

Loans to the Vulnerable

The Ethics of Microlending

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Microcredit and microfinance have received considerable attention recently in both aid and business communities. The year 2005 was named the International Year of Microcredit by the United Nations, and in 2006 Grameen Bank and founder Muhammed Yunis jointly won the Nobel Peace Prize for their contributions to poverty reduction in rural Bangladesh. However, the merits of microlending remain a topic of great debate. Centred largely in Asia and Latin America, the numerous studies on microcredit and microfinance have displayed significant variations in their findings. Many aspects of microlending are widely disputed, such as the ability of microcredit to reach the core poor, the way that it affects women and families, the commercial potential of microfinance, the ethics of profiting from the poor, and ultimately whether governments should act to either promote or regulate microlending. This paper addresses only the final two: are borrowers without collateral too susceptible to coercion to justify commercial microfinance? Should states regulate such

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practices to prevent exploitation? To answer these questions, I observe a number of key conceptual and methodological areas of concern within the field of microlending in Asia and Latin America and consider whether commercial microfinance as an industry might benefit or exploit the poor. I conclude that commercial microfinance is not suitable for the most vulnerable in society for three reasons: microfinance institutions have too great an interest in lending to those who cannot repay; data is too easily manipulated to show that programs are helping those they are not; and borrowers with no other source of credit are too vulnerable to defend themselves from aggressive lenders.

A crucial distinction for this paper is between the commercial *microfinance* industry, which originated in the 1990s, and non-profit *microcredit* initiatives, which began approximately two decades earlier. In Asia, microcredit is said to have begun with the Grameen Bank in Bangladesh. In 1974, the country suffered a severe famine, putting millions of people at risk of starvation. In 1976, Muhammad Yunis, a Bangladeshi economics professor frustrated by the futility of his lessons in helping those in need, began giving small loans to nearby villagers so they could invest in small businesses. After his initial microloans proved both effective and repayable, his lending project and capital pool began to grow. In 1982, with the help of special government legislation, the Grameen Bank was officially created, and it has continued to grow considerably over the past twenty-five years. Today, the bank is a large, self-sufficient financial institution. It is owned by its seven million members and lends approximately US \$60 million per year.¹ Microcredit in Latin America is said to have begun in 1961 with what is now called ACCION International. In the case of ACCION, the work of student volunteers in shantytowns outside the Venezuelan capital of Caracas has turned into an international organization of microlenders, spanning twenty-three countries within Latin America, the Caribbean, Asia, Africa, and North America. Since 1996, ACCION and its affiliate microlenders have lent nearly US \$9.4 billion to 3.97 million people.² In both Asia and Latin America non-profit microcredit remained the only existing form of microlending throughout the 1970s and 1980s.

In what follows, I reserve the use of the term microcredit for non-profit microlending, and microcredit institution (MCI) for any non-profit bank, credit union, or nongovernmental organization (NGO) that provides microcredit.³ Although most MCIs still charge relatively high interest rates and in some cases have rapidly growing assets, profits are reinvested or donated to other causes. Most MCIs are based upon the assumption that access to credit is a fundamental human right, and that

the provision of credit to the poor is thus a form of social and economic revolution.⁴ Although this distinction is not made by much of the literature, it is quite an easy distinction to make when discussing the institutions themselves.

The term microfinance is a product of the 1990s. Although it is quite often used inclusively to refer to all aspects of microlending, including microcredit, savings, insurance, and management assistance, I restrict my usage of microfinance and microfinance institutions (MFIs) to commercial microlending and the associated services. By the time of the 1997 Microcredit Summit in Washington, D.C., twenty years of apparent microcredit successes had entrepreneurs from around the world excited about developing the microfinance industry. After the conference, which was concerned with poverty reduction on a global scale, the microfinance industry underwent rapid proliferation, with commercial banks and private businesses engaging in microfinance programs. Today the term microfinance may refer to a broad set of practices, of which a comprehensive account is quite impossible.

Although the term microfinance emerged at the same time as the implementation of many additional credit and support services, MCIs generally adopted similar programs at the same time. Thus it is not actually useful to distinguish between microcredit and microfinance by the kind of services provided.⁵ Conversely, as discussed below, the difference between microcredit and microfinance is absolutely crucial for the well-being of vulnerable borrowers and therefore state regulation: commercial lenders can too easily disguise harmful practices with positive repayment figures. I use the term microcredit only to refer to non-profit microlending; I use the term microfinance to refer to commercial, profit-driven microlending, and MFI for institutions thereof.

