



## **EMERGING EVIDENCE REPORT 1**

# **INTERVENTIONS TO COMBAT HIGH-INTEREST INFORMAL MONEYLENDING**

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# ABOUT THIS REPORT

This Emerging Evidence Report acknowledges that high-interest informal moneylending can serve a useful purpose in developing countries, helping those without the means to access credit from formal financial institutions. However, the high charges for these informal loans can lead to people being caught in a debt trap and losing their assets. Promoting access to credit for the poor through microfinance institutions (MFIs) has advantages and disadvantages. Microcredit can bypass the ultra-poor or, alternatively, it may be given to those unable to repay the loans, trapping them deeper in poverty or even lead to people using high-interest informal moneylenders to pay back the MFI loans. Community-based financial organisations (CBFOs) generally rely on people forming savings groups and recycling the funds as loans. They may promote a savings culture, but there is little evidence of their impact specifically on people's use of high-interest informal moneylending. This Emerging Evidence Report concludes that more research is needed on how high-interest informal moneylending operates in different contexts, and what interventions could be effective in combating it.

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# SUMMARY

## SUMMARY

High-interest informal moneylending can serve a useful purpose in developing countries, helping those without the means to access credit from formal financial institutions. However, the high charges for these informal loans can lead to people being caught in a debt trap and losing their assets. Legislation, interest rate caps, and debt relief have shown very limited effectiveness in combating the problem. More common is promoting access to credit for the poor through microfinance institutions (MFIs), i.e. microcredit, or through community-based financial organisations (CBFOs). Each of these has advantages and disadvantages. Microcredit can bypass the ultra-poor or, alternatively, it may be given to those unable to repay the loans, trapping them deeper in poverty. In addition, engaging in microcredit can lead to people using high-interest informal moneylenders to pay back the MFI loans. CBFOs generally rely on people forming savings groups and recycling the funds as loans. They have strengths (e.g. promoting a savings culture) and weaknesses (e.g. offering limited financial products), but there is little evidence of their impact specifically on people's use of high-interest informal moneylending. Overall, this literature review highlights the need for more research on how high-interest informal moneylending operates in different contexts, and what interventions could be effective in combating it.

### High-interest informal moneylending

Use of high-interest informal moneylenders (commonly referred to as 'loan sharks') is widespread in many developing countries. While such loans can be simple and accessible, particularly when people need cash quickly (e.g. to deal with a crisis, to overcome liquidity constraints during certain seasons), very high interest rates are charged. These rates are generally too high for investment in business, and the poor can end up in a debt trap and lose critical assets such as land and even face violence if they cannot make the repayments. It can also lead to people becoming trapped in bonded labour, which can persist across generations. The available evidence indicates that informal high-interest moneylending is prevalent in Bangladesh, Myanmar and Nepal – with interest rates especially high in Myanmar. Negative consequences, including loss of assets, violence, homelessness and even suicide, are seen in all three countries.

The major factor driving the use of high-interest informal moneylenders is that people who are poor or who have

low incomes lack access to credit through formal financial institutions. This can be due to them living in remote locations, lack of verifiable income, lack of collateral and/or illiteracy and, on the part of banks/financial institutions, lack of profitability.

### Countermeasures

There are three broad measures that can be taken to combat high-interest informal moneylending: legislation, debt relief, and increasing access to credit for the poor. While there are examples of national/subnational-level legislation specifically to combat high-interest informal moneylending (loan sharks) – such as in India – this review found little evidence of implementation and enforcement. A related approach being tried by some governments is setting interest rate caps. However, capping is an inefficient tool to lower interest rates, is hard to enforce against unlicensed moneylenders, and can curtail access to credit. One example of the latter approach, i.e. debt relief, is the Debt Conciliation Boards set up in the Indian state of Haryana, which have the power to declare debts fully discharged if the debtor has repaid double the principal (amount borrowed). The challenge is to ensure that deserving debtors get relief.

This review focuses on interventions to enable the poor to access credit through less exploitative sources. There are two key approaches for this: (a) microcredit through microfinance institutions (MFIs), and (b) community-based financial organisations (CBFOs).

### Microcredit

Microcredit is the provision of small loans to poor/low-income people/enterprises, in order to help them generate income/smooth consumption/protect against risks, and thereby alleviate poverty. The concept gained prominence through Muhammed Yunus and Grameen Bank, which he set up in Bangladesh in 1983. Over the next two decades there was a huge expansion in the microfinance sector, particularly in South Asia, which now accounts for around half of global active borrowers of microcredit.

**Characteristics** of microcredit include:

- **Loans are usually of small amounts, with short repayment periods and a tight repayment schedule (usually weekly or monthly, starting immediately after the loan is given).**
- **Rather than using assets as collateral, microcredit relies on joint group liability – borrowers form**

**groups who thereby create pressure on individual members to repay.**

- **Microcredit also offers dynamic incentives: borrowers who make repayments on time and in full can then access increased credit.**
- **Microcredit particularly targets women: over 80 per cent of global borrowers are women.**

**Challenges** – MFIs were initially largely non-governmental organisations (NGOs) funded by donors, but pressure grew on them to become financially viable. This led to the commercialisation of MFIs, with many becoming ‘for-profit’ entities. This in turn created tension between the drive for profitability (high interest rates) and the goal to reach and support the poorest in society. MFIs have also been criticised for bypassing the ultra-poor, preferring to lend to relatively richer households with less risk of default. Conversely, MFIs are blamed for encouraging over-borrowing by already vulnerable groups, leading to over-indebtedness and making their situation even worse.

**Impact on use of moneylenders** – Ironically, in situations where microcredit leads to indebtedness on the part of borrowers (where they struggle to make repayments) it can lead to (renewed) use of informal moneylenders. There is some evidence that MFI clients use informal finance to manage their finances. A 2016 study by Berg, Emran and Shilpi in Bangladesh on the impact of microcredit on moneylender interest rates and use of moneylenders, found that rates did not go down but MFI households were borrowing significantly less from moneylenders. They concluded that MFIs were reaching the better-off households, while moneylenders retained the relatively poorer and riskier households.

## **Community-based financial organisations (CBFOs)**

CBFOs provide a range of financial products and services to a small target market in a limited geographic zone. They are able to overcome the ‘outreach’ problem faced by many MFIs because of the latter’s high transaction costs. As low-cost organisations, CBFOs can reach those in sparsely populated rural areas, and are able to provide small pools of capital to large numbers of people. They often operate in remote areas, are self-formed and self-governing, rely partially or wholly on volunteers, and are primarily savings driven, mobilising funds from their members. There are different types of CBFOs, varying by size, ability to mobilise funds, when they distribute funds,

if and how much interest they pay on deposits and charge on loans, and the range of products they offer.

**CBFOs have a number of strengths:** (a) as mentioned above, they have greater outreach than MFIs in reaching very remote areas; (b) they promote local ownership which leads to greater trust and empowerment; (c) through compulsory payments, they encourage a savings culture; (d) they are easily replicated; and (e) by grouping together, CBFOs can become attractive enough to form links with the formal financial sector (allowing access to larger loans and other financial products).

**However, CBFOs also have weaknesses:** (a) it is hard for CBFOs to generate a big pool of funds, which in turn limits the products and services they can offer; (b) they often charge higher interest rates than commercial financial institutions; (c) they require considerable technical assistance and training at the outset, and then continued monitoring and oversight; (d) being self-managed by locals often on a *pro bono* basis, they can lack financial management skills and governance can be weak, which could lead to mismanagement of funds; and (e) they are vulnerable to elite capture.

The literature reviewed did not provide evidence on the impact of CBFOs on use of high-interest informal moneylending.

## **Role of donors**

### **Microcredit programmes**

Seen as a tool for poverty reduction, microfinance and microcredit has been a significant area for donor support; for example, by the World Bank. However, the findings from evaluations of donor microcredit programmes are generally disappointing. A 2006 evaluation by Richard Rosenberg of the World Bank and United Nations Development Programme (UNDP) microcredit portfolios concluded that most were unlikely to produce long-lasting results (judged in terms of loan repayment and cost recovery). Another synthesis of evaluation findings focusing on client income and expenditure (Kovsted, Andersen and Kuchler 2009) reported ambiguous results from peer-reviewed journal studies, but more positive effects in donor evaluations; however, the latter never reached the ultra-poor and were dependent on donor subsidies. None of the impact evaluations included the use of high-interest informal moneylending as a performance indicator. The literature shows a clear tendency to attribute at least some responsibility for the shortcomings of microcredit on the donor agencies that have promoted MFIs.

**Good practice guidelines for donor support of microcredit include:** (a) MFIs should pay for themselves, financed by attracting domestic deposits and recycling them into loans and other financial services; (b) donors should only provide grants or loans on a temporary basis to build institutional capacity of MFIs; (c) donors should focus on capacity building, including ensuring accurate reporting on financial and social performance; and (d) it should be taken into consideration that for the ultra-poor, microcredit might not be the answer – other kinds of support (e.g. social protection) might work better.

