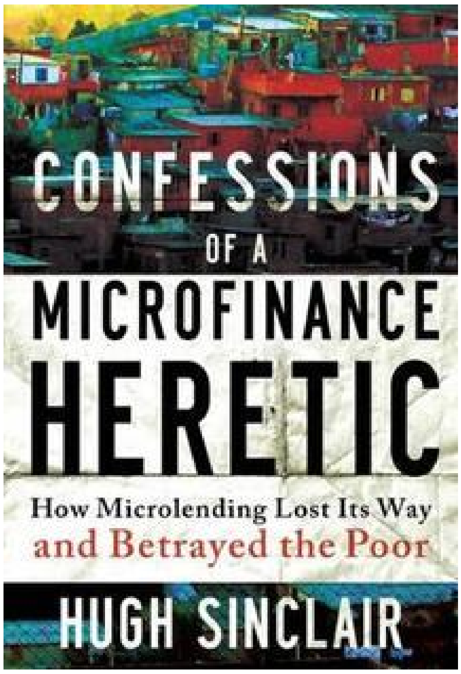
How to Fix Microfinance - Some Ideas by Hugh Sinclair

These suggestions are taken from the final chapter of *Confessions of a Microfinance Heretic* (Berrett-Koehler, 2012) entitled “The Good, The Bad and The Poor”, pages 225 to 232. It is intended as a practical guide to various participants in the microfinance sector in response to the problems identified in the book. This suggested list of considerations is not, alas, exhaustive.



<u>For those interested in investing in microfinance:</u>

• Assume a priori that the funds or peer-to-peer organizations you consider are crooks out to serve their own ends. Be happy to be proved wrong with actual, solid evidence.

• Ensure that you know who is actually deciding which investments to make and what their due diligence and monitoring processes actually are. Ask probing questions. Treat evasive answers with suspicion.

• Find out what ground-level microfinance experience those managing the investments and making decisions on your behalf have. MBAs and fancy degrees are no substitute for field experience.

• Consider the alignment of interests: If the investment collapses, does the fund manager stand to lose financially?

• Does the monitoring process involve actually visiting individual clients, and if so, who selects which clients are visited?

• In a peer-to-peer lender (like Kiva, MicroPlace, or MyC4), make sure you can track the actual flow of money from your account to the poor person’s wallet and back. Fancy photos and heart-warming stories are nice(and important marketing materials for the platforms), but look for hard data. Can the platform confirm the actual interest rate being charged, for example? If it cannot provide this one piece of critical data, demand a very good explanation. This is a major alarm bell.

• Read rating reports. Ask the fund if they have at least read the ratings for their MFIs if they exist. If they are investing in MFIs that do not have ratings, and the fund is unwilling to insist upon a rating, proceed with extreme caution.

• Ask specifically about the policies of controlling and reporting the actual use of funds, in particular what proportion of the loans are for consumption, productive use, and inventory finance. Make sure the answers are compatible with your view of what actually helps the poor.

• Ask for specific policies regarding protection of clients, and be sure to focus on the actual interest rates the poor are paying, verified by someone credible, and find out whether client protection extends to the children of the micro-entrepreneurs. Do not be fooled by meaningless endorsements by self-regulated bodies. What do they actually do to check these issues in practice?

• Ask for social performance data. There is no point in knowing about a few success stories of micro-entrepreneurs if you don't know how many failures there were and how many showed no notable effect either way.

• Attend AGMs and ask annoying questions. Record the questions and the answers, if any.

• Check where your pension fund invests. Private pension funds have invested billions of dollars in microfinance, usually through investment companies like BlueOrchard, and count this as being "socially responsible." Ask for and critically check their investment criteria and processes, and complain if you suspect that your money is being invested in unsavory activities.

• Examine fund websites in detail to determine if the level of disclosure is adequate for a formal regulated investment fund. Is it a glorified marketing brochure?

For the microfinance funds:

Frankly, I think the only means to reign in these guys is to formally regulate them. Pensions, savings accounts, and fund managers in the "developed world" are all formally regulated, and this hasn't worked entirely smoothly to date. That a microfinance fund remains unregulated in practice is entirely ridiculous and inevitably leads to problems. However, even if a microfinance fund or lending platform is technically subject to some national regulation such as Calvert by the SEC, BlueOrchard and responsAbility in Switzerland, and Triple Jump by KIFID in Holland, this means little in practice—the sector needs specific, dedicated, qualified regulators who understand the microfinance sector in particular. There are none currently. For the few funds that do strive to honestly tackle the problem of poverty, here are some suggestions to help produce positive results:

• Demand a higher management fee—2 percent is not enough to cover genuine due diligence and will inevitably lead to cutting corners. If your investors don't appreciate the benefit of this, find new investors or close your fund. Pay peanuts, get monkeys.