The terms microcredit and microfinance encompass a wide variety of enterprises and projects throughout the world today. Despite common generalizations about the prevalence of microcredit in Asia and microfinance in Latin America, commercial and non-profit microlending can be found in numerous forms and on every continent. As such, few generalizations about this particular form of lending are meaningful unless qualified by institution, region, or specific practice. Although this paper does attempt to consider global practices of microlending in aggregate, my intent is to discuss certain qualitative and theoretical aspects of microlending that relate in some way to all practices of lending to the poor. The aim of these broad generalizations is to separate the microcredit from microfinance, and thereby allow further research to more

accurately discover the impact of each kind of lending and prevent the exploitation of the poor by aggressive moneylenders.

Despite significant academic ambivalence, much of what is written about microlending is positive. For example, there is general agreement that it has changed many lenders' attitudes toward helping the poor and has provided credit to large numbers of people who would otherwise be excluded from the financial institutions.⁶ In addition, the reported benefits to borrowers are numerous. In 1993, for example, a study by the Grameen Bank found not only positive financial indicators of increased employment, income, and assets of its poorest borrowers, but also numerous personal welfare indicators, such as improved diet, schooling for children, and better access to clean drinking water, contraceptives, and toilet facilities.⁷ Many remain highly critical of the methods used in Bangladesh and elsewhere to make these sorts of claims; nonetheless, stories of success abound. Whether or not microcredit has (or at least has the potential to) pull millions out of poverty is far beyond the scope of this paper. Regardless of the many methodological difficulties related to proving the success of microcredit, it has been associated with the financial and social empowerment of the poor.

Another associated benefit of microlending is the potential social gains for women within borrowing communities. In a 2005 study, Frank Tesoriero reports progress against oppressive social structures in southern India by women's self-help groups (SHGs) created for local microcredit enterprises.⁸ In certain rural regions of India, where some still practice female foeticide and infanticide, women are often exploited and commodified minorities. Taking the view that poverty is more than a purely financial condition, the study focuses on the social and economic opportunities of women in SHGs. The study surveys a sample of 387 SHGs of twelve to twenty members, all of whom are extremely poor. Using financial records, surveys, and in-depth interviews, the project seeks to develop a broad understanding of the women's experiences. Although the study notes few economic gains, its results are quite positive: Tesoriero reports an overall trend toward social empowerment for women in their communities. The SHGs led to unprecedented community involvement, with some members even being elected to local civic councils: "[t]he change from women needing permission to leave their home to full and enthusiastic participation in the economic, social, and political life of the villages captures the startling extent of empowerment outcomes."⁹ And so, although the financial gains from local microcredit schemes remained modest, the study concludes that the

social aspect of community borrowing is hugely instrumental in increasing borrowers' capabilities, a key aspect in poverty reduction.

However, there is also evidence that microcredit can have much less empowering effects on borrowers. For example, a 2006 study by John A. Brett of women in El Alto, Bolivia shows detrimental effects at the household level for borrowers from a local microcredit program, which effects are obscured by focusing on the institutional level.¹⁰ The study is an ethnographic account of twenty-eight women who borrow from Promujer and Crecer, two prominent MCIs of the region. The women in the study, most of whom are classified either as poor or very poor, attempt to increase their household income with such ventures as knitting sweaters at home. In most cases, they have no free time outside of managing their households, and so they must do income-generating work after their families have gone to bed. To repay loans, the women frequently are forced to borrow money from friends and family, and only break even at the best of times. However, although the women work harder, sleep and eat less, and make no profit from their businesses, they repay their loans on time and show, on paper, an increase in total household income. By the standards of many institutional surveys, the hardships of these women would be considered stories of success.

This brings us to a crucial problem within the study of microcredit and microfinance. Brett's study led him to the conclusion that microcredit research must be conducted at a household level, taking into consideration the many hidden costs that are overlooked by studying institutional outcomes. With the exception of the most recent studies and a small number of older ones, Brett argues that the relatively high cost of ethnography has made researchers excessively reliant upon misleading institutional measures of costs and benefits. However, as his study indicates, unqualified data can be dangerously misleading. For example, one easily-quantifiable cost that is often ignored by institutional surveys is the transaction costs, including the cost of transportation, food, childcare, and time lost travelling to markets and MCIs to sell goods and make payments, sometimes in areas lacking public transportation. Together, these costs may have dramatic effects on borrowers' incomes and lifestyles. Only with thorough investigations such as Brett's ethnography can we get a clear picture of the conditions that affect the options of borrowers.

