# Nout Wellink: Microfinance – small loans, big differences

Speech by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the Roosevelt Academy, Middelburg, 1 June 2007.

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Today is special. You represent the very first graduation year of the Roosevelt Academy, and undoubtedly there awaits a bright future for you all wherein chances of success will abound. Clearly your accomplishment also signals the big achievement by the Academy and its faculty members. Today, I wish to talk to you about another success story, namely that of microcredit.

The UN designated 2005 the International Year of Microcredit. The aim was “building inclusive financial sectors and strengthening the powerful, but often untapped, entrepreneurial spirit existing in communities around the world.” The Year of Microcredit has proved highly successful. It has raised awareness around the globe about the importance of microfinance in fighting poverty and empowering the poor by enhancing higher incomes and more jobs. In other words, microfinance can promote economic and social inclusion.

Permit me to address the issue of microfinance in greater depth. “Microfinance” generally stands for financial services for the poor. Microfinance is important because well over three billion people do not have access to basic financial services such as credit, savings accounts and insurance. Microfinance can offer such basic financial services, which is of prime importance to these people. These financial services are provided by so-called "microfinance institutions" (MFIs) or "microlenders", which are simply generic terms for the estimated 10,000 diverse entities such as commercial banks, NGOs, credit unions, finance companies etc. While from now on I will have microcredit in mind when referring to microfinance in general, please keep in mind that microfinance services are much broader and also include insurance, deposit taking and sometimes even pensions. However, the most important element of microfinance today is still micro credit.

Let me therefore begin by explaining what microcredit is, how it works and whether it helps poor people to improve their living standards. Thereafter I will discuss the market for microcredit. In particular, I will focus on initiatives that have been taken in the Netherlands. With pride I can say that the Netherlands is amongst the frontrunners when it comes to developing and supporting new initiatives in the field of microfinance. The fact that Her Royal Highness princess Maxima was a member of the Advisors Group to the United Nations International Year of Microcredit 2005 has undoubtedly contributed to the growing involvement of the Dutch in microfinance. And, she continues her work as a member of the UN Advisory Group on Inclusive Financial Sectors. Finally, by way of a conclusion I will identify some challenges for the future.

## Microcredit – what is it?

Microcredit is the extension of very small loans (micro loans) to the unemployed, to poor entrepreneurs and to others living in poverty who are not considered bankable. These individuals typically lack collateral, steady employment and a verifiable credit history. Therefore they cannot meet even minimal qualifications to gain access to traditional credit. Microcredit is a financial innovation which originated in developing countries where it has successfully enabled extremely impoverished people (mostly women) to engage in self-employment projects that allow them to generate income and to begin to build wealth and ultimately to exit poverty. Thanks to the success of micro credit, many people in the traditional banking industry have begun to realize that these microcredit borrowers can be seen as pre-bankable. Microcredit is gaining credibility in the mainstream finance industry. Many traditional large finance organizations are now considering microcredit projects as a new source of future growth.

## How does microcredit work?

As you all know, microfinance has been invented by Nobel Prize laureate Muhammad Yunus, who was here last year when he received the Four Freedoms Award by the Roosevelt Foundation. In the 1970’s Professor Yunus was working at the Chitttagong University in Bangladesh. At that time, he started experimenting with providing small loans to the people in the villages surrounding the university. In 1976 he started the now famous Grameen Bank with help from the government. The goal was simple: providing small loans to the very poor. Regular banks would not provide such loans because they considered them too risky – poor people typically lack collateral – and too costly. The small scale of the loans and high monitoring costs for each individual loan typically increase operational costs.

An interesting feature of Grameen bank's initial lending methodology is that loans were provided to groups rather than to individuals. Let me briefly illustrate how some of those first schemes worked in practice. Two members of a five-person group receive their loans first. If all instalments are paid on time, the initial loans are followed four to six weeks later by loans to two other members. After another four to six weeks, the remaining member, known as the group chairperson, receives his or her loan – of course provided all goes well. In the beginning the group was typically seen as a source of solidarity. For example, when one member could not repay the loan, the group chairman could help out. In this way the credit record of the defaulted borrower would remain clean, and thereby also that of the group as a whole. Over time, formal sanctions by the bank became more common. If one or more group members failed to repay, all group members would be cut off from future loans. The incentive to help each other out in times of need, but also to check on each others repayment record, became stronger through this joint liability system.

In practice the group lending methodology functioned well, as repayment rates were generally high. Group lending is not only beneficial for the poor people as they gain access to credit, it is also an advantage for the microfinance institution that is providing the loans. Part of the responsibilities of the microfinance institution, such as monitoring loans and enforcing repayments, are taken care of through the group's own checks and balances. In this way the operational costs of microfinance have reduced and it becomes possible to give poor people loans that would otherwise not be available or at least would not be available at such low interest rates. The group lending methodology thus increases social capital and efficiency.