• Assume a priori that every MFI you consider is a jazzed-up Ponzi scheme. Be happy to be proved wrong.

• Listen to what your investors actually want. If you can't actually deliver it, don't take their money.

• Do proper due diligence, on-site, including an auditor; take an IT expert to sniff around in the MFI's back office; do background checks on managers and look for conflicts of interest within the MFI. Don't subcontract due diligence to another fund, particularly one that has already invested in the same MFI.

• If you engage in debt and equity investing, actively manage the potential conflicts of interest that occur from mixing these two.

• Verify the actual interest rates charged on-site by visiting actual clients and hearing from them how much they actually pay, and ensure this corresponds with the accounts, ratings and other documents.

• Publish your investments and the interest rates the MFIs charge openly on your website. If you're embarrassed to publish either, perhaps you shouldn't have made the investment in the first place.

• Hire staff with actual microfinance field experience.

• Do random spot checks on clients. This is easy and cheap. Ask a trusted person living in the region but unrelated to the MFI, perhaps working at a local NGO, to visit clients and ask some questions, particularly about treatment at the hands of the loan officers and the rates charged. The MFI need not know you are doing this.

• Expect to make mistakes, warn your investors you will make mistakes, and if they don't accept this, don't take their money. When you (inevitably) make a mistake, tell your investors. There is nothing wrong with making a mistake, correcting it if possible, and learning from it. There is something deeply wrong with claiming you are invincible and covering up your mistakes.

• Always read ratings, and if there are none, or they are out of date, employ a rating agency. This is a service to you, a service to the MFI, a service to your investors, and a service to the poor. This may actually save you money both in the short run (reduced due diligence expenses) and in the long run (you will know more about the investment, and be less likely to make a mistake). Don't simply read them—take note if they have words like "illegal" on the front page—these are warning signs you may wish to consider. These guys invariably know way more than you do about microfinance.

• People are watching you increasingly closely. There are whistleblowers in most funds—I know them.

For the management of an exploitative MFI:

• Quit.

For the management of an ethical MFI:

• Pick your investors carefully—they can have a surprising influence on your operations and mission, not always for the benefit of the poor. Wolves wear sheep's clothing.

• Microfinance funds will often structure deals to personally benefit the management team, in the name of "aligning interests" or "providing tangible performance incentives." Ask yourself if this is any more than veiled bribery, and whether such actions will benefit the poor.

• Beware of "free" technical assistance from a microfinance fund. They are invariably trying to sniff you out or secure a deal for themselves. Exploit such offers by all means, but do not consider them "free." What assurance do you have that information will not discreetly benefit a competitor if the fund has other investments in the region? Many funds have technical assistance arms that they claim are separate, independent entities. Dream on.

• Good customer service and fair interest rates for your clients generate loyalty, which appears an expensive asset in the good times, but when a crisis strikes you will be better protected than your competitors.

• Review your mission statement, and rephrase it if necessary in a measurable, explicit way. Then do it.

• Beware of unintended consequences of incentive plans—you might just get what you incentivize.

• Ensure that your staff know that sometimes rejecting a loan application is the kindest thing you can do for the client. And also for the MFI.

• Take an explicit decision on the share of consumer loans in your portfolio, and publish it, along with the interest rates you actually charge the poor.

• Do not give in to pressure from your investors to endlessly grow at any expense. Slow and steady wins the race. Exponential growth often involves either taking your eye off the ball or screwing your clients. You are in charge. Grow at the speed you think suitable.

• If you have a problem, contact your investors immediately and be open with them from the outset.

• Do not accept clauses in contracts with microfinance funds that you think will place you under huge pressure if a crisis strikes.

• Spend time on your own in the field visiting clients. This reinforces the idea that management is aware of the field operations and is proactive. Chat informally with junior staff about their working conditions. Time simply sitting in a branch will provide the best sense of the actual customer experience at your MFI.

• Get ratings, ideally paid for by your investors. Sit down with the rating agency informally after the rating and ask their frank advice on what they think you might want to focus on. These guys have seen endless MFIs and you can tap this wisdom over a beer. Doing so is worth its weight in gold.

• Know who you are actually lending to. Capture more data on clients. This will help you understand which clients are likely to benefit and repay a loan, and which are not. It's a service to you, and a service to the client. The IT staff are not "geeks," they are the guardians of some of the most critical information within the entire MFI. Get to know them.

• Beware—a growing number of people are watching you, and blowing the whistle is getting easier by the day.

To a potential regulator:

You have a massive, miserable job ahead of you. You are going to discover endless problems and will face huge resistance. A disturbing number of the funds or MFIs you are regulating will fall way short of even modest regulatory requirements. When you ask funds detailed questions about their investments and they eventually reply "no idea," they are probably telling the truth. Consider hiring a bodyguard.