A number of sophisticated methods have been created to try quantitatively to gauge the impact of microcredit and microfinance, although none is able to answer the range of questions raised by microlending practices. To establish whether a certain group is being

reached by a program, the Consultative Group to Assist the Poorest (CGAP) has created a poverty assessment tool (PAT), which uses a weighted index to measure the outreach of microlending to the poor, but tells little about the effect of the programs. To study impact, a number of researchers began the Assessing the Impact of Microenterprise Services (AIMS) Project, which compares the development of participants to a control group. However, there are a number of unobservable factors that could lead to upward bias, such as self-selection of subjects and the fact that those approved for loans will already be the most likely to succeed.¹¹ In addition, although there have been countless studies conducted regarding the cost-effectiveness of MFIs, they too cannot be assumed to accurately correspond with studies of outreach and impact. This has led to the conclusion that future studies, if they are to offer any significant insight, must address outreach, impact, and cost-effectiveness at the same time.¹²

The methodological difficulties of research on the effects of microlending allow researchers to gather data in ways that tell distinctly different stories. For example, consider the women in Brett's study of microcredit in El Alto. Were his research methods different, he could have told a greatly different story. From the standpoint of outreach, the story is a success from the moment the women are given their loans. From the standpoint of the lender, the project is a success because the women were able to repay their loans on schedule, and the institution can build a profitable market upon such practices. Even basic surveys of household impact may show these women to be successful on the grounds that they were able to maintain their businesses and their total income increased. However, only at an experimental, ethnographic level can we see that the programs did not benefit the women at all. This can be generalized to the entire region: whereas Latin American MFIs can provide data showing high levels of repayment and even increases in family income, such statistics may not actually correspond to an increased standard of living.

This leads us directly to why commercial MFIs must be distinguished from non-profit MCIs. Given their ability to show positive results even within negative experiences, commercial enterprises have a significant conflict of interests.¹³ As long as commercial institutions seek profit, that necessarily must be the aim of their programs. And, as we have seen, a lucrative market does not necessarily correspond to benefits for borrowers. Furthermore, as long as microcredit and microfinance are confused for one another, supporters of microlending are unable to advocate one without the other: the success of idealistic MCIs in Asia is

thought to correspond somehow to the practices of MFIs throughout the world. Thus it is extremely difficult to distinguish between truth and falsity, aid and business. In addition, because the extremely poor generally have no other options, they are easily forced into borrowing money they cannot repay. Nobody would choose starvation over a loan he cannot repay. It has been suggested that the majority of chronically poor borrowers use microfinance for basic consumption, not income promotion, which means that borrowers are in extremely vulnerable positions.¹⁴ If an institution relies upon a profit base for its continuation, it must lend to those it may profit from, not those who will benefit from the loans.

This suggests that some form of state regulation is needed to protect the vulnerable from predatory lending by MFIs. The first question policy-makers must address is how to prevent the exploitation of the poor by MFIs. Although thresholds of vulnerability are difficult or impossible to pinpoint exactly, it is not impossible to design legislation that could potentially lessen the likelihood of exploitation. For example, because administrative costs are fixed at a certain rate per loan (e.g., the wages paid to staff for meetings and paperwork), smaller, more short-term loans require relatively higher interest rates. Were a local government to place restrictions on the rate of interest a commercial MFI could charge, it would prevent the institution from making very small loans to very poor clients. Or, instead of restricting the lending process, governments could determine a maximum point to which interest could be charged on such loans, such as the total amount that would be paid if the loan were repaid on schedule plus a given percentage. A third option would be to create a rigorous investigation process with distinct criteria to assess whether a given loan was repayable in the event of a default, and have the MFI liable for the cost of hiring an independent investigator. Such legislation would prevent or simply dissuade MFIs from aggressive lending since they would lose the monetary incentive to lend to those who have less chance of repaying their loans. Were MFIs subjected to such regulations, MCIs alone would be able to lend to the most vulnerable.

The aim of such legislation would be to permit the microfinance and microcredit industries to reach those they can benefit most. The transitory poor, those who may fall temporarily into poverty as a result of fluctuations in income, often draw upon microfinance in times of need. Microfinance may also provide opportunities for low-income earners to create their own savings where the regular commercial banks would not.¹⁵ For these less vulnerable borrowers, microfinance is far less

likely to be exploitative. Similarly, there seems to be a point at which extremely poor borrowers are unreachable by microcredit. There are a number of barriers to borrowing for the core poor. Primarily, those who borrow to meet their basic needs have far less chance of having investment returns that can cover the generally high interest rates of microcredit and microfinance. As a result, the core poor are the least likely to be able to repay their loans. Many of the core poor do not seek loans, are denied by the lenders, or are ostracized by groups of borrowers who see them as a liability.¹⁶