**Evaluations of donor support for CBFOs** (revolving funds) found that, even though these had easier standards than MFIs, ratings were still low. Savings-based groups and self-help groups were more careful with lending and collection than those using donor funds, but even with these results were weak.

**Good practice guidelines for donor support of CBFOs include:** (a) consider whether providing quick access to external credit directly to CBFOs may be

counterproductive, undermining a savings culture; (b) CBFOs should be locally owned, with external agencies only filling capacity gaps as needed; (c) CBFOs should not be supply driven, i.e. put under pressure to meet donor disbursement requirements when they lack the capacity to do so; (d) clear monitoring and evaluation systems should be in place, even for small CBFOs; and (e) consider whether it would be more practical for donors to support large numbers of CBFOs through second-tier organisations such as NGOs.

**Other areas for donor support:** Research and understanding of high-interest informal moneylending, especially in the South Asian context, is very limited. Donors could support such research, which in turn would help inform design of policies and programmes to combat informal moneylending. The approaches discussed in this report – promoting access to credit through MFIs and CBFOs – can help combat the problem, but their main objective is poverty reduction. Donors could support interventions that more directly combat high-interest informal moneylending.

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# ACRONYMS

**ACP** African, Caribbean and Pacific

**AIL** agent intermediated lending

**ASCA** accumulating savings and credit association

**CBFO** community-based financial organisation

**CGAP** Consultative Group to Assist the Poor

**CLARISSA** Child Labour: Action Research Innovation in South and South Eastern Asia

**CVECA** self-managed village savings and credit banks

**IDS** Institute of Development Studies

**IFAD** International Fund for Agricultural Development

**IFC** International Financial Corporation

**IPO** initial public offering

**JLG** joint loan groups

**KPI** key performance indicators

**M&E** monitoring and evaluation

**MFI** microfinance institutions

**NBFC** non-banking financial company

**NGO** non-governmental organisation

**RCT** randomised controlled trial

**ROSCA** rotating savings and credit association

**SACCO** savings and credit cooperative

**SHG** self-help group

**TUP** Targeting the Ultra-Poor

**UNDP** United Nations Development Programme

**WFW** Women for the World

*Section 1:*

# **INTRODUCTION**

## 1 INTRODUCTION

High-interest informal moneylending is a major problem in many developing countries, including in Asia. This report looks at interventions to combat such lending and evidence of their effectiveness. The aim is to support the Child Labour: Action Research Innovation in South and South Eastern Asia (CLARISSA) research programme led by the Institute of Development Studies (IDS), and help inform policymaking in target countries, notably Bangladesh, Myanmar and Nepal.

The report is structured as follows. Section 2 examines the problem of high-interest informal moneylending, and the negative effects this has on borrowers and their families. It also looks at the factors driving use of such informal moneylending, as well as legislative and other policy measures by governments to address the problem. One approach is to give poor people access to credit, so they do not need to turn to high-interest informal moneylenders. Such interventions fall into two broad categories: (1) provision of microcredit through MFIs and (2) CBFOs, of which there are a range. Section 3 focuses on MFIs, looking at how these have developed, the main features of microcredit, the challenges involved, and the impact of microcredit provision on poverty reduction. Section 4 looks at CBFOs and describes the different types, along with their overall strengths and weaknesses. Section 5 looks at the role donors are playing and can play in supporting microcredit provision for the poor, and CBFOs.

### 1.1 Methodology

The evidence in this report was identified through a rapid desk-based search. The literature reviewed was a mixture of academic papers and grey literature, including reports

by development agencies. Key databases searched included Google, Google Scholar, and Scopus. Key search terms included 'informal moneylenders', 'loan sharks', 'microcredit' and 'community-based finance organisations' as well as the geographical focus regions/countries ('South Asia', 'Bangladesh', 'Nepal', and 'Myanmar'). The review also drew on newspaper articles, blogs, think tank pieces and webpages where relevant. In addition, a number of experts in the field were identified and approached for recommendations and contributions.<sup>1</sup>

There were considerable limitations in the literature. Literature on the scale, distribution, and impact of high-interest informal lending, as well as legislative and other policy measures to counter it, was very limited. Considerable literature was found on microfinance and microcredit, including some on its impact on high-interest informal lending. There was also literature on the different types of CBFOs, but the review found little specifically discussing the impact of CBFOs on high-interest informal lending. Finally, limited literature was found on the role of international development partners in promoting MFIs and CBFOs. Overall, the evidence base on the problem of high-interest informal lending and interventions to combat it is weak.

With regard to the focus countries for this review – Bangladesh, Myanmar and Nepal – literature on high-interest informal lending was limited for all three. However, Bangladesh is covered extensively in the literature on MFIs and microcredit, as well as CBFOs. Far less was found on Myanmar and Nepal. The literature reviewed was gender blind to some extent: women only specifically featured in the literature on MFIs (which target women) and CBFOs, as well as in individual stories of people negatively affected by high-interest informal moneylending.

<sup>1</sup> See Acknowledgements section.

*Section 2:*

# **HIGH-INTEREST INFORMAL MONEYLENDING**

## 2 HIGH-INTEREST INFORMAL MONEYLENDING

### 2.1 Nature and scale

High-interest informal moneylenders (aka 'loan sharks') are prevalent in many parts of the developing world and typically meet urgent needs. Such loans have been the traditional source of credit in many poor communities, particularly in rural areas (Jacoby 2008). This review found negligible recent literature on the spread and scale of such lending. Aryeetey reports that it is widespread in most of rural West Africa:

[T]he clientele is wide ranging, including farmers, market women, other traders, non-farm entrepreneurs and other self-employed craftsmen. Farmers sometimes borrow money from moneylenders during the planting season to maintain their households until the next harvest. They may also borrow for expenditure on funerals and other social events (Aryeetey 1998: 11).

The appeal of borrowing through 'loan sharks' lies in the fact that it is readily accessible and is rarely tied to collateral. This in turn means that it is based on the moneylender having proximity to borrowers and local knowledge to assess their creditworthiness (Thomas 1992: 13). Loans from moneylenders are typically extended to clients of long standing (World Bank 1989: 114). Loans can often be obtained at short notice and tend to be short term, with high interest rates. One example is the five–six arrangement under which the borrower receives \$5 in the morning and repays \$6 in the evening, at an interest rate of 20 per cent (*ibid.*: 113).

#### 2.1.1 Exploitation...

The high interest rates associated with moneylenders (and pawnbrokers) are in part due to the high costs (moneylenders use their own funds for lending) and risks associated with informal loans (e.g. moneylenders must maintain adequate liquidity to meet demand for loans in a timely manner, but some of that will be idle in slack periods) (World Bank 1989: 114). However, the high

interest charges can also stem from the power imbalance between borrowers and lenders, and the latter can use intimidation and violence to secure repayments (Aliber 2015: 42). Borrowing from loan sharks can lead to people becoming caught in a debt trap and losing critical assets like land (Ritchie 2007). For example:

Moneylending in India has retained much of its negative image up to recent times, especially in rural areas. Accusations are still rife that rural moneylending is applied perniciously to dispossess people of their land, especially *Dalits* (so-called 'untouchables') and members of the scheduled tribes. A vivid manifestation of this pressure are the intermittent spates of suicides committed by farmers in the rural areas around Nagpur who are indebted to moneylenders and who cannot repay their loans when the harvest fails (*Indian Express*, 13 February 1999) (Aliber 2015: 41–42).

In some parts of the world, particularly South Asian countries, it can lead to debt bondage, whereby lenders keep piling on interest, and borrowers cannot repay the amount and are forced into labour to pay off the debt (which keeps mounting because of the exorbitant interest charges).<sup>2</sup> Oosterhoff and Sharma (2018) describe how landless labourers become trapped in bonded labour after borrowing money from their landlords (often to pay for a family member to emigrate in the hope of better livelihoods). IDS carried out a number of studies and programmes in South Asia on bonded labour, and one of the aspects looked at was the link between this and high-interest loans.<sup>3</sup> The studies consistently found strong links between loans and bonded labour, with moneylenders being one of the most common sources of loans. The two most common reasons given by participants in the studies for taking high-interest loans were disease (ill health) and marriage (e.g. Oosterhoff *et al.* 2019: 55). In many parts of India and Pakistan, this has led to whole generations being trapped in bonded labour, as the unpaid debt is passed from the parents to their children. People in debt bondage typically work in very harsh conditions and can face physical and even sexual abuse.