**Effect on poverty and economic development**

With innovative concepts such as group lending it is possible to give poor people access to credit. An obvious next question is: what does this credit do for them? Can people actually improve their living standards with the help of micro credit? There are basically two ways to answer this question. The first way is to look at the data and the available scientific studies and carefully assess the results. This is how central bankers typically approach economic questions. The second way is to pack your bags, hop on an airplane, and see for your self how microcredit affects the lives of people in developing countries. Let's start with the second approach, which is not so common for central bankers, but undoubtedly no less illuminating.

My personal experience with microfinance in Ghana has been very positive. And this holds for many observers who have witnessed the activities of microfinance institutions on the ground. But is microcredit really an effective means to alleviate poverty? Are the high expectations justified and can we establish a clear causality between microfinance and higher socio-economic welfare? To answer this question, we have to go beyond personal experience and also look at the data and results of the available scientific studies. However, there has been surprisingly little scientific work on the effectiveness of microfinance programs. According to some experts this may be explained by the fact that many donors who finance microfinance institutions are focussed on reaching as many poor people as possible. Evaluating programmes is often seen as a waste of time and money – and let me say that from a practical point of view such a perception is understandable.

But, from a broader policy point of view, it is important to know which concepts work best and which concepts are less effective. Careful experimentation with sound control groups may provide such insights. Another explanation for the limited degree of scientific evaluation is lack of data. Often there are simply not enough data available to study the effectiveness of microfinance. Moreover, the available data may be of limited use because, for example, accounting definitions differ between institutions in the microfinance industry. I therefore welcome recent initiatives, for example by the World Bank, to improve the quality of reliable data to increase our current knowledge. With these shortcomings in mind, the available studies provide a rather positive picture of microfinance and confirm my personal observations. It turns out that microcredit helps people to increase their income through entrepreneurial activities. The effects are often larger for women than for men and seem to diminish if the size of the loan increases. This latter result suggests that the smallest loans can actually make the biggest difference! And that women remain an important target group.

## The market for microcredit and initiatives in the Netherlands

The prospect for the microcredit industry in general is strong. The market is growing rapidly and supply can hardly keep up with demand. It is estimated that only 4 percent of global demand for microfinance services is being met. Note that the potential global microfinance market is worth roughly $300 billion, although estimates vary widely. Also, with the growing development of the microfinance sector, sources of funding for MFIs have diversified. Official donors are no longer the primary source, as tens of microfinance funds and more and more private sector investors are also offering capital to MFIs and are rapidly commercialising microfinance. These investors are typically private-sector funding arms of donors and socially motivated, privately-managed investment funds financed by public and private capital. Although both types of investors generally take a commercial approach in the rigor of their investment analysis and monitoring, they are not always fully commercial in the sense of trying to maximise profit.

The Dutch involvement in microfinance has not been left to chance. On the contrary, already in 1997 the first effort was made to co-ordinate microfinance activities by several co-financing agencies (Cordaid, Hivos, Interchurch Organisation for Development Co-operation and Novib) and their main funder the Ministry of Foreign Affairs. With the growing involvement of other private and commercial organisations in microfinance there was a need to include a larger and more diverse group of actors in this initiative. So, in January 2003 thirteen organisations agreed to formalise their efforts to co-ordinate and work together. They jointly established the Netherlands Platform for Microfinance. Dutch organisations that support the microfinance sectors in developing countries through investments or subsidies can join. Since its establishment the Platform has grown to comprise fifteen organisations.

To give you some idea of what the Platform does: in 2005 the Platform invested over Eur 360 million in the form of loans, equity investments, guarantees, seed capital and subsidies; this is up more than 50% from the Eur 225 million in 2004! These investments reached more than 550 organisations in 78 countries that offer financial services to poor people, ranging from community-based organisations, co-operatives, non-governmental organisations, banks and other financial institutions. A large share of this money has been invested in Latin America, followed by Asia, Central and Eastern Europe. Surprisingly, Africa has the lowest share (around 12%). The West still seems to lack the commitment to truly help this continent forward. The distribution over the four regions has by and large remained steady over the last three years. This reflects the fact that in general microfinance markets have matured, especially in Latin America, compared to the development of the sector on the African continent. But, although the market for microfinance is growing and more and more organisations are supporting this development, there remain important challenges for the future.

## Challenges for the future – by way of conclusion

If we truly wish to succeed in providing microfinance services to the poor on a large scale, further contributions are desperately needed. This is not only an issue of financing. Regulators and governments, in particular, need to develop legal and regulatory frameworks for microfinance, consumer protection, and financial infrastructure. Also prudential supervisors – and as a prudential supervisor myself I find this very important – can contribute to the growth of microfinance by defining clear criteria for microfinance institutions. This pertains in particular to institutions that wish to take deposits from the public or expand their services cross sectorally. And, last but not least, perhaps you yourselves as successful graduates of the Roosevelt Academy can also make a contribution to the success of microfinance, as future investors, entrepreneurs, or simply by telling others in your environment about the potential of microfinance. The latter can actually prove to be very effective, as you undoubtedly have a bright future as the next generation of influential professionals in our society.