



# Is microfinance an ethical way to provide financial services to the poor?

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## **ABSTRACT**

Microfinance is increasingly seen as a major development tool. Its promise to help the poor by providing financial services is seen as the major reason for its support. Nevertheless, its ability to effectively reduce poverty is not yet clear, and it generates some unresolved ethical questions. These become even more prominent in the process of commercialization. The impact on poverty is usually measured in financial terms. In this paper, poverty is defined in a broader sense to include deficiency in human and social capital. The article shows that, in this broad sense, microfinance may have negative as well as positive effects on poverty.

**Key words:** Ethics, microfinance, commercialization, poverty

**JEL:** A13, D63, I321.

## INTRODUCTION

Since the 1990s microfinance has become an important development tool. The successful experiences of different private institutions in providing small-scale financial services to the poor have attracted the attention of an increasing range of players. Donors, social investors, as well as for-profit foundations, have all shown an ever-growing interest in the development and promotion of these organizations. The idea that microfinance could help the poor and generate some profit for the institutions involved seemed promising. It entailed a win-win situation<sup>1</sup>. From an ethical point of view, however, an important tension in the motivations behind microfinance remains unresolved: If the *raison d'être* of microfinance is poverty alleviation, how can it simultaneously be profit oriented?

Most actors use the argument of poverty reduction as a way of obtaining support for the movement. For example, Mohammed Yunus claims that microfinance will make poverty history<sup>2</sup>. Equally, the decision to award the Nobel Peace Prize to Mohammed Yunus and his Grameen Bank was based on the claim that microfinance “*plays a major part in poverty reduction*” and thereby enhances peace.<sup>3</sup> Members of another school of microfinance institutions (e.g. Accion in Bolivia)<sup>4</sup> state that they are developing a “new market segment for financial services”; but even such commercially driven institutions still claim on their website that they are “reducing poverty”.

However, it is unclear what is meant by poverty reduction. This creates the first problem. Namely, how can one assess whether microfinance institutions do what they say they will do? This article proposes a broad measure of poverty and shows that it is not clear how microfinance affects it. Moreover, in many cases, the promise of microfinance is reduced to transforming subsidy-dependent institutions into financially sustainable ones that serve the poor. The effect on poverty reduction then represents no longer a goal as such, but becomes a possible side-effect. As we will see, this raises a couple of ethical questions. Firstly, by creating a solution to an unjust situation one has to be careful not to create a new one. Secondly, it is not legitimate to claim to reduce poverty while pursuing other objectives. This is particularly so because other people's money is involved<sup>5</sup>. I therefore argue that real

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<sup>1</sup> Morduch, J. (2000), The Microfinance Schism, *World Development*, Vol. 28, No. 4, pp. 617-629.

<sup>2</sup> Yunus, M. (1999), *Banker to the Poor: Micro-Lending and the Battle Against World Poverty*, Public Affairs, Perseus Books Group, USA, 298p.

<sup>3</sup> [http://nobelprize.org/nobel\\_prizes/peace/laureates/2006/press.html](http://nobelprize.org/nobel_prizes/peace/laureates/2006/press.html) (Consulted: December 2006)

<sup>4</sup> [www.accion.org](http://www.accion.org) (Consulted: April 2007)

<sup>5</sup> Most microfinance institutions have received some kind of financial support at some point of their existence. Especially, international donor institutions have supported these organizations because one of the main objectives of these institutions is to help eradicate poverty through lending to the poor.

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objectives should be made explicit. Microfinance institutions should be more transparent about their objectives and their limits. To meet the demands of ethics, institutions should act as they say they will and their promises should be carefully formulated. Evaluation of their efficiency should also be consistent with these requirements. If poverty alleviation is the real objective, then the objective in terms of profits should be consistent with it. In addition, a clear definition of poverty should be given.

In what follows, the emergence of microfinance institutions as an answer to an unjust situation is addressed. To begin with, a broad definition of poverty is given. Subsequently, the effect of microfinance on three different forms of capital is assessed.

### **FINANCIAL MARKET FAILURE AND ETHICAL SOLUTIONS**

According to Wilber<sup>6</sup>, there are three ways in which ethics enters economics. Firstly, economists have ethical values that help shape the way they do economics. Secondly, economic actors have ethical values, which help shape their behaviour. Thirdly, economic institutions and policies impact people differentially and thus ethical evaluations, in addition to economic evaluations, are important.

There are a couple of ethical questions related to providing financial services. One of the main issues originates from the imbalance of power between the lender and the borrower. Stiglitz<sup>7</sup> argues that credit markets are imperfect and that borrowers traditionally have access to only a limited amount of lenders, while lenders face a lot of borrowers. Borrowers are also typically poorer than lenders. These asymmetries lead to possible abuse. Traditionally important market failures exist in developing countries where poor people often do not have access to formal financial services. To obtain financial services they often have to turn to moneylenders, who ask usurious interest rates.