<sup>2</sup> [www.antislavery.org/slavery-today/bonded-labour/](http://www.antislavery.org/slavery-today/bonded-labour/)

<sup>3</sup> The studies/programmes were carried out in Tamil Nadu, Uttar Pradesh and Bihar in India and in Nepal. For reports see: [www.ids.ac.uk/projects/modern-slavery-in-india-and-nepal/](http://www.ids.ac.uk/projects/modern-slavery-in-india-and-nepal/)

### Box 1: Negative effects of loan sharks in Ecuador

Loan sharks in Ecuador are known as *chulcos*. A particularly infamous group of *chulcos* operates out of Guayaquil, where they are known for their motorcycles, their Colombian origin, and their 20 per cent compounded monthly interest rate. This group of *chulcos* is as efficient as any financially self-sustaining microfinance organisation: they promote their services with flyers, divide up the city into quadrants, each with its own assigned *chulco*, and they police their quadrants on motorcycles for new or delinquent borrowers. They are much like any reputed microfinance organisation... except for the fundamentally exploitative, violent, and illegal nature of their work.

Guayaquil is the biggest and most dangerous city in Ecuador, and a high number of local crimes are attributed to this type of organised predatory lending. The trouble with illegal lending is that wronged borrowers are powerless to report *chulco* misbehaviour to the authorities. And unfortunately, it is more than a fear of reprisal that keeps these crimes from being reported: it is a need for continued access to credit, at any price. *Chulcos* or *chulqueros* charge annual interest rates as high as 150 per cent (and in the case of *chulcos* in Guayaquil, 791.61 per cent annual compounded), imposing truly unfair and abusive loan terms on borrowers.

The danger of borrowing from these loan sharks is twofold. First and foremost, they take advantage of vulnerable small business owners, simultaneously depriving them of the benefits of lending from accredited institutions while engaging in exploitative and illegal practices. *Chulcos* lack all the benefits of legitimate microlending institutions, such as establishing a credit history to ensure continued access to credit in the future. Furthermore, the inordinately high interest rates tend to trap borrowers in a cycle of debt, borrowing repeatedly only to pay off their existing loans. Lending from *chulcos* means a life of repayment; the capital never even pays off. Not to mention the inherent dangers of lending from loan sharks, who take drastic measures to ensure they collect their money, whether through threats, public humiliation, leaving pigs' heads on doorsteps, seizure of other family members' assets (in some cases, *all* of their assets), or outright violent and illegal actions.

Source: Based on Bennett, K. (n.d.) 'Loan Sharks, Microloans and the Highest Interest Rates Around (They Aren't on Kiva)', <https://pages.kiva.org/blog/loan-sharks-microloans-and-the-highest-interest-rates-around-they-arent-on-kiva>

#### 2.1.2 ... or vital service?

While high-interest informal lending is seen as exploitative, it is important to note that for the poor it can also represent a convenient and flexible way to meet short-term financing needs. Ghate describes the work of Sikh moneylenders in the Philippines as

doing their rounds on motorcycles with bags of cash hanging from their shoulders, redistributing as loans what they had just collected... they managed to collect and disburse unsecured loans with absolutely no recourse if a borrower refused to pay. Clearly, they were perceived to be providing a valuable service (Ghate 2015: Chapter 4).

Even for those who could access bank loans, moneylenders can be preferable because the transaction is based on a personal relationship, and has a much simpler application process (no long bank queues, documentation to provide, forms to fill in, or delays in waiting for a decision) (Aliber 2015: 10). Moreover, the high interest rates are 'now rationalised as necessary to compensate the moneylender for the seriousness of the risk borne, the screening costs incurred by the moneylender, and the high level of the opportunity cost of the moneylender's capital' (*ibid.*).

Parussini (2015) describes the vital role of informal moneylenders in fuelling India's massive informal economy: 'Despite their high rates they provide the credit that fuels India's informal sector, which accounts for about

half of the nation's economic output. And they operate outside the rules that often restrict bank credit.' Unable to access banks because of lack of collateral, unregistered moneylenders are the main source of funding for small businesses and individuals. Parussini quotes Shamika Ravi, a leading Indian economist: 'Moneylenders can't be replaced: they perform a key function in the market' (*ibid.*).

Thomas (1992: 13) concludes: '[T]he view of the money lender as an exploiter of the poor and helpless needs to be investigated carefully before judgement is passed.' Aliber makes a similar point: '[T]he modern trend is to doubt both the extent of monopoly power and the exploitative character of such lending' (2015: 10).

## 2.2 Informal moneylending in Bangladesh, Myanmar, and Nepal

This review was unable to find evidence about the precise scale of high-interest informal moneylending in the CLARISSA focus countries: Bangladesh, Myanmar and Nepal. However, media reports and other sources (notably development organisations) indicate that the problem is widespread in all three countries and has significant negative effects on borrowers.

### 2.2.1 Bangladesh

Informal moneylenders have long had a place in Bangladeshi rural communities (EASO 2017: 74). According to the European Asylum Support Office (EASO), the interest rates charged by moneylenders are far higher than those for microcredit and bank loans (*ibid.*). Moreover, many traditional moneylenders use violence and threats to enforce repayment:

[F]ailure of repaying debts can led [sic] to the vicious circle of loaning from other moneylenders, losing homesteads and agricultural land, bondage, or in the most extreme case by the sale of organs. Sometimes the debtors 'went into hiding to escape wrath of usurers'. There are also reports that people committed suicide after being harassed by debt collectors (EASO 2018: 5).

A newspaper article from 2012 describes the situation in Jhenidah district (Harinakundo *upazila*):

Throughout the district, stories of helpless poor peasants getting entangled in the vicious traps of loan sharks are widespread... Intimidated, harassed and often assaulted by the loan sharks, many debt-ridden farmers and poor people in the area

have left home and gone into hiding. Many people have lost their homesteads and agricultural lands as these gangs, prowling the villages with ready cash, had entangled them into a vicious cycle of loan and its unbelievably high interest.

In two unions of Harinakundo, loan sharks have lured scores of farmers into their nets, keeping them in the dark about exorbitant amounts of interest (Rehman 2012).

### 2.2.2 Myanmar

Numerous media articles indicate that high-interest informal moneylending is a particularly serious problem in Myanmar. An Al Jazeera report (2018) estimates that 85 per cent of households in Yangon's poorest neighbourhoods borrow money from loan sharks just to survive. Interest rates on such loans are very high: estimates range from 10 per cent per month (Finch 2012) to 20 per cent per month (Myanmar Business Today 2017) to as high as 50 per cent a month (Arnold 2018). A former UN Habitat staffer and consultant on urban poverty, Mike Slingsby, says Myanmar has the worst levels of informal household debt in the region: 'I've never come across such bad conditions in terms of people being in the hands of money lenders, both in terms of the percentage and the rates of interest' (Myanmar Business Today 2017). As people struggle to make the repayments, they become trapped in an evergrowing cycle of debt. One direct consequence of this is children being sent out to work (Al Jazeera 2018; Arnold 2018).

The widespread use of loan sharks stems from the country's limited formal financial sector and the fact that 'access to fairly priced credit remains beyond the reach of a large proportion of Myanmar's citizens' (Myanmar Business Today 2017). An economist who has studied the issue in the country, Sean Turnell, notes: 'Far and away the majority of people in Myanmar have no relationship with a formal bank, or an ability to borrow from them' (Finch 2012).

### 2.2.3 Nepal

Evidence on the prevalence of informal moneylending in Nepal is limited. A 2005 study of the Eastern Terai region found that well over half of the households surveyed had informal loans – largely because they lacked collateral like land and hence could not access formal lending institutions – and over 60 per cent of these were from moneylenders (Haugen 2005: 5). A study by the

UN Capital Development Fund of financial services in Nepal reported that use of informal moneylending in the country was on the decline, as the formal financial sector improved (MicroSave 2014: 17). However, recent media reports on informal moneylending in Nepal suggests that it is a growing problem in the country (Chhatyal 2019).

Estimates of interest rates on such loans range from 24 per cent per annum in the Eastern Terai study (Haugen 2005: 5), to 60 per cent per annum (Amnesty International cited in Chhatyal 2019). In their participatory action research study in Nepal, Sharma, Oosterhoff and Burns (2019: 12) found that in one village most people in the community did not own property which they could use as collateral for a bank loan, and hence they had 'to go with their own landlord or money lender in [the] community, who charge[s] 40 to 60 percent interest per annum'. Moreover, 'Due to the high interest rates, they cannot pay back their debt in time' (*ibid.*).

Negative consequences of people becoming caught in debt traps to loan sharks include loss of assets, bankruptcy, homelessness, and even people committing suicide. Oosterhoff and Sharma (2018) note: 'Moneylenders in small villages in Nepal often treat their impoverished clients terribly. They may seize their property, call in government authorities or employ violence – whatever leverage is necessary to recover the loans they have made, often at exorbitant interest rates.' According to one Nepali academic: 'The massive network of loan sharks and fraudsters has resulted in dangerous situations in which many people have turned homeless while some have been forced to commit suicide. Such cases are on the rise because the police administration is not taking required action' (cited in Chhatyal 2019). Civil society activists claim the reason for police inaction, and for few complaints of illegal moneylending even being made to the police, is the powerful nexus between loan sharks and local politicians and officials (*ibid.*).

