the development of the full range of services and products that poor people want and need—flexible savings, contractual savings, loans for education and health, microinsurance and lines of credit.

The 1990s have been the 'Decade of Microcredit Complacency'. It is time to stocktake—to stop recycling myths and to stop copying the initial breakthrough products—and to focus on the real job in hand: developing institutions that can create and provide the broad range of microfinancial services that will support poor people in their efforts to improve their own and their children's prospects.

REFERENCE

Montgomery, R. (1996), 'Disciplining or protecting the poor: avoiding the social costs of peer pressure in microcredit schemes', *Journal of International Development,* Vol. 8 No.2, pp.289–305.