In response to the injustice of this situation, private actors have created microfinance institutions that focus particularly on the poor. As a result, the poorer parts of a population can gain access to financial services. We could imagine that the first pioneers were led by their ethical values and concerns. Nevertheless, traditionally microfinance institutions also ask high interest rates as they bear high costs. Are these institutions in danger of becoming the new moneylenders in town?<sup>8</sup>

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<sup>6</sup> Wilber, Ch. (1998), Economics and Ethics, in *The Elgar Handbook to Economic Methodology*, eds. Davis, J. B., Hands, D. Wade and Maki, U., Edward Elgar Publishing, p. 572.

<sup>7</sup> Stiglitz, J. (2003), Ethics, Market and Government Failure, And Globalization, *Paper Presented* to the Vatican Conference at the Pontifical Academy of Social Sciences, Casina Pio IV, 2-6 May 2003.

<sup>8</sup> There is, currently, a discussion in the field about Compartamos, a Mexican non-profit microfinance institution that has turned into a commercial bank and has for many years been charging around 100% effective interest rates. It has about 600.000 clients. Its profit was \$57

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Economic theory predicts that people calculate the costs and benefits of a good before they buy it. Consequently, proponents<sup>9</sup> of microfinance use the huge demand for credit by poor people and the fact that moneylenders are omnipresent in poor societies as a proof that access to financial services is more important than its costs. However, this presupposes that access to financial services 'as such' should have a positive impact on the poor. Evidence from existing studies on this relationship is ambiguous. The following section analyses the effect of microfinance on poverty based on a broad conception of poverty.

### **POVERTY, THE LACK OF WEALTH, AND MICROFINANCE'S EFFECTIVENESS IN AFFECTING IT**

Poverty is commonly defined as an income below a certain level. For instance, the World Bank uses measures of a daily income below a poverty line of US\$1 and US\$2 respectively. Policies are designed to lift people above this poverty line. According to this conception, poverty reduction is effective only when it increases income. Yet, poverty is multidimensional and can be seen as a deprivation of different forms of wealth<sup>10</sup>. For the purpose of this article, I will use a broad measure of wealth that integrates three different forms of capital, namely financial, human, and social capital. Financial capital is the net amount of financial assets a person possesses. It is measured in monetary terms and thus the easiest to measure. Human capital can be defined as the stock of skills accumulated, allowing someone to receive a flow of income.<sup>11</sup> It is obviously much more difficult to quantify human capital than financial capital, but various proxies are used. For instance, a typical proxy for human capital is the amount of cumulative learning, a measure of which is typically further simplified to the level of education attained. Finally, social capital is traditionally defined as "the collective value of all '[social networks](#)' and the desires which develop amongst participants in these networks to do things for each other."<sup>12</sup>

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million last year. As it is not clear how microfinance impacts poverty, or what the effect of these high interest rates is, one can ask whether they are ethically justified. <http://www.reuters.com/article/newIssuesNews/idUSN2025193920070420?pageNumber=1> (Consulted: April 2007).

<sup>9</sup> E.g. Robinson, M (2001), *The Microfinance Revolution*, The World Bank, Washington DC, 304p.

<sup>10</sup> The World Institute for Development Economics Research (WIDER) in Helsinki released in December 2006 the first global survey on personal financial wealth (defined as the net value at purchasing power parity of the sum of financial assets, real estate, consumer durables and livestock). Financial wealth is shared much less equitably than income: more than half is held by just 2% of the world's adults. Many people in the bottom half (including in the developed world) own next-to-nothing.

<sup>11</sup> Becker, G. (1964), *Human Capital: A Theoretical and Empirical Analysis*, New York, Colombia University Press.

<sup>12</sup> Putnam, R. (2001), "Social capital measurement and consequences", *ISUMA*, Vol. 2, No. 1,

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All three forms of capital should be taken into account to evaluate whether someone's wealth has increased or not. For instance, is someone's wealth really growing when their financial capital is increased at the cost of a significant drop in social capital? When analyzing whether microfinance is ethically sound, the overall effect of the practice should be evaluated. Several valuable studies evaluate the impact of microfinance on each different form of capital. These are separately discussed in the following paragraphs. To my knowledge, no study takes into account the interaction among all three forms of capital.