### 2.3 Driving factors

The key factor driving use of high-interest informal moneylending is lack of access to credit through formal financial institutions such as banks, i.e. to a lack of financial inclusion on the part of many poor and low-income people. Poor people's inability to get bank loans can be due to several reasons:

- **The nearest bank branch could be too far away for them to travel to (takes too long and/or costs too much to get there);**

- **They have insufficient funds to open a savings account or maintain a minimum balance;**
- **They do not have collateral (e.g. house deeds or land ownership deeds) to secure a loan;**
- **They are self-employed and have no verifiable or regular source of income;**
- **They are illiterate/poorly educated and hence unable to complete the requisite paperwork (CARE n.d.).**

Lack of collateral is a key constraint. Jacoby (2008: 2) explains that informal moneylenders thrive in settings where collateral is scarce or legal enforcement of debt contract is weak or non-existent. Banks can also be reluctant to loan money to the poor because it can be uneconomic for them: loan amounts and thus profits are generally low, and administrative costs on numerous small loans can be high – they would prefer to lend larger amounts to fewer, richer borrowers.

In the context of West Africa, Aryeetey notes that 'credit from moneylenders is often the most expensive credit available; hence the demand for it usually comes from persons without any other options. Such credit remains the only source of informal credit that does not require borrowers to satisfy specific membership requirements' (1998: 11).

### 2.4 Links between formal and informal credit providers

The literature highlights two key ways in which formal and informal credit markets can be linked and interact with/influence each other (Jacoby 2008). The first is a vertical structure whereby moneylenders act as middlemen, borrowing from the formal sector and then lending the funds on to borrowers who cannot access such credit. Banks and other formal financial institutions will, as noted above, be reluctant to lend to poor people without collateral. However, 'the suppliers of loans in the informal sector usually possess enough assets to qualify as credit-worthy to the lending institutions in the formal sector, which often serve as their source of funds' (Bose 1998: 266). Unlike formal sector lenders, informal moneylenders are not deterred by lack of collateral since 'due to their power, position and personal relationships within the village community, and their informational advantage from being insiders, [they] enjoy lower enforcement costs, and can also differentiate amongst their clients according to risk of default' (*ibid.*). In such a scenario, the moneylenders effectively become a channel for bank/formal financial institution funds. Arp, Ardisa and



Ardisa (2017) describe how this works in the case of MFIs in Indonesia. Their paper aggregates findings from two studies in Indonesia to try to explain why informal high-interest moneylending can still thrive when low-interest microfinance is widely available. They find that when poorly managed, microfinance initiatives can provide entrepreneurship opportunities for 'middlemen': people who more easily qualify get microcredit from MFIs and then use the funds to lend to poorer borrowers. Arp *et al.* (2017) call this phenomenon 'informal intermediation'. They note that poor staff management facilitates – even fosters – informal intermediation. Loan officers know that some borrowers will use the funds to lend to others, but because they know these informal intermediaries will reliably pay back their loans, they still lend to them. The authors (*ibid.*) even found collusion between loan officers and intermediaries, as well as former loan officers becoming informal lenders themselves.

The second arrangement is one in which bankers (formal sector lenders) and moneylenders compete with one another, with residual (unfulfilled) demand for credit from the formal sector spilling over to drive borrowing from informal moneylenders (Jacoby 2008). The literature describes two phenomena in this regard: one where moneylenders coexist with formal sector lenders by virtue of exogenous ceilings on formal sector credit (Bell, Srinivasan and Udry 1997; Kochar 1997); and the other where moneylenders' informational advantage over banks allows coexistence in equilibrium without formal sector credit rationing (Jain 1999; Giné 2005). Jain notes that 'the formal sector's superior ability in deposit mobilisation (due to economies of scale and scope, and the security of deposit insurance) is balanced against the informational advantage that the informal sector enjoys' (1999: 420).

The informational advantage of the moneylender stems from the fact that they either reside in the same village or locality as their clientele, and are thus more likely to have much more personal knowledge of and contact with them than would a bank, or are simultaneously dealing with their borrowers in another market (Jacoby 2008: 2). Because of proximity the moneylender will have a better idea of whether a borrower can successfully implement a given project and thus repay a loan (*ibid.*). In addition, moneylenders may more readily exchange information about borrowers' repayment histories than banks in developing countries (*ibid.*).

Maitra *et al.* (2020) highlight the role that certain nodal individuals in a community can play in ensuring the success of agricultural credit programmes. Under

agent intermediated lending (AIL), selection of local beneficiaries is delegated to an intermediary from within the community. The approach seeks to 'leverage the intermediary's specialized information and connections with local residents, while avoiding the pitfalls associated with elite capture' (*ibid.*: 1). The authors compare the impact on borrowers' productivity and income of lending through AIL conducted by trader lenders and by people with political connections. They find that the former – borrower selection through local trader agents – leads to higher productivity and income, which they suggest is due to them helping more able borrowers to reduce their unit costs and increase output. By contrast, agents with political connections helped less able borrowers and reduced their default risk. Repayment rates for both beneficiary selection routes were similar, illustrating the importance of local knowledge – 'informational advantage'.

## 2.5 Countermeasures

There are three broad measures that can be taken to combat high-interest informal moneylending:

- **Using legislation to ban/control the practice, and enforcing this;**
- **Providing debt relief to debtors; and**
- **Increasing access to credit for the poor.**

While there are examples of national/subnational level legislation specifically to combat high-interest informal moneylending (loan sharks), this review found little evidence of implementation and enforcement. In Nagpur, India:

Despite legislation such as the Bombay Moneylenders Act of 1946 (extended to the whole of modern Maharashtra state by 1960), which requires moneylenders to sign up with the Registrar of Moneylenders and also imposes interest rate ceilings, many moneylenders – especially those catering to low-income [*sic*] clients – operate outside of these regulations (Aliber 2015: 42).

Indian states generally require that moneylenders are registered and have a licence: rules establishing the maximum amount of interest charged (see below) vary from state to state, as do penalties for failing to provide account statements to debtors and for intimidating them (Parussini 2015). Despite this, 'large amounts of credit flow from unregistered moneylenders' (*ibid.*).

Bangladesh has no specific law banning usury, but there are anti-usury provisions and measures for the

protection of borrowers in different laws (EASO 2018). The Bangladesh Moneylenders Act 1940 limits repayment to twice the principal of the original loan and sets annual interest rate caps of 10 per cent on unsecured loans and 8 per cent on secured loans (*ibid.*: 4). In Nepal, Oosterhoff and Sharma (2018) note that: 'By law, annual interest rates by moneylenders or middlemen cannot exceed 10 per cent, and the total sum owed over a period of time cannot exceed the original amount which you borrowed – but the law is routinely ignored.'

A related approach tried by some governments is **setting interest rate caps**. These 'can protect consumers from usury and exploitation by guaranteeing access to credit at reasonable interest rates and to facilitate prosecution of exploitative and deceptive lenders' (Maimbo and Gallegos 2014: 3). Rate caps are generally more applicable to banks and MFIs than to informal moneylenders – though, as noted above, in Indian states maximum interest charges are set out for registered moneylenders. Arguments against the use of interest rate caps include that they are an inefficient tool to lower interest rates, they limit access to credit, reduce transparency, and decrease product diversity and competition (*ibid.*). Critically, they can lead to financial entities lending to clients with higher collateral, and curtailing lending to those who need it most and have little access to alternative sources of credit (*ibid.*). In this way they can push low-income borrowers to turn to unlicensed moneylenders, at a much higher interest rate (*ibid.*).

The effectiveness of measures such as interest rate caps is also limited by the linkages between formal and informal lenders, described above. Both in the vertical structure, whereby informal lenders use credit from the formal sector as funds to lend on to the poor, and in horizontal arrangements, where banks and informal moneylenders operate side by side in competition, policies such as interest rate controls and subsidies will have little impact on informal moneylenders. Jain (1999: 434–5) notes that much of the empirical literature on the efficacy of monetary policy in the presence of active informal credit markets is premised on the difficulty of implementing interest rate regulations in informal markets.

Some countries have approached the problem of high-interest moneylending from the other direction, namely debt relief – helping people to pay off their debts so they

are free of the clutches of unscrupulous moneylenders. A historic example of this was the **Debt Settlement Boards** set up in Bengal (India) in the 1930s to deal with the problem of drought and depression leading to increased rural indebtedness, and to peasants losing their lands (to the landlords or moneylenders from whom they had borrowed).<sup>4</sup> The Boards would hear both parties and give relief to indebted farmers mainly by scaling down their outstanding debts, or declaring the debtor insolvent (thereby relieving him of the debt), or by allowing the scaled down debts to be paid in easy instalments over a period of up to 20 years. The Boards were most effective in areas where peasants were relatively weak socially and politically: in areas with strong peasant organisations, they had little interest in going to the Boards. However, in the long run, the Boards led to the traditional rural credit market shrinking; this in turn led to a decline in acreage and in food production – some scholars have even claimed this was a factor in the famine of 1943. The Boards were closed in 1944.