• Ensure that all MFIs have a formal complaints procedure—also for the investors in the microfinance funds themselves.

• Oblige all MFIs and their investors to publish the actual, total cost of capital charged to the poor, according to internationally agreed best practice, and considering the effects of all fees, taxes, and forced savings. Invite MFTransparency to assist—it's cheap, quick, and easy.

• Consider a prudent use of interest-rate caps to prevent usury. They should not be so low as to dissuade any MFIs from operating.

• Insist, and verify, that all forced savings are deposited in a reputable external bank, and are only used by the MFI for onlending if this is expressly permitted within the country.

• Promote the use of local credit bureaus.

• State and monitor accepted debt collection practices.

• Hold microfinance funds legally liable if they are found to be investing in illegally operating MFIs without due effort to check the legality of the MFI.

• Consider encouraging, or obliging, all potential investments to undergo a formal, external rating performed by a reputable rating agency. This may not be possible with private financing, but can be required with public financing.

To the poor:

• Think at least twice about obtaining a loan.

• Find out the complaints procedures within the MFI (if any).

• Understand the interest rate you are being charged, and try to do some simple calculations of how much you estimate your business will grow and if it will be sufficient not only to repay the loan comfortably but also to make a reasonable profit. If it isn't, don't take the loan.

• If you are thinking about getting a consumption loan, don't do it unless it is an absolute emergency. Save up first and then buy it. Doing so is way cheaper.

• The moment you have to get a loan from MFI A to repay MFI B, you already have a problem. Stop immediately—things will only get worse.

• If you are ill-treated or threatened, don't commit suicide—complain directly to the MFI, investigate if there is a local regulator, or go to the local press. Journalists love pictures of loan officers harassing poor clients. Do not hesitate to use this method of publicizing your problem as a last resort.

• If you suspect that such practices are common and can find enough other victims or sympathizers, you may collectively have enough negotiating power to simply refuse to repay your loans. Individually you are weak, but if you can gather hundreds or thousands of clients together, you will get media coverage more easily and can genuinely threaten the bank with widespread defaults and contagion to other regions.

For microfinance whistle-blowers:

• If you are working in an MFI and perceive injustices or are obliged to perform unsavory acts to "problem clients," go online and anonymously blog about this almost anywhere. There are enough people now aware of the problems that someone will eventually pick up the thread. Be very careful to protect your identity. Consider contacting the regulator if appropriate. If the MFI is rated, contact the rating agencies as to "areas they may wish to investigate in more detail." They will not publish anything unless they can back it up, but they may consider such advice. It's worth a try.

• If your MFI uses Kiva, go to www.Kivafriends.org. They are particularly paranoid about yet more bad publicity, so this will probably get picked up quite quickly. Again, stay anonymous.

• Local media is also possible. There are a surprising number of journalists willing to sniff out the latest microfinance scandal. If you explain you are an insider, they will often take the case seriously. Often you need do little more than slip the phone number or address of an abused client to the journalist. The reporter will do the rest, and no one need know you were the source. Journalists usually protect the identity of their sources, but do take care.

• If you are considering a major whistle-blowing exercise on a large scandal, get a book on the subject if possible—they exist and are helpful. It is a risky undertaking, and the good guys do not always win. Do not embark on such a journey unless you have sufficient funds to weather up to a year of unemployment. If you are doing this within a "developed" country, take extra precautions, get legal advice, and consider moving assets or bank balances out of your name.

• Never reveal all your information. Keep something up your sleeve, so if the MFI or fund attempts to attack you, you still have something additional to leak. For as long as they don't know how much you know, they will tread carefully. By formally attacking you they risk full disclosure of all documents, at which point you can have a field day.

• Be bold. A simple photograph, with supporting evidence, can have a huge impact. I will personally pay $1,000 to the first person who can produce a photograph of a Compartamos client who has had to remove her child from school to work in some microbusiness in Mexico. I need the contact details of the client, the interest rate she is paying, and a photograph, and I will then do the rest. Proof that this is taking place at the behest of one of the most divisive MFIs in the sector, which generated hundreds of millions of dollars for Accion via its stock market flotation, will be explosive. Accion is, of course, the mastermind behind the SMART Campaign, and the irony of this connection will not be lost on the international media. Compartamos naturally endorsed the SMART Campaign, as did LAPO. If you prefer, expose the situation yourself. This book explains how.

About the author

Hugh Sinclair is an economist and former investment banker. He has spent the last decade working in microfinance in Latin America, Asia and Africa. He has worked with various microfinance banks, peer-to-peer organizations, microfinance investment funds, rating agencies and investors, and currently works as a consultant.