This suggests that microcredit and microfinance are most valuable to different levels of need. Given the difficulty for microcredit programs to reach the core poor, including those extremely disadvantaged physically or socially, the need for states to provide a "social safety net" remains unchanged. The most vulnerable of the working poor, however, have great potential to benefit from non-predatory microcredit loans, as well as the community created by group borrowing. Microcredit is most suitable for those who remain poor from lack of opportunities, but are too vulnerable to accept potentially coercive microfinance. And finally, the economically active poor—those who are both familiar with managing money and able to support themselves already—may benefit very much from a sophisticated microfinance sector. It is already clear that the commercialization of the microfinance industry has allowed for the rapid development of microlending in many areas and has attracted a wide range of financial experts. As the commercial financial sector is able profitably to lend to more disadvantaged clients, MCIs can focus on those most in need. *By making the distinction between the two groups, policy-makers can prevent exploitation by predatory lenders while allowing the microfinance industry to grow. People at different levels of need would have access to credit, but only the kind of credit that is appropriate for their situation. The establishment of the different thresholds of borrower vulnerability will be quite difficult but is absolutely necessary.*

In conclusion, non-profit microcredit and commercial microfinance must be distinguished from one another, as microfinance is not appropriate for the most vulnerable poor. Commercial microlending will necessarily experience a tension between seeking profit and the betterment of its borrowers, and data is all too easily created to show benefit where there is none. The poorest borrowers are far too vulnerable to be subjected to predatory lending, and governments must restrict the commercial banking sector from exploiting the poor. However, the widespread implementation of such policy is unlikely given the dearth of studies that properly differentiate between microcredit and microfi-

nance. If the entirety of microlending is studied as though it were homogeneous, researchers will continue to be baffled by the extreme variation in findings. Thus the first step toward properly addressing the systemic problems in the microlending industry is for researchers and policy-makers to distinguish between non-profit microcredit and commercial microfinance: in addition to asking whether microlenders help those in need, it is worthwhile to ask whether or not they are intending to do so.¹⁷

Notes

¹ Grameen Bank, *Grameen Bank At a Glance*, 2007, <http://www.grameen-info.org/bank/GBGlance.htm> (accessed 8 April 2007).

² ACCION International, *About ACCION*, 2007, http://www.accion.org/about_our_history.asp (accessed 8 April 2007); ACCION International, *ACCION Key Statistics*, 2007, http://www.accion.org/about_key_stats.asp (accessed 8 April 2007).

³ I have not actually seen the term MCI used in the microcredit literature; however, this paper seeks to show the necessity of such a distinction.

⁴ Khandakar Qudrat-I Elahi and M. Lutfor Rahman, "Micro-Credit and Micro-Finance: Functional and Conceptual Differences," *Development in Practice* 16 no. 5 (2006): 476-483.

⁵ Ibid.

⁶ Heather Montgomery and John Weiss, "Great Expectations, Microfinance and Poverty Reduction in Asia and Latin America," *Oxford Development Studies* 33 no. 3/4 (2005): 391-416; Kathryn Imboden, "Building Inclusive Financial Sectors: The Road to Growth and Poverty Reduction," *Journal of International Affairs* 58 no. 2 (2005): 65-86.

⁷ Grameen Bank, *Poverty Reduction Strategy: The Grameen Bank Experience*, February 1994, <http://www.gdrc.org/icm/grameenbank.html> (accessed 8 April 2007).

⁸ Frank Tesoriero, "Strengthening Communities Through Women's Self Help Groups in South India," *Community Development Journal* 41 no. 3 (2005): 321-333.

⁹ Ibid., 330.

¹⁰ John A. Brett, "'We Sacrifice and Eat Less': The Structural Complexities of Microfinance Participation," *Human Organization* 65 no. 1 (2006): 8-19.

¹¹ Montgomery and Weiss, 398.

¹² Ibid., 413.

¹³ While MCIs may also be under pressure to show good results to attract donor funding, the primary concern of aid donors is — by definition — social improvement, not profit.

¹⁴ Montgomery and Weiss, 395.

¹⁵ Ibid.

¹⁶ Ibid., 396.

¹⁷ The following sources were also consulted while researching this paper: Syed Masud Ahmed et al., "Targeted Intervention for the Ultra Poor in Rural Bangladesh: Does it Make any Difference in Their Health-seeking Behaviour?," *Social Science & Medicine* 63(2006): 2899-2911; Kazi Rafiqul Alam, "Ganokenda: An Innovative Model for Poverty Alleviation in Bangladesh," *Review of Education* 52 (2006): 343-352; Connie Bruck, "Millions For Millions," *The New Yorker* (30 October 2006) http://www.newyorker.com/printables/fact/061030fa_fact1 (accessed 3 February 2007); Patrick Develtere and An Huybrechts, "The Impact of Microcredit on the Poor in Bangladesh," *Alternatives: Global, Local, Political* 30 no. 2 (2005): 165-189; Katharine Rankin, "Governing Development: Neoliberalism, Microcredit, and Rational Economic Woman," *Economy and Society* 30 no. 1 (2001): 18-37; Linda Weiss, "Globalization and National Governance: Antinomy or Interdependence?," *Review of International Studies* 25 (1999): 59-88.