A similar more recent example is the **Debt Conciliation Boards** set up in Haryana, India for implementation of the Haryana Debt Relief of Agricultural Indebtedness Act 1989.<sup>5</sup> In 2007, the state government announced a fund of Indian rupees 60,000 crore to waive agricultural loans. The Boards were set up in each district to distribute this relief by identifying deserving candidates. They are mandated to provide relief not only to debtors of cooperative banks, cooperative societies, and commercial and nationalised banks, but also of private creditors and moneylenders. Any debtor who has paid back more than double the principal can take their case to a Debt Conciliation Board, which has the power to declare the debt fully discharged. Alternatively, if the debtor can make a payment so that the total paid back is double the principal, the debt will be cleared; or the Board can order a repayment schedule based on the payment capacity of the debtor. In practice, the Boards have been criticised for being ineffective in providing relief to those who deserve it. The government has also been accused of having a 'lackadaisical attitude' to the problem because many political leaders have their own agents in rural markets who act as moneylenders to farmers. The Bangladesh Debt Settlement Act 1989, created to protect farmers from falling into indebtedness to moneylenders, contains several provisions against usury crime practices (EASO 2018: 4).

4 [http://en.banglapedia.org/index.php?title=Debt\\_Settlement\\_Board](http://en.banglapedia.org/index.php?title=Debt_Settlement_Board)

5 [https://en.wikipedia.org/wiki/Debt\\_Conciliation\\_Board](https://en.wikipedia.org/wiki/Debt_Conciliation_Board)

As outlined above, legislative and debt relief approaches to the problem of high-interest informal moneylending are limited, both in their use (as indicated by the negligible literature on these), and in evidence of effectiveness. Hence, this review focuses on interventions to promote financial inclusion and access to credit for the poor.

Given the predominance of financial exclusion – and specifically lack of access to credit – as a driving factor in high-interest informal moneylending, such interventions are critical. The two main approaches to increasing access to credit are through MFIs (microcredit) and through CBFOs.

*Section 3:*

**MICROFINANCE  
INSTITUTIONS  
AND MICROCREDIT**

### 3 MICROFINANCE INSTITUTIONS AND MICROCREDIT

#### 3.1 Definitions and objectives

Microfinance is the provision of basic financial services including loans, savings, money transfers, and insurance to households and micro-enterprises with limited or no access to banks and other formal financial institutions (Beck 2015: 3; CARE n.d.). Promoting financial inclusion enables poor and low-income people to fund activities to generate income, to build assets, stabilise consumption and protect against risks: it can play an important role in improving the lives of the poor.

Although the terms 'microfinance' and 'microcredit' are often used interchangeably, they are distinct. Microfinance refers to the broader concept of financial services covering loans, saving, insurance, transfers, and other products; microcredit refers specifically to the provision of small loans. These are aimed at the poor to help them establish or expand an income-generating activity, and thereby escape from poverty (Mehta and Bhattacharya 2018; Bates 2011; CARE n.d.).

In relation to high-interest informal moneylending, microfinance targets the poor – those usually lacking land or other collateral – who also constitute the bulk of clientele for moneylenders (Berg *et al.* 2016: 2). MFIs can thus create effective competition for the moneylenders:

The availability of microcredit at relatively lower interest rates without any collateral allows poor households to substitute away from the high interest rate loans from traditional moneylenders and landlords. Microcredit thus is expected to drive down the moneylender interest rate and eventually drive them out of business as the microcredit market deepens (*ibid.*: 2–3).

MFIs include NGOs, credit unions, cooperatives, sectors of government banks, and even commercial banks (see below). MFIs draw their funds largely from banks and other formal financial institutions, as well as international donors. As discussed below, there has been a big push to make them financially self-sustaining and to wean them off their dependence on external funding.

#### 3.2 Key features of microcredit

The typical characteristics of microcredit are as follows:

- **Short-term loans** – Loans are usually relatively short term, less than 12 months in most instances

and often even six months or less, and generally for working capital.

- **High repayment frequency** – Repayments start immediately and there is high repayment frequency (regular weekly or monthly repayments). This is because people on low incomes can struggle to accumulate cash over longer time periods.
- **Dynamic incentives** – Loans are usually quite small to begin with, typically in the range of US\$100–500. As borrowers regularly repay their loans and demonstrate their creditworthiness, they become eligible for larger loans. The promise of being able to borrow again and larger amounts serves as a disciplining tool for borrowers and helps reduce risks for the lending institution.
- **Joint liability lending** – The traditional lender's requirements for physical collateral such as property are usually replaced by a system of collective guarantee (or solidarity) groups whose members are mutually responsible for ensuring that their individual loans are repaid. [Alternatively, borrowers may be requested to find one or two personal guarantors – often these are respected local community leaders.] Joint liability can both have an insurance function, and serve as a screening and monitoring mechanism (ensuring money is spent properly) (see below).
- **Simple procedures** – Loan application and disbursement procedures are designed to be easy for the poor – they are simple to understand, locally provided, and quickly accessible with minimal paperwork. Loans are disbursed promptly after approval.
- **Focus on women** – Microcredit is disproportionately aimed at women, who tend to be financially excluded to a greater extent than men: around two thirds of microfinance clients worldwide are women (see below) (Beck 2015: 7–9; CARE n.d.).

Two characteristics of microcredit provision merit further attention. The first is lending to solidarity groups, or individuals with personal guarantors. This has proved remarkably successful in terms of loan repayment – repayment rates are around 97 per cent, making them higher than those of commercial banks lending to wealthy borrowers (CARE n.d.). The approach works because of a number of factors (*ibid.*):

- **Peer monitoring** – members can monitor what others do with their money and ensure that they use the money wisely.

- **Social ties** – individuals who fail to repay their loan will face social pressure from other members of the community, and the desire to avoid this can be a powerful incentive to make the repayments.
- **Group pressure** – if one member of the group defaults the others can expel him/her from the group, thus depriving them of access to credit.

The second is the targeting of women, who are usually among the most vulnerable and poorest in society. Microcredit can promote women's empowerment by giving them opportunities to earn (additional) income, in turn raising their status within their household and community, and boosting their self-esteem and self-confidence, and giving them a greater voice. Another reason for targeting women is that they have been shown to spend a greater share of their income on the welfare of their households than men (CARE n.d.), leading to improvements in health, nutrition, and education. Over the long term, as women have become organised through microfinance, they have tackled issues such as domestic violence. A further reason that MFIs target women is because they have proved to be more reliable borrowers and more likely to repay promptly than men (*ibid.*).

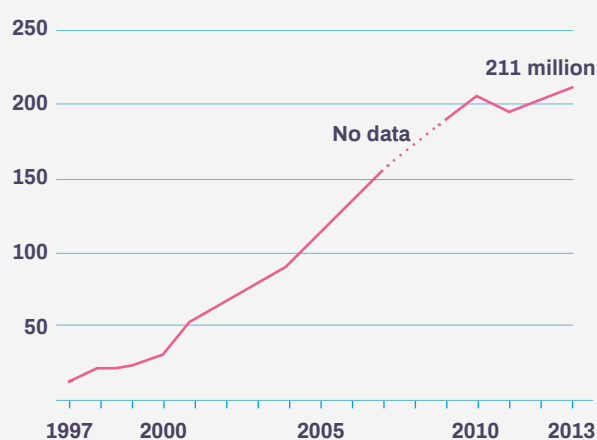
### 3.3 History and development of MFIs

Lending money to the poor was long seen as problematic: the high costs involved, lack of collateral, high risk of default, and the fear that already poor people would become further impoverished by taking on debts, all discouraged microcredit. The change in these perceptions – so that microcredit was seen as something that could help the poor – is attributed to Muhammed Yunus, an economist in Bangladesh.

Visiting poor villages there in the early 1980s, Yunus came up with the theory that lending small amounts to villagers would help increase self-employment and reduce poverty. He began by lending US\$27 to several women, and earned 83 cents interest on the loans, proving the concept could be viable. In 1983 Yunus set up Grameen (meaning 'village') Bank. By 2007, Grameen Bank had made more than US\$6bn in loans to micro-entrepreneurs with no access to traditional banking.

It is important to clarify that Yunus did not 'invent' the concept of microcredit: this had been around in diverse forms and countries for many decades prior to Grameen Bank – for example, Accion, working independently in Latin America, developed a similar idea in the 1970s (Wykstra 2019). Nonetheless, Yunus and Grameen

Figure 1: Rise in global microcredit borrowers



Source: Microcredit Summit Campaign 2015 report, in Wykstra (2019).