### **IS MICROFINANCE CREATING FINANCIAL CAPITAL?**

The most common product of microfinance is microcredit: a small loan that provides people with the means to invest in an income-generating activity<sup>13</sup>, and thereby might increase their financial capital. Hulme and Mosley give limited evidence that microfinance increases income. Yet, they also show that the impact highly depends on the level of income. Specifically, the poorest borrowers do not seem to benefit from a significant income increase<sup>14</sup>. By contrast, Khandker<sup>15</sup> finds that access to microfinance contributes significantly to poverty reduction and that this is especially true for poor women. Not only participants seem to benefit, but the whole local community. Armendariz and Morduch<sup>16</sup> show that measuring the impact of microfinance on poverty is not straightforward. A lot of factors should be taken into account and it is particularly difficult to isolate the effect of microcredit. They conclude that no consensus has been found yet.

In addition, the effectiveness of increasing financial capital through microcredit depends on the interest rates microfinance institutions charge. Specifically, if the interest rates are high, the net capital accumulation accrues to the lender rather than the borrower. The topic of interest rates has become highly controversial in microfinance, because it raises some difficult ethical questions about making profits on the back of the poor.<sup>17</sup>

Another aspect, which should be taken into account, is that financial capital is obviously decreased whenever the microcredit is used for consumption rather than investment.

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Spring 2001.

<sup>13</sup> Yunus, M. (1999), *Banker to the Poor: Micro-Lending and the Battle Against World Poverty*, Public Affairs, Perseus Books Group, USA, 298p.

<sup>14</sup> Hulme, D. & Mosley, P. (1996), *Finance against Poverty, Volume 1*, Routledge, London, 221p.

<sup>15</sup> Khandker, R. (2005), Microfinance and Poverty: Evidence Using Panel Data from Bangladesh, *The World Bank Economic Review*, Vol. 19, Issue 2, pp. 263-286.

<sup>16</sup> Armendariz, Beatriz & Morduch, J. (2005), *The Economics of Microfinance*, MIT Press, pp. 346.

<sup>17</sup> Hudon, M. (2006), Fair interest rates when lending to the poor: Are fair prices derived from basic principles of justice?, *Working Paper*, WP-CEB 06/15, Solvay Business School, Université Libre de Bruxelles.

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Microcredit can also be looked at as micro-debt<sup>18</sup>. Whenever microcredit is not used to invest in an income-generating activity, no additional means are generated to repay the loan. This could make the repayment difficult. Indebtedness is becoming a major issue in microfinance. This is especially true as increased competition has led to irresponsible lending from some institutions, leading to social dramas<sup>19</sup>. Indebtedness also decreases the level of freedom the poor have. It has been Sen's<sup>20</sup> contribution to development theory to define development as freedom. Although access to financial services could increase the poor's capabilities and possibilities, once the level of indebtedness is too high and the individual becomes dependent on different institutions, one cannot claim that one has become freer.

In conclusion, we cannot automatically assume that microcredit improves the financial capital of all borrowers. The result will depend on the income level of the borrowers, on the purpose of the loan, and on the interest rate charged by microfinance institutions.

### **IS MICROFINANCE CREATING HUMAN CAPITAL?**

Some microfinance institutions not only provide credit, but also a set of other programmes or services. These programmes are generally defined as “microfinance plus” programmes and are informed by a welfarist approach. Contrary to the minimalist or institutional approach, defenders of this approach believe that credit alone is not sufficient to fight poverty. For example, ProMujer, a microfinance institution in Bolivia, provides not only credit to women but also educational and even health services. There has been an intense discussion in the microfinance field regarding the two visions. While the institutional approach promotes financial sustainability, the “welfarists” highlight that the emphasis on outreach of traditional microfinance will not solve the poverty problem.<sup>21</sup>

While the impact of microcredit on poverty is ambiguous, there is increasing evidence that “microfinance plus” programmes have effects that are easier to assess. Karlan and Valdivia<sup>22</sup> provide evidence of such programmes benefiting clients. They claim that the institutions also

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<sup>18</sup> Hulme, D. (2000), Is Microdebt Good for Poor People? A Note on the Dark side of Microfinance, *Small Enterprise Development*, Vol. 11, No. 1, March 2000, pp. 26-28.

<sup>19</sup> See for example, Marconi, R. & Mosley, P. (2005), Bolivia during the global crisis 1998-2004: Towards a ‘Macroeconomics’ of Microfinance, *Sheffield Economic Research Paper Series*, No. 2005007, University of Sheffield, UK. And Roesch, M., Fouillet, C. & Guérin, I. (2006), Debt, debt burden and interest rates; has the “Microfinance machine” gone mad? Crisis in Andhra Pradesh (India), *Working Paper*, French Institute of Pondicherry.

<sup>20</sup> Sen, A. (1999), *Development as Freedom*, Anchor Books, New York, 366p.

