

**The Future of Microfinance:
Creating Financial Systems to Serve the Poor Majority
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It is a real honor to be invited to be part of this conference. I want to thank the organizers and acknowledge the ever growing contribution that BYU is making to microfinance. Your dogged deliberate work is paying off as more and more folks get involved.

Thanks to the producers of “Small Fortunes” riveting portrayal of the power of poor people when given an opportunity, and a spiritual shake down for those who aren’t paying attention to how most of the world lives. Thank you for your work.

Last November I met a widow in Arusha, Tanzania. Intent on providing a better life for her children and surviving as best as she could, she had started a business selling rice ten years ago when her husband died. Sophia has little education. With a first loan of \$50 she purchased a few kilo bags of rice for on-selling to retailers. This is how she began a business that today, many loans later, has grown to employ several people and sells considerable quantities of rice, ground nuts and beans.

Set in a gritty, dusty run down street, Sophia runs her business out of her house, to which she has clearly added a couple of small rooms. In the inner courtyard of her house an elderly woman cleans the rice by passing it through a homemade tin strainer. The 150 kilo bags of cleaned rice stacked floor to ceiling in her dirt floor living room and one other room, are carefully weighed in an old scale and divided up into smaller bags. Two young men, employed by Sophia, deliver these bags throughout the city, carrying them in ancient, wooden hand-pulled wagons. Sophia’s two daughters are at the university, and she also takes care of her aging, invalid mother and aunt, both of whom I met.

At first sight, taken by itself, this is a humble story of little interest to a passerby. However, played out over and over again in markets, slums, barrios, villages around the world, this is a compelling and inspiring story of resolute perseverance; of the power of the human spirit; of the dignity needed to overcome the enduring grasp of poverty.

For us in microfinance, it is also about the lead character in our story. For me, it is about a leading character in my life journey...

- The lesson we all draw from Sophia's story is that very good things happens when small amounts of capital are placed in the hands of hardworking poor people.
- The dream we draw from Sophia's story is about creating systemic change around the world, one in which we would rebuild the exclusive financial systems that have for decades benefited and protected the wealthy, so that they serve the impoverished majorities, help lift them out of poverty and make them full participants in their country's social and economic development. That is the dream.

As we look ahead ten years, there will be more and more Sophias. I don't need to give you data about poverty around the world – we are well versed. They will be running their tiny businesses to survive, to support their families, to educate their children, and for this purpose they will seek financial services.

Microfinance has proven that the Sophias of the world are credit worthy, that they make productive use of loans, and that they improve their lives and that of their families with their added income. In the next ten years, our task is to make certain that the millions of men and women like Sophia currently excluded can access financial services. But how do we get there? Let us first look at where we are.

Let me use this time to explore two key questions -

- What is the starting point in microfinance to guide us in the next 10 years?
- What developments can we expect by 2015 – and what do we need to have in place to reach our goal. I will focus on what channels we use to extend financial services – the institutions; who we will reach - the market, what innovations we will need; and what role governments will need to play.

An important point of reference for me is the experience of ACCION International – permit me to give you a brief sketch. As the movie chronicled, ACCION made its first loans in 1973 in Brazil, and has spent the last 3 decades developing a model for microfinance with two characteristics: the capacity to reach massive numbers of poor people; that it rely on self sustaining institutions.

ACCION’s work is done through a network of microfinance institutions, many of which ACCION created from scratch, first in Latin America and for the last 5 years in Africa and now globally. The approach ACCION applied led to the creation of the first self sufficient institutions (covers their costs) and then in an effort to capture private capital to grow the lending, to the first transformation of a non-profit into a commercial bank, BancoSol,. This model was followed by organizations within the ACCION Network – Mibanco in Peru, Compartamos in Mexico - and outside – KREP in Kenya, and today many others, including Opportunity and FINCA. For ACCION this model has led to enormous growth in people of poor borrowers. In the last four years, for example, the ACCION Network has added over one million clients, from 450,000 in 2000 – which took two decades to build, to 1. 5 million today. We plan to at least double this number in the next 3 years.

ACCION’s International Network today is comprised of 26 MFis – some of them the leading – in 20 countries. The ACCION USA Network operates in over 30 cities in this country. ACCION provides technical assistance – we have a team of 60 people, and we manage two investment funds that invest equity in microfinance institutions that transform into banks.

From this experience and that of other leading institutions - and I emphasize here the leading microfinance institutions – we hear that there are about 7,000 or 10,000 institutions, but in fact about 150 or 200 of them are doing the heavy lifting and are considered the leading ones.

Their experience and their accomplishments inform the next ten years.

Let me talk about these microfinance institutions because they are central to our story – Without them we have nothing more than transitory efforts or only good intentions.