Bank did pave the way for countless others to provide microcredit and other services: investors and donors poured money into microfinance and, by 2015, over 3,000 organisations around the world were reported to be providing microcredit to the poor (*ibid.*). While many were found in India and Bangladesh, MFIs were set up across the developing world. Figure 1 shows the rapid rise in microcredit borrowers.

As of 31 December 2010, 3,652 MFIs reported reaching 205,314,502 clients, 137,547,441 of whom were among the poorest when they took their first loan (Maes and Reed 2012: 3). Of these poorest clients, 82.3 per cent, or 113,138,652, are women (*ibid.*). The *Microfinance Barometer 2019* (Convergences 2019: 2) reports that in 2018, 139.9 million borrowers benefited from the services of MFIs, up from 98 million in 2009. Of these, 80 per cent are women and 65 per cent are rural borrowers, proportions that have remained stable over the past ten years, despite the increase in the number of borrowers (*ibid.*). The 2019 report also notes that South Asia continues to dominate global microfinance: it is the region with the largest number of borrowers (85.6 million in 2018), with this number growing faster than in other regions (+13.8 per cent between 2017 and 2018) (*ibid.*). In 2018, 54 per cent of global active borrowers of microfinance were from South Asia (Mehta and Bhattacharya 2018: 155). South Asia also has the top three markets in terms of borrowers: India, Bangladesh and Vietnam (Convergences 2019: 2).

Many MFIs started off as non-profit entities – mostly NGOs and often donor driven – which were unregulated



(Beck 2015). In the 1980s, the prevailing free market ideology led to a push for financial sustainability on the part of MFIs and growing stress on weaning them off long-term donor support. 'It was felt that the poor should pay the full cost of any support received, rather than impose an additional tax burden on others.'<sup>6</sup> There was a drive for MFIs to cover their own costs through greater commercialisation, private ownership, and profit-driven incentives with market-based interest rates (discussed further below). 'It was thought that market forces and profits would ensure financial self-sustainability, generating a cost-free increase in the supply of microfinance to the poor.'<sup>7</sup>

The 'commercialisation' or transformation of an MFI refers to a change in its legal status from unregulated non-profit to regulated, for-profit institution. Regulated MFIs differ from non-profit institutions in that they are held to performance and capital adequacy standards and are supervised by a financial authority, typically the central bank of the country where they are registered or microfinance regulatory authority.<sup>8</sup> For-profit MFIs are sometimes referred to as non-banking financial companies (NBFCs). MFIs are now generally for-profit entities: NBFCs, specialist commercial microfinance banks, or microfinance departments of larger commercial banks (CARE n.d.). Leading MFIs include: Accion International (started in Latin America but now works globally), BRAC<sup>9</sup> (Bangladesh), FINCA<sup>10</sup> (operating largely in Latin America and Africa), Freedom from Hunger (works in countries across Latin America and Africa, as well as in India), Grameen Bank (Bangladesh), and Kiva (operates globally – in 77 countries).

### 3.4 Challenges

#### 3.4.1 Push for financial viability: poverty reduction vs profitability

As noted above, one of the main challenges facing MFIs is financial viability: giving small loans to large numbers of poor borrowers, who typically require a lot of support from MFI staff, and carry a high risk of defaults on loan repayments, does not generate profits. Long-term dependence on banks or donors is not considered sustainable. In order to meet their costs, and in the case of for-profit entities, to earn revenue MFIs have to charge interest from their borrowers.

This leads to the second challenge of how high to set interest rates. What level of interest is acceptable and what is exploitative? Some argue that MFIs should charge market rates, but others note that the main objective of MFIs is to help the poor (and empower women) and hence they should keep interest rates low (Beck 2015: 18). On average, MFIs offer loans at annualised interest rates of around 20–30 per cent though some rates are much higher (Wykstra 2019). Again, some (including Yunus) argue that interest rates above a certain level mean MFIs have turned into 'predatory loan sharks'; others counter that the high rates are necessary to cover the costs of sustainably lending to the poor (*ibid.*). The fierce debate between microfinance advocates focused more on the social and outreach side, and those focused on the profitability side is illustrated by the argument between Mexican Compartentos, the first commercial MFI to go public, and Muhammed Yunus who criticised Compartentos for charging too high interest rates (almost 100 per cent per annum) (Beck 2015: 18).

One analysis, written in 2012 in the wake of the Andhra Pradesh MFIs crisis (see below), highlighted the worry 'that microfinance has taken a wrong turn, that it has drifted away from its original mission, that it has [sic] been co-opted (or even corrupted) by the pursuit of size and profitability' (Andrew Hilton cited in Maes and Reed 2012: 11). Hilton argued that microfinance and individual MFIs were at a tipping point:

Will the industry continue to evolve – to grow, to offer new products, to move up market – until it is essentially indistinguishable from conventional financial institutions (banks, consumer finance companies, etc.)? Or will it rediscover its roots as a more modest source of small-scale credit to a relatively limited market amongst lower-income groups in generally poor countries? (*ibid.*)

#### 3.4.2 Not reaching the poorest

The drive for profits can also lead MFIs to move away from the very poorest in society, since these are the people who typically borrow the least, entail the highest transaction costs and are the most likely to default. But this clearly undermines the objective behind MFIs which is to help lift people out of poverty.

6 <https://microfinanceinfo.com/micro-financial-institutions/>

7 <https://microfinanceinfo.com/micro-financial-institutions/>

8 <https://microfinanceinfo.com/micro-financial-institutions/>

9 Building Resources Across Communities.

10 Foundation for International Community Assistance.

This failure by MFIs to reach the 'poorest of the poor' would appear to be confirmed by extensive empirical evidence from Bangladesh. Berg *et al.* (2016: 38) cite recent evidence from multiple data sets which show that a household with less than ten decimal of land has a much lower probability of becoming an MFI member, and another study which found that as MFI coverage increased in a village in Bangladesh progressively richer households became MFI members. The authors say this reflects the demand on loan officers to maintain high repayment rates and rigid repayment schedules: 'It is widely discussed that the loan officers exclude households if they do not have a steady source of income to ensure weekly repayments' (*ibid.*). Berg *et al.* claim that Bangladesh is not unique in this: '[T]he tendency to attract relatively richer households with MFI penetration has been widely noted in other countries' (*ibid.*: 39). This point is echoed by Arp *et al.* (2017) who note that loan officers in MFIs have an incentive to focus on quantitative outcomes such as number of loans provided and rollovers of 'safe' loans, rather than on funding the poorest borrowers. Consequently, 'the poorest of the poor... benefit less than the less poor do' (*ibid.*: 112), and this reinforces existing socioeconomic hierarchies in these countries. In the case of Bangladesh, the fact that the ultra-poor were being bypassed by microcredit led BRAC to design specialised asset transfer programmes for them: the Targeting the Ultra-Poor (TUP) programme started in 2002.

### 3.4.3 Driving indebtedness

Conversely, the other charge levelled against MFIs is that they lend to those who cannot afford to borrow, and thus burden them with debts. In other words, microcredit ends up causing more harm than good. Microcredit is most effective when provided to people who have already identified a productive and profitable economic opportunity, have the necessary entrepreneurial skills and can use credit (loans) to set up/further their business and are capable of making regular repayments (Mehta and Bhattacharya 2018: 161). By contrast, 'providing credit to those who cannot use it productively could push already vulnerable poor people into debt and in fact worsen their situation' (*ibid.*; CARE n.d.). This was the experience of the Indian state of Andhra Pradesh (see Section 3.5) and of South Africa: the microfinance movement took off after the end of apartheid in the country in 1994 but was largely used for consumption spending rather than enterprises (Bateman 2013). As a result:

With few poor individuals possessing a secure source of income stream that might ensure full

repayment of a microloan... many of the poorest individuals have been forced to repay their microloan by selling off their household assets, borrowing from friends and family, as well as simply taking out new microloans to repay old ones.... South Africa's poor are now caught in a micro-debt trap of unimaginable proportions (*ibid.*).

Estimates are that 40 per cent of the South African workforce's income is spent on repaying debt (Bateman 2013). Bateman (*ibid.*) attributes a lot of the problems with microcredit in South Africa to the extensive commercialisation of the sector in order to make it financially self-sustaining. He notes that the underlying assumption that private banks and MFIs would be responsible 'proved to be spectacularly wrong'.

According to Mehta and Bhattacharya (2018: 154), the frequent and tightly structured repayment schedule that MFIs typically impose on poor borrowers means the latter 'find it difficult to invest borrowed money into projects that have long gestation period [*sic*] as the repayment begins long before the return on investment is realized'.

