How can a MFI manage to have a commercial status and still target "vulnerable" people as a core client group?

Claus-Peter Zeitinger *Main strategic investor – PROCREDIT*

November 20 2009

When loans are extended to "vulnerable" people, too many of them are left overindebted – this could lead to a highly risky credit crisis. If microfinance institutions need to develop into fully-fledged banks – particularly in order to mobilize deposits from the public – they must also first and foremost help make the sector more responsible.

Before sharing my thoughts on how a microfinance institution (MFI) can be profitable while targeting "vulnerable people" as a core customer base, please allow me to clarify two points:

First, any MFI wanting to be more than a donor-driven NGO or a funding organisation backed by sponsors in developed countries should attempt to acquire a banking licence or register as a regulated non-banking financial institution. By taking such a step, a MFI can attract local deposits and thus achieve a certain degree of independence and sustainability. In the case of ProCredit institutions, customer deposits exceed the loan portfolio in most of our branches in Latin America and all of those in Africa. The exception is Eastern Europe, where the pace of market expansion has been exceptionally strong over the last few years. The challenge in these markets is not so much the lack of savings, but rather the relative institutional weakness of the banking sector and the absence of a long-term vision. This weakness, rather than the lack of money, is the true missing link in these markets.

The second point that requires clarification is the term "vulnerable" when applied to customers. A financial institution that intends to generate even a modest profit could, of course, extend loans to the truly downtrodden, but that does not mean that they should. Many players in the microfinance sector have been pulling the wool over the world’s eyes for a long time with claims that they could eliminate global poverty if only they were given sufficient means. But I would strongly argue that the most vulnerable groups in society do not, as a priority, need loans: they need governments to invest in better infrastructure, schools, health and clean water. Very often the “poorest of the poor” are not running viable enterprises and they are very vulnerable to consumer debt they simply cannot afford.

As soon as an institution begins providing credit to micro-enterprises it already has one foot in the quicksand of consumer lending. The owners of very small businesses do not usually draw a clear line between working capital and family expenses. The old-school practitioners of microfinance have always been aware of this grey area and deal with it sensitively as part of their credit analyses. Bolivia, with its well-developed microfinance sector, provides a good and positive example of this approach by drawing a clear line between microenterprise and consumer finance.

Recently, however, MFIs have become socially acceptable for a growing number of institutions. The United Nations dubbed 2005 the International Year of Microcredit, and the Nobel Peace Prize was awarded to a pioneer in this field in the following year. This surge of interest soon prompted “real banks” to offer assistance and support: Citibank, Deutsche Bank and Credit Suisse, among others, started providing funding to the microfinance sector. In short, the capital market and the MFIs threw themselves at each other like two young lovers. The banks were enticed by the prospect of high returns, while the MFIs were basking in the light of their newly-found recognition and respect from the major banks – not to mention of course the fact that finance was suddenly much easier to obtain and came with fewer strings attached.

At the same time, the industry discovered the “working poor” as another potential customer base in addition to micro-entrepreneurs. By now, MFIs have both feet caught up in the quagmire of consumer lending. My fear is that the end result of this shaky relationship with the working poor will be a subprime crisis in the microfinance sector. Given that the majority of MFIs are not subject to strict accounting and banking requirements, things may carry on in this way for some time to come. In their quest to reach a large number of poor people and families with no regular income, many MFIs have showered their customers with consumer loans, in many cases making them too indebted to repay all of their obligations. To be fair, it should be added that these developments have mostly taken place in Eastern Europe and Latin America.

Rather than talking about “vulnerable” people and microfinance, which is in any case a term that different people can associate with different things, I prefer to talk in terms of developing “responsible banking” for ordinary people. It is less spectacular, and certainly not as popular. Moreover, it requires a lot of staying power: I believe the two essential ingredients for success are structure and discipline. Never mind if my choice of words on this point exposes me as a German. It is important to reflect on how to build commercially viable financial institutions committed to traditional business concepts such as efficiency, growth and customer service, but not driven by concepts like bonuses and short-term profits, because I do not believe that the latter are compatible with serving “ordinary” people in a responsible way.

