

Microbanks: Subsidy Dependent or Self-Sufficient?

BY MATTHEW CONNER

The goal of “microbanks” is to reduce poverty by providing short-term, low-principal loans that serve to increase access to credit which might otherwise be closed to those in the developing world. The literature concerning microlending ranges from unabashed praise to harsh criticism.

Some see the trend as one of the greatest forms of humanitarianism in recent years — Muhammad Yunus, founder of the Grameen Bank of Bangladesh, one of the pioneer microbanking programs, recently received the Nobel Peace Prize. Others see microlending as little more than a glorified welfare program.

Subsidies appear to play a very large role in the sustainability of nearly all microbanks. This is due to the fact that microbanks face two large problems. One, they lend primarily to people who can offer no collateral. Two, they attempt to generate profit while granting relatively small loans.

Even the Grameen Bank of Bangladesh, which has reported profits nearly since its inception, may not be as self-sufficient as once thought. According to economist Jonathan Morduch of New York University, when Grameen's accounts are followed over time, he finds that “categories and expenses are moved around to ensure that Grameen posts a modest profit.”

In addition, he also notes the fact that the subsidy rate (as a percentage of total loan portfolio), while falling over recent years, still rests at approximately 9 percent. In a comprehensive survey of microfinance firms targeting the poorest borrowers, research showed that these banks were generating only enough revenue to cover 70 percent of their full costs.

However, microbanking is a very complex industry with many variations in how each institution lends money and the mechanisms used to encourage repayment. In a recent article, Morduch and economists Robert Cull and Asli Demirgüç-Kunt of the World Bank performed a global analysis of leading microbanks. They split microbanks into three categories depending on lending type: 1) village lending in which there is large-scale joint liability for repayment 2) group lending where the focus is on self-formed groups of borrowers (solidarity groups) that assume joint liability for repayment and 3) individual lending that centers around a more traditional bilateral relationship between bank and customer.

To assess the profitability of these microbanks, the

researchers used a financial self-sufficiency ratio, a measure of a bank's ability to generate enough revenue to cover its costs. The ratio is derived from revenue divided by the sum of adjusted financial expenses, adjusted net losses from loans, and adjusted operating expenses.

Village banking serves the poorest customers, with an average loan size of approximately \$149, but it also reaches a large number of borrowers. The troubled financial positions of the clientele causes the average interest rate of village-based loans to be the highest of the three types studied.

These banking operations also face the highest average

costs, since the small loan amounts generate small incremental payments compared to the operating costs associated with managing such a vast number of outstanding loans. According to the survey, the average return on assets for village-based lending was negative.

The banks that employ the group lending technique follow the same guidelines as the village

banks but on a smaller scale. Group banks have an average loan amount of \$430.98 and also charge slightly lower interest rates, given that their clients are financially better off and are more likely to fully repay loans. Operating costs are also lower than village-based lending because of the larger loan amounts and smaller outreach, but these banks also show a negative return on assets.

Individual-based lenders are the only group that reported profit not enhanced by subsidies and grants, but they also exhibited the lowest amount of outreach. The average loan amount for these banking operations is approximately \$1,220, which reduces average costs and allows for a slightly positive return on assets.

Working with customers who can handle such large loans and are obviously not the “poorest of the poor” seems to veer from the primary targets of microbanking. There appears to be a viable trade-off between profits and outreach, with the more profitable banks possibly experiencing what the authors refer to as “mission drift,” or a shift toward prioritizing revenue over the reduction of poverty.

This situation presents a conundrum. It seems that the surest way to be a successful microbank is to act more like a traditional bank. The authors note that there are “examples of institutions that have managed to achieve profitability together with notable outreach to the poor — achieving the ultimate promise of microfinance. But they are, so far, the exceptions.”

RF

“Financial Performance and Outreach:
A Global Analysis of Leading
Microbanks” by Robert Cull, Asli
Demirgüç-Kunt, and Jonathan Morduch.
Economic Journal, February 2007,
vol. 117, pp. 107-133.