### 3.4.4 Microcredit pushing people into arms of loan sharks

Ironically, in situations where microcredit leads to indebtedness on the part of borrowers (where they struggle to make repayments) it can lead to (renewed) use of informal moneylenders. Meyer (2002: 357) notes that one of the arguments given for expanding the microfinance industry was to help poor people escape the clutches of 'evil moneylenders' who allegedly charge usurious rates of interest: formal finance was expected to substitute for informal sources. However, 'there is widespread evidence that MFI clients widely use informal finance as part of their financial management strategy' (*ibid.*). He cites a 1998 case study that collected detailed information on all credit transactions in a sample of households in northern Bangladesh in a region where several MFIs competed. 'Almost all households (87 per cent) reported borrowing from informal sources and the proportion was higher for MFI clients than for non-clients. Household consumption and payment of other loans were the two most frequently reported uses of the informal loans' (*ibid.*). Mehta and Bhattacharya echo these findings, noting that the failure of MFIs to reach out to the poor and underserved population 'results in the existence of informal moneylenders who not only lend their own savings to the poor at exorbitant interest rates but also borrow from formal sources for further lending to the poor' (2018: 155).



## Box 2: Impact of microcredit on poverty reduction

The theory behind microfinance for the poor – and specifically provision of microcredit – was that it ‘would boost their income-generating capacity, unbridle their entrepreneurial spirit, support the development of businesses, and ultimately alleviate poverty’ (Maitrot and Nino-Zarazua 2017: 1). This fundamental premise that microcredit alleviates poverty has increasingly come under question.

Initial arguments about the poverty-reducing effects of microcredit were largely based on anecdotal evidence, descriptive statistics, and impact studies that failed to disentangle causation from correlation (Banerjee, Karlan and Zinman 2015: 1). There was a big evidence gap in the first few decades of microcredit’s expansion (Wykstra 2019). This situation has changed in the past decade, with several studies being carried out across different countries and generating substantial systematic evidence on microcredit. Banerjee *et al.* (2015: 2) give the findings of six different randomised controlled trials (RCTs) carried out by economists working independently in six countries: Bosnia, Ethiopia, India, Mexico, Mongolia, and Morocco. Key findings of the studies in relation to different outcomes are as follows:

- **Business activity** – Increased access to credit leads to increased business activity. Businesses expand, though the extent of expansion may be limited, and there are hints that profits increase.
- **Income** – Two studies found that increased business income offset reductions in wage income (suggesting that microcredit offers people more freedom in their choices of occupation and allows them to become more self-reliant) while two studies found increases in both wage and business income.
- **Consumption** – No evidence was found of an increase in total household consumption, but there was a decrease in discretionary spending (recreation/entertainment, temptation goods). There were no significant effects on health and education spending.
- **Social indicators** – No impact was found on child schooling, with the exception of Bosnia which showed a significant decline in school attendance among 16–19-year-olds. Only one study reported a small but significant increase in female empowerment (*ibid.*: 11–13).

Banerjee *et al.* (2015: 13) conclude that the studies find no clear evidence of reductions in poverty or substantial improvements in living standards. However, they stress that this should not obscure other more modest, but potentially important, effects: on occupational choice, business scale, consumption choice, female decision power, and improved risk management. Furthermore, they note that while there is little evidence to support microcredit’s strongest claims (about poverty reduction), ‘there is also little support for microcredit’s harshest critics. The studies found little evidence of harmful effects’ (*ibid.*: 14).

A 2017 systematic review of poverty and wellbeing impacts of microfinance (Maitrot and Nino-Zarazua 2017: 6–7) found inconclusive evidence of microfinance impacts on per capita income, non-land asset value, and poverty, and on other welfare dimensions including food and non-food consumption, medical expenditures, health, nutrition, and education. The positive poverty impacts of microfinance were largely found in studies on Bangladesh, which showed that it seems to benefit the vulnerable non-poor more than the extreme poor (*ibid.*).

While recent evidence does not point to microcredit leading to reduced poverty, this does not mean it has had no positive effects. Wykstra (2019) argues that the results are only disappointing if one thought microcredit could get people out of poverty – something that many researchers say was not realistic to begin with. Wykstra cites research by Collins *et al.* (2009) on the financial lives of people living on US\$2 or less per day, which shows that credit plays a crucial role in borrowers’ lives: helping meet emergencies, pay for a big purchase, or for consumption smoothing when income fluctuates. Banerjee *et al.* echo this, noting that ‘if microcredit’s promise were increasing freedom of choice it would be closer to delivering on it’ (2015: 14).

Source: Based on Bennett, K. (n.d.) ‘Loan Sharks, Microloans and the Highest Interest Rates Around (They Aren’t on Kiva)’, <https://pages.kiva.org/blog/loan-sharks-microloans-and-the-highest-interest-rates-around-they-arent-on-kiva>

Berg *et al.*'s study (2016) in Bangladesh presents somewhat different findings. The study looked at the effects of microcredit penetration into the village credit market, focusing on the effects on moneylender interest rate and household borrowing from informal sources (*ibid.*: 39). The theory was that microcredit would reduce both. The study was based on two large survey data sets from Bangladesh, covering almost 800 villages (*ibid.*: 5). It found that:

- **Moneylender interest rates do not go down when microfinance comes to a village; in fact, the interest rate increases when the MFI penetration into the village credit markets is high enough.**
- **The effect is heterogeneous; at low levels of MFI coverage, there does not seem to be any perceptible impact, and the effect is strong for the villages in the top quartile of coverage.**
- **The evidence based on the panel data demonstrates clearly that a household's propensity to borrow from informal sources declines significantly once it becomes a member of an MFI, and that the total volume of credit from informal sources (and formal banks) also decrease substantially in both absolute and relative terms (*ibid.*: 40–41).**

The authors conclude that the evidence on the declining importance of informal sources in rural credit markets along with higher informal interest rates contradicts some of the widely held perceptions among contending camps of practitioners:

While our results do not support the view of MFI proponents that MFI competition reduces informal interest rates, the evidence also rejects the claim by the critics that MFIs cause increased reliance on informal loans among its borrowers due, for example, to rigid repayment schedules and indivisibility of investment projects (*ibid.*: 40).

Taken together with empirical evidence from other studies from Bangladesh on MFIs (cited above), the likely explanation is that MFIs attract the less risky borrowers with more land and steady sources of income, while the moneylenders retain relatively poor and risky borrowers (*ibid.*: 38).

### 3.5 Case study: Andhra Pradesh – 'Microcredit over-reach?'

Andhra Pradesh in the south-east of India saw a 'microfinance explosion' in the 2000s (Mader 2013). The

state was home to the four largest MFIs in the country, as well as a state-supported programme that promoted self-help groups (SHGs) and linked them to formal financial institutions. The rapid growth in MFIs in Andhra Pradesh was fuelled by huge investment in the sector. Prior to 2006, US\$6.3m was invested in Indian microfinance: this grew to US\$118.3m in 2008 and US\$528.6m up to July 2010 (*ibid.*: 51). The Indian regulation regime encouraged this by making borrowed capital more cheaply and amply available for MFIs; the government also failed to regulate the sector because MFIs were NBFCs and NGOs, rather than banks. The massive equity infusion drove huge growth in lending, mostly among the six large MFIs that attracted 80 per cent of investments (*ibid.*).

However, the immense growth also vastly overstretched MFIs' internal systems, and they cut corners everywhere, particularly in the client acquisition process. External 'agents' were apparently widely used to recruit new clients. A post-crisis survey of 100 MFIs found that most lacked guidelines on lending to clients of other MFIs and did not have systems in place for measuring a client's level of indebtedness (Maes and Reed 2012: 6).

From April 2008 to March 2010, each of the six leading MFIs added 2,389 new active clients, or 479 new joint loan groups (JLGs) on average every day, so that by March 2010 statistically 35.9 per cent of all households in Andhra Pradesh had an MFI loan (Mader 2013: 51). By November 2010, SHGs and MFIs were reaching over 23 million clients in the state (Maes and Reed 2012: 6). Each loan officer was dealing with 488 loans by 2009 (Mader 2013: 52). Many clients had loans from several different sources, putting the average microfinance debt per household in Andhra Pradesh over US\$1,700, compared to less than US\$150 per household in the other states of India (Maes and Reed 2012: 6). One study found that 83 per cent of microfinance clients in the state had loans from more than one source, and many had four or more loans at the same time (*ibid.*). A report from the Consultative Group to Assist the Poor (CGAP) concluded: 'The picture that emerges from the data suggests that households in Andhra Pradesh [had] too many loans and [more] debt than [seemed] supportable considering their income levels and ability to repay' (*ibid.*: 6).