Structure begins at the shareholder level and should be reflected in the composition of the management and the organisation as a whole. With a clear structure in place, the result is a high degree of transparency in the institution. Discipline is more than a secondary virtue, it is an approach to life that implies a broad range of values and their dissemination at all levels of the organisation. The shareholders of a responsible bank should be investors with a long-term vision whose interest in making a profit is balanced by a strong commitment to economic development. Those who think they need an exit option after 5-7 years should not even consider entering a market that is characterised by steady institutional growth over the long term. This tends to rule out those players in the private capital market dominated by short-term “shareholder value” thinking. One needs to find socially responsible private investors who are looking for sustainable, reliable long-term returns. My own personal experiences with public shareholders have been good.

The management team of a responsible bank should be guided by a competent supervisory board. Competence, in this particular sense, refers more to life experience and an adherence to ethical principles than to any specific technical knowledge. In order to ensure that they truly share a commitment to the institution’s mission, the members of the supervisory board should only have their out-of-pocket expenses covered.

The question of salaries is of no less importance at the management level of such a bank. I believe that very high salaries and performance-related bonuses are completely inappropriate, particularly in financial institutions that claim to be driven by ethical values; here they would do nothing less than poison the heart of the organisation. Of course I am in favour of commercial success (which is not the same as profit maximisation), but I do not support the idea of motivating managers with pay bonuses just because it is difficult to think of any other way to inspire them or to engage in meaningful communication. After all, in order to lead a responsible, target group-oriented financial institution, the first requirement is a team of managers who are open and able to deal with shareholders as well as their employees, who have strong communication skills, and whose motivation is rooted to some extent in ethical principles – all criteria which typical bankers are only rarely able to meet. Based on this observation, there is no reason why others should follow their way of doing business. Below management level, autonomy and decision-making skills should pervade the organisation all the way down to its lower levels. When lending to micro, small and medium-sized enterprises, a bank must always take individual circumstances into account and build a close relationship with its clients. This entails a high degree of personal contact, a significant investment of time and the compilation of detailed information about each client. It is a strategy which can only be carried out by adopting a decentralised approach to doing business and establishing a similarly decentralised decision-making process. That said, it would be naïve to think that each branch will inevitably act in the best interests of the institution. A sound internal control system, including credit control and an internal audit department, is therefore a vital component alongside clearly defined standards set by the management and a common business philosophy among all staff members. These measures might be expensive and drive up the cost-to-income ratio, but they are indispensable. To reduce expenses and generate a higher level of income, an exclusive focus on one core group – such as micro-enterprises – should be avoided.

ProCredit banks are characterised by a portfolio which, in addition to loans to micro-enterprises, also contains a significant volume of loans to small and medium enterprises. These clients represent a considerable source of revenue as they subscribe to a broad range of banking services. From a development perspective, they are also a vital force in the creation of jobs and prosperity in a country.

I have just outlined the type of structure that is needed within an institution but it goes without saying that its soul is also a key factor. This is a combination of the corporate spirit, the image that staff have of themselves and role models. In saying this I have other organisations in mind such as Germany’s Sparkassen, Austria’s Raiffeisen banks and the French Credit Agricole Group. These are all companies with a long history, established traditions and a strong sense of identity yet lost much of their original soul (and a lot of their money) when they decided to become “real banks”.

A company only has a soul if the majority of its staff are truly committed to a vision and take an active part in achieving that vision. I consider it less important for employees to hold shares in the company they work for, even though I personally favour the idea. What seems more crucial to me is that they are able to take part in the decision-making process. It is precisely for this reason that discipline is needed, as mentioned earlier. For staff to develop the ability to make decisions effectively, they should be trained in technical areas and, moreover, empowered to do so in a humanistic sense. I do not believe in financial incentives to urge staff to behave in a certain way but in the power of intelligent communication and the use of rational arguments and relevant examples to convince them. The self-centered, neo liberal man [of the post-modern era] has proven to be quite vulnerable from an anthropological and sociological perspective, and in my opinion the financial crisis has buried this model once and for all.

In our day-to-day work we follow the admittedly time-consuming processes of developing insight through critical thinking and putting shared values into practice. Being disciplined involves fully understanding your own role and being able to assign a role to your colleagues; in no way does it equate to following orders. Communicating with your staff in this way fosters a strong identification on their part with the institution and with its core target groups – and it is to our customers in particular that our banks should demonstrate a high degree of social responsibility. As far as we are concerned, this is the only way to achieve commercial success and personal fulfilment at the same time.