<sup>21</sup> See Woller, G., Dunford, C. & Woodworth W. (1999), Where to Microfinance, *International Journal of Economic Development*, Vol. 1, No. 1, pp. 29-64.

<sup>22</sup> Karlan, D. & Valdivia, M. (2007), Teaching Entrepreneurship: Impact of Business Training on Microfinance Clients and Institutions, *Working Paper*, No. 107, Center for Global Development.

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gain as repayment rates increase due to increased business profits. Other research has shown that educational services not only influence the level of human capital of the clients but also of their children.<sup>23</sup> It is therefore tempting to conclude that “microfinance plus” programmes have the ability to increase the level of human capital.

Maldonado *et al.*<sup>24</sup> also provide some preliminary evidence that increased financial income leads to better education. Through increasing income, microfinance might help to improve education levels. However, as mentioned above, among the “poorest of the poor” especially, the increase in income resulting from microcredit may not be sufficient to make a real difference.

### **IS MICROFINANCE CREATING SOCIAL CAPITAL?**

Many microfinance institutions use commitments of groups as a substitute for collateral. Peer pressure from groups is seen as one of the main reasons why microfinance works.<sup>25</sup> By using social relations as collateral an important kind of market failure is resolved. Critics argue that microfinance exploits social relationships to obtain higher repayment rates and to reduce administrative costs.<sup>26</sup> This is especially true in the minimalist approach, where cost-effective measures are used to become financially sustainable. Rankin<sup>27</sup> argues that under these circumstances the health of the financial system rather than the welfare of the poor becomes the main objective of microfinance.

A recent study shows that social relationships indeed deteriorate in case of default: trusting friends and neighbours can suddenly turn into mistrust.<sup>28</sup> This means that microfinance transactions can actually reduce social capital. The question then becomes: whenever financial capital is generated at the expense of social capital - typically the only form of capital that the poor have been able to accumulate - what is the net wealth effect? More importantly: how should we weigh such an increase of financial capital *versus* the cost it entails in terms of social capital from a normative perspective?

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<sup>23</sup> Maldonado, J.H., González-Vega, C. & Romero, V. (2002), The Influence of Microfinance on Human Capital Formation: Evidence from Bolivia, *Contributed paper* Seventh Annual Meeting Latin America and Caribbean Economic Association, Madrid, Spain.

<sup>24</sup> *Ibid.*

<sup>25</sup> Armendariz, B. & Morduch, J. (2005), *The Economics of Microfinance*, MIT Press, 346p.

<sup>26</sup> Guérin, I. & Palier, J., (2005). « *Microfinance Challenges: Empowerment or Disempowerment of the poor ?* », Institut Français de Pondichéry, 384p.

<sup>27</sup> Rankin, K. (2007), Social capital and Microfinance, in *Microfinance: Perils and Prospects*, ed. Fernando, J., Routledge, London, 242p.

<sup>28</sup> Karlan, D. (2005), Social Connections and Group Banking, *Center Discussion Paper*, No. 913, Yale University.

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Some studies that show that microfinance programmes can rebuild social capital, too.<sup>29</sup> In particular, this is true for programmes that use a village bank methodology, a programme inspired by the cooperative movement. The authors claim, though, that financial intermediaries ought to recognize the importance of building social capital in their overall programmes rather than consider it as an indirect benefit.

More recently, a trend away from group-based lending has been observed. More and more microfinance institutions start to work with the individual approach, as experience shows that the poor are reliable clients<sup>30</sup>. This way social capital can neither be built, nor exploited.

### **CONCLUDING REMARKS**

Microfinance institutions can be seen as an answer to market failure, which created ethical concerns. Microfinance institutions claim to fight poverty by providing financial services. Implicitly, this entails that giving access to financial services is the main objective. However, the major reason for the promotion of the movement is poverty reduction. It is unclear how poverty is defined here. The article proposes a broad measure of poverty. As I have shown, it is far from obvious how microfinance impacts the three different forms of capital discussed.

The transformation of the microfinance movement has brought these questions to the fore. When microfinance organizations turn into financial institutions, becoming financially sustainable or even maximizing profit becomes the main objective, whereas poverty reduction becomes a side-effect and not a goal as such. If this is the case, the whole purpose of the movement changes. An ethical approach would then entail that this objective is made explicit so as not to deceive the people involved.

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<sup>29</sup> Bebbington, D.H. & Gomez, A. (2006), Rebuilding Social Capital, in *Microfinance: Perils and Prospects*, ed. Fernando, J., Routledge, London, 242p.

<sup>30</sup> Karlan, D. & Giné, X. (2007), Group Versus Individual Liability, *Working Paper*, No. 111, Center for Global Development.