These institutions have advanced microfinance from initially using donor funds to experiment and get off the ground, to the point where in some countries, like Bolivia, Ecuador, Kenya and others they have become among the most effective and efficient formal financial institutions specialized in reaching the poor.

While each country/market has unique characteristics, microfinance at its best, as transacted in all these nations to all the Sophias, is defined by a set of common attributes which form the starting point for the next ten years.

These attributes correspond to what has come to be known as the commercial approach to microfinance.

- If microfinance institutions want to make a real impact, they have to be permanent. And in order to be permanent, they must be economically viable. Why economic viability? Look at the scale of the problem we are dealing with. The poor make up the majority of the world's population. It shouldn't be a surprise that if we want to deal with a massive problem like that, the only way to do so is to mobilize an equivalent amount of economic firepower? The only place where that economic firepower exists is in the financial markets of the world, because it's the financial markets of the world that represents the savings of the world. And to connect the savings of the world, the private capital, you need a commercial model that can access this capital on a continuing basis.

For me the most poignant argument for the permanence of microfinance institutions was brought home in my conversation with five women from a solidarity group in Lima Peru. Our affiliate, Mibanco, now a commercial bank, has operated as an NGO since 1979. A few years ago I asked to meet with some of the borrowers who had been borrowing for a long time, and so I met with these women, whose first loan was given in 1980. I met with them in the market where they work, each has a stall and made food to sell. One has grown and had two stalls, a refrigerator and a rotisserie for chickens. The others had grown some but not much. But they told me that it meant to have a steady source of income for 20 years; what peace of mind this gave them, what hope for the future, what plans they developed; how all their children were at the university or technical school.. How their lives were changed. This is why

permanence of institutions is essential – this is why running out of money to lend, or being sloppy in the management cannot happen, because these five women would have returned to a life of poverty and misery. Permanence is about these five women.

- The microfinance institutions responsible for this intermediation operate under general charters established by the national banking or financial authorities that are in charge of all financial institutions. Many of them – dozens – have converted from NGOs to commercial financial institutions. Their operations take place under the oversight of the national banking or financial regulatory and supervisory authorities and their data is completely transparent and accessible to the public.

These leading microfinance institutions share common traits, and I highlight four.

One

- They understand their market, poor households, and know how to develop products that are useful to them. They consider not just the microenterprise but the financing needs of a poor household and develop financial products that include savings, home improvement loans, insurance, money transfers and small consumer loans. This is why they have grown at a consistent and often dramatic rate, which they aim to maintain.

Two

- They have a history of being self sustaining, with income earned from their financial services able to cover costs and to generate a profit; this profit, and access to the capital markets, allow them to grow.

Example: Compartamos, our affiliate in Mexico, whose Director spoke in the film, added 100,000 new clients in just 2004 – how did they do this. They plowed their earnings back into the institution, and they issued paper on the local Mexican market, based on their sterling performance, generating almost \$50 million.

Three

- They have learned how to operate in competitive environments. In more and more countries there are several microfinance institutions competing for the same borrowers – we see this in Bangladesh, Bolivia, Uganda, Nicaragua to name a few.

Why is competition good?

Example: I recall when we started in Bolivia in 1986, a very poor humble indigenous woman who sold onions applied for a loan and asked incredulously: You mean if I pay this loan back you will give me another? Today, that same woman can choose from among several institutions, compare products, interest rates and another benefits, and choose. She chooses now. As someone remarked “How cool is that?”

Competition also makes institutions more efficient, seeking to lower their costs and hence their interest rate to the borrower. Data from several countries in LA shows that with competition the annual interest rate to the borrower has steadily decreased, in some cases, like Bolivia, being cut from 70% when BancoSol started in 1992 to just over 20% today. It also shows fast and furious innovation in the use of technology and other means to lower costs.

Four

- Their late payments are maintained at a very low level, usually below 5%, regardless of growth. These microfinance institutions also set aside a reserve, or provision against bad loans, some as high as 100% of their late portfolio. For most, repayment over the years remains above 98%.

Advancing microfinance to its current state is, under any measure, an outstanding achievement. This achievement has been accomplished by the leading microfinance institutions of the world. I have placed my focus on the institutions because the future of microfinance will be built on the quality of microfinance institutions we develop today. Nothing more and nothing less.

Now let's look ahead:

It is this very success that has opened the way for a series of events that in the coming years will have the potential to significantly alter the microfinance industry and to create explosive growth. Principal among these are:

1. The leading microfinance institutions have been fueling their growth by constantly expanding their access to more and more commercial sources of funds. In the next decade, some of them will complete this process. The next step will be what BRI in Indonesia has already done: it issued the first IPO; others will issue bonds in their local markets, as several have already done in Latin America, including two which are NGOs. We will see more microfinance institutions follow their lead, relying on the local and international capital markets to grow their institutions. And we will have an explosion of interest from private capital, especially social investors from the north who wish to invest in microfinance.

