CHAPTER 10:

Sustainability in Microfinance – Visions and Versions for Exit by Development Finance Institutions

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Success calls for justification. If microfinance institutions were a failure, nobody would envy development financiers that pour money into them without receiving any financial return. But now they are profitable: many microfinance institutions (MFIs) have proved that this business can be done in a financially sustainable way. Sometimes they are even very profitable while still reaching the target group and contributing to poverty alleviation.

This creates a new issue: Why should development finance institutions continue to be involved in these projects after achieving success? Why not sell their equity stakes in MFIs to private investors so that public money can be used for other development ventures, leaving private investors to keep successful MFIs running? Are not private investors even better investors in MFIs since they can tap the capital market, have more financial know-how and suffer less bureaucracy than development financiers?

The issue of exit is becoming a new mantra in microfinance, innately linked to its accelerating commercialisation. Development financiers usually emphasise exit strategies, and the exit of development finance from a microfinance institution is defined here as sale of equity to a private investor that is not a development finance institution.[1]

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[1] Equity is a crucial form of involvement: It gives development financiers decision making power in the governing bodies of microfinance institutions. It bears the risk of losing the investment, and the chance for gains. In general, development finance institutions use three different forms of financial support to microfinance institutions: technical assistance, (structured) loan products and equity. Technical assistance usually is intended for a limited time only, and loan products may have lives of their own. It is only equity that has the capacity for continuity and also for termination of the relationship between the microfinance institution and the supporting development finance institution.

In our view, exit is not a goal in itself. We discuss when and why development finance institutions should sell their holdings in microfinance institutions, handing over their stake to other investors, or when and why they should stay engaged. In order to find a satisfactory answer, we first have to determine the motives and reasons that lead development finance institutions invest in microfinance in the first place. What is the case for public support of MFIs?

Market Failure and Sustainable Financial Intermediaries

The involvement of development finance institutions in microfinance is based on the fact that the market does not offer adequate financial services to the poor. Banking reality differs from the perfect market model of neoclassical economic theory, where banks have all information needed to accurately assess potential borrowers' actual and future repayment capacities and their willingness to repay. In reality, banks apply screening devices and decision-making techniques to assess potential credit risk and make credit decisions under the conditions of imperfect information. These imperfect assessment techniques can lead banks not to lend at all to certain groups of customers whose risks are perceived as too high or too difficult to assess – instead of offering loans to these customers at higher interest rates that cover their risk. As a consequence, the market can fail to serve particular groups.[2]

The case for public action in microfinance may also be derived from the credit-rationing argument in economic theory, as described above: The poor are not served, although they are willing to pay interest rates high enough to cover the overall costs of the services. But there may be more promising investment opportunities for commercial banks or they systematically overestimate the risks or underestimate the gains of lending to the poor. Or they simply lack the knowledge of how to deliver profitable services to the poor. In addition, they may be restrained by regulations, such as those governing collateral requirements.

This "market failure argument" is not specifically aimed at developing countries or transition economies. It also holds true for industrialised countries with developed financial markets and calls for specific state or public action in order to make market mechanisms work. In the United States, for example, in 1977 the Community Reinvestment Act (CRA) was adopted by Congress after banks had "redlined" slum areas which did not promise adequate returns, and closed branches and declined to lend in these areas. Now supervisory authorities verify if banks make adequate efforts to lend in poor areas.[3]

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[2] In economic theory, key arguments were first provided by Stiglitz/Weiss (1981).

[3] A political rush to abolish this law or to soften the requirements and controls has caused apprehension that banks may again leave these low-income areas because returns are below average. High social and economic costs for the respective areas are expected.