2. Additional microfinance institutions will join the 200 leading ones as the lessons of good transparent performance are disseminated and applied. Some of these will continue to operate as NGOs and will continue to play the role of pioneers, innovators, for example working in very remote areas, or experimenting with self-sufficient models that may include education or health service delivery.

3. Conventional banking will enter the microfinance field: Being totally ignored in its early days, microfinance has emerged as a segment that conventional banking is beginning to study from a commercial perspective. Many banks are losing their current markets to international banks, are seeing that microfinance's record is very good, that microenterprises are very resilient during economic cycles and political and financial crises. They are reading about the fortune at the bottom of the pyramid. In preparation for the paper ACCION is preparing for the Microcredit Summit in Chile, and the plenary speech I have been asked to deliver, we interviewed over 30 key players in microfinance in the region – all but one believe that in Latin America the banks will become important players in the next ten years.

The banks' large infrastructure, their internal systems and their capital make them very attractive for growing microfinance larger and faster. Banks will find different models to become involved. We have developed one model that creates a separate private company which operates much like a microfinance institution but uses the bank's capital and systems. In Haiti, Ecuador and Brazil we are working with large banks and with this model they are reaching poor and very poor borrowers. Other large banks in Africa, India are becoming active in microfinance.

4. The dominance of today's microfinance leaders will be sustained only if these institutions are capable of developing a set of capabilities which they do not, by and large, possess today. They will face more competition, consolidation of microfinance institutions, the entry of banks, and the need to maintain high performance over time. To be prepared they will need excellent governance and management that will avoid the complacency of success and will continue evolving and improving. More important, they will need to remain focus on who they are trying to reach – the poor and the very poor.

5. New key and massive markets, to date not significant in the development industry, will open to microfinance - China and India. The sheer size of these countries carries with it the potential of affecting the whole microfinance industry in ways that are complex and not readily discernible. Success will hinge on the application of the lessons of successful microfinance: they understand their market; their price their loans to cover their costs and yield a profit; they keep their costs low; they think long term survival.

These advances raise important challenges for the different players in microfinance.

1. **Governments:** the role of governments is to develop a regulatory framework that facilitates the growth of microfinance. The work to be done here is enormous. When one considers that the development of a good regulatory framework in Uganda, which is leading to the transformation of FINCA Uganda, of UMU, ACCION's affiliate and other NGOs took six years and the full-time presence of two excellent German consultants, it is discouraging. Regulatory and Supervisory work has been left in the dust by the growth of microfinance and urgently needs to catch

up - this requires building awareness, lobbying, drafting the regulatory norms, equipping supervisory agencies to provide good oversight, it is a huge job.

Governments can get in the way by making microfinance part of their political campaign (it has become so popular that it is starting to appear in all campaign promises), insisting on doing it themselves or making policy decision that adversely affect microfinance, particularly setting ceilings on interest rates.

2. **Industry shakeout** – More microfinance institutions will apply the lessons of the leading ones or will gradually run out of funds to lend. If donors continue to provide soft funds to finance portfolios, weak institutions will continue to survive. Also in small countries, such as Nicaragua, where there are over 100 microfinance institutions, we will see mergers and purchase of portfolios.
3. **Need to capture the collective wealth of the poor through savings:** BRI has been a global pioneer in mobilization of savings, demonstrating both the great need as well as the magnitude of the collective wealth that can be unlocked with appropriate products and distribution channels. Several members of the ACCION Network are covering half of their portfolios of \$100 million with deposits, most Latin American institutions have been far less successful at mobilizing savings and can learn a lot from their Asian and African counterparts.
4. **Innovation** – There will be explosive growth in new products and in use of technology. Credit cards, smart cards and others will be added to products – and we will use technology to add points of sale, to make the administrative work of the loan officers more efficient, to transfer information, to lower costs even more. This is a very exciting piece in the coming years.
5. **Conventional banks** – While they have many advantages, they face significant barriers in reaching a market they have excluded or ignored. They lack information, they suffer deeply-rooted cultural preconceptions regarding the poor; and they lack the methodology that can lend with no collateral. Banks will do well to form

partnerships and proceed hand in hand with well performing microfinance institutions.

6. **Donors:** As part of their millennium development goals, they will continue to be essential players in microfinance, providing resources to develop institutional capability necessary for microfinance. Today, there are many many countries that lack even one strong microfinance institution – the donors need to help build this capacity, using the lessons we know work.

The task will continue to be enormous and will require the open hand, the committed spirit, the restless brain of many of us. Our vision is grand and it may require new ways of operating, new ways of thinking. The advice we must heed is: do not be afraid to reinvent yourself along the way, but remain steadfast and unwavering in the mission of helping lift the poor out of poverty.

Thank you.