In July 2010, SKS Microfinance Ltd (SKS), the largest of the Indian MFIs (with more than seven million clients at the time), held an initial public offering (IPO). The IPO raised US\$155m for SKS and valued the company at US\$1.5bn; existing shareholders also sold US\$195m worth of their shares in the offering, making huge profits

(Maes and Reed 2012: 6). While the SKS IPO, the first by an MFI in India, was seen by some as signalling the strength of the sector, on the ground in Andhra Pradesh a crisis was brewing.

There were reports as early as June 2010 of default rates being far higher than stated, and of MFIs covering them up (Mader 2013: 55). There were also reports of coercive repayment techniques being used against borrowers. Ironically, people resorted to informal loan sharks to pay their debts to the MFIs: 'Traditional moneylenders were not being displaced by MFIs, but rather were thriving thanks to them, effectively becoming part of the business model as moneylender loans were increasingly taken to repay MFIs' (*ibid.*: 52). In late September and October 2010, accounts of borrowers in Andhra Pradesh committing suicide accumulated: as of 15 October 2010, a total of 30 suicides had been committed in 45 days (*ibid.*; see Biswas 2010).

In response, the Andhra Pradesh government issued an Ordinance<sup>11</sup> on 15 October 2010 severely restricting the activities of MFIs in the state. The Ordinance required MFIs to state their interest rates clearly and register all recovery personnel in each district they operated in; prohibited the recovery of loans and granting of new loans until such registration was completed; forbade the collection of collateral on loans; forbade the issuing of multiple loans to the same borrower group; and banned MFIs from deploying any agents for recovery or using any other coercive action (Mader 2013: 55).

'As a result microfinance operations in Andhra Pradesh came to a grinding halt' (Maes and Reed 2012: 6). No fresh loans were sanctioned by MFIs, and the loan recovery rate fell to under 10 per cent (*ibid.*). MFI field staff were unable to carry out collection duties for fear of the punitive measures in the Ordinance. This was exacerbated by politicians seeking to make political mileage by encouraging borrowers not to repay their loans. Poor recovery of loans and lack of liquidity meant many small MFIs were threatened with closure. Moreover, while resolving the issue of reckless lending, the Ordinance also deprived 'legitimate' borrowers of access to credit.

Mader concludes that the policy of using microcredit to address poverty was flawed in design and implementation:

The persistent social crisis of India's poor (particularly in Andhra Pradesh), which policymakers sought to address through credit via SHGs and MFIs, made borrowers increasingly dependent on debt for survival. MFIs competed with SHGs and each other to feed that debt dependency. The reckless and unregulated growth of the Indian microfinance industry, concentrated on one state, created a drive for profitability at all costs (including human costs), and the industry's unwillingness to heed any warnings, even from well-intentioned insiders, sealed its fate (Mader 2013: 61).

11 An Ordinance to Protect the Women Self Help Groups from Exploitation by Micro Finance Institutions in the State of Andhra Pradesh and for the Matters Connected Therewith or Incidental Thereto (<http://indiamicrofinance.com/wp-content/uploads/2010/10/Andhra-MFI-Ordinance.pdf>).

*Section 4:*

**COMMUNITY-  
BASED FINANCIAL  
ORGANISATIONS**

## 4 COMMUNITY-BASED FINANCIAL ORGANISATIONS

### 4.1 CBFOs vs MFIs

As shown above, MFIs can have significant shortcomings. A major one is limited outreach. MFIs tend to serve populations in urban, semi-urban, and densely populated rural areas: it is hard for them to reach people in sparsely populated rural areas because transaction costs are so high (Ritchie 2007: 35). There is thus a need for low-cost organisations that can cover the costs of providing small pools of capital for a large number of customers, i.e. can carry out a large number of small (in monetary value) transactions. Community-based financial organisations (CBFOs) meet this need, and represent a viable alternative to high-interest informal moneylending.

The International Fund for Agricultural Development (IFAD 2014a: 1) defines 'community-based financial organisation' as covering a variety of entities that provide a range of financial products and services to a small target market in a limited geographic zone. They often operate in remote areas, are self-formed and self-governing, rely partially or wholly on volunteers, and are primarily savings driven, mobilising funds from their members (*ibid.*). According to Ritchie the central characteristics of CBFOs 'are their financial and institutional independence, and mobilisation and management of their own resources' (2007: 3). Table 1 summarises the main differences between CBFOs and MFIs, and compares these to high-interest informal moneylenders.

### 4.2 Types of CBFOs

While CBFOs have common features, there can be many different types of CBFOs – they range from highly decentralised, very unsophisticated entities to more formal, centralised CBFOs with more sophisticated products and services (IFAD 2014a). IFAD (*ibid.*: 2–6) identify three main subgroups of CBFOs according to their main mode of operation: small community-based time-bound savings groups; small community-based accumulating savings groups; and large community-based cooperative groups.

#### 4.2.1 Small community-based time-bound savings groups

These are informal groups in which all members have to save a fixed amount of money in each cycle (typically each month). All the funds are disbursed to one or more members after each cycle, and the groups are dissolved

once everyone has had their turn to receive funds (or the process starts again). They often form and operate without any external intervention or support. The main examples are **rotating savings and credit associations (ROSCAs)**, **village savings and loan associations (VSLAs)**, and **village banks**.

- **ROSCAs** usually have 5–20 members (but can be up to 30) with compulsory savings by all, loans given to each member in turn, and no interest on savings. There can be accumulation of savings for the first few cycles to establish a credit fund, before distributing any funds.
- **VSLAs** differ from ROSCAs primarily in that they pay interest on savings, and interest is payable on loans.
- **Village banks** are similar to VSLAs but aim to continue operating at the end of each savings–lending cycle (VSLAs can disband, start anew, or have members leave and new members join).

#### 4.2.2 Small community-based accumulating savings groups

Here too, savings are compulsory to be part of the group, but size and timing of contributions/withdrawals are more flexible. Accumulating funds means they have more complex operations than time-bound groups, and they can have more capital for lending and thus vary their loan products. It also means they have an unlimited life. The main examples are **accumulating savings and credit associations (ASCAs)** and **self-help groups (SHGs)**.

- **ASCAs** can have around 12 members, but with more heterogeneous membership than ROSCAs and VSLAs. Members are paid interest on savings according to their contributions: they can just save, and not take loans. Loans can be larger and have a longer maturity than ROSCAs and interest is charged on loans. Since operations are more complex, rules may be documented, and these are harder for non-literate people to manage.
- **Self-help groups** have 10–30 members, mostly women from similar socioeconomic backgrounds. They have links to formal financial institutions and use the latter's deposit facilities for the group's pooled savings; these links also give them access to larger and longer-term loans to lend to members. They are regulated by the national financial institution. Interest is earned on savings and paid on loans. They are often trained in the

**Table 1: Comparison of main characteristics of CBFOs, MFIs and informal moneylenders**

<b>Characteristics</b>	<b>CBFO</b>	<b>MFI</b>	<b>Informal moneylenders</b>
<b>CLIENT BASE</b>	<ul style="list-style-type: none"> <li>• Common membership, e.g. women living in a particular village</li> <li>• Eligibility determined by members</li> <li>• High degree of trust between members</li> </ul>	<ul style="list-style-type: none"> <li>• Varied clients</li> <li>• Eligibility determined by MFI</li> </ul>	<ul style="list-style-type: none"> <li>• Usually people living in local community</li> </ul>
<b>STAFF</b>	<ul style="list-style-type: none"> <li>• Volunteer members</li> </ul>	<ul style="list-style-type: none"> <li>• Paid full-time staff (not necessarily clients)</li> </ul>	<ul style="list-style-type: none"> <li>• Moneylenders operating individually or with partners/staff</li> </ul>
<b>MANAGEMENT</b>	<ul style="list-style-type: none"> <li>• Smaller ones managed by members, larger ones by professional staff and management</li> </ul>	<ul style="list-style-type: none"> <li>• Managed by recruited staff</li> </ul>	<ul style="list-style-type: none"> <li>• Self-managed</li> </ul>
<b>GOVERNANCE</b>	<ul style="list-style-type: none"> <li>• By board – elected by members</li> </ul>	<ul style="list-style-type: none"> <li>• By board – appointed/ salaried and elected</li> </ul>	<ul style="list-style-type: none"> <li>• None</li> </ul>
<b>REGULATION AND OVERSIGHT</b>	<ul style="list-style-type: none"> <li>• Not compulsory – often unregulated in the case of smaller CBFOs, e.g. VSLAs, but usually in place for entities such as credit unions</li> </ul>	<ul style="list-style-type: none"> <li>• Compulsory, but not always developed</li> </ul>	<ul style="list-style-type: none"> <li>• None</li> </ul>
<b>COLLATERAL FOR LOANS</b>	<ul style="list-style-type: none"> <li>• Includes savings, use of guarantor, social collateral of the entire local group</li> </ul>	<ul style="list-style-type: none"> <li>• Often group guarantee (as in Grameen Bank where clients in a group co-guarantee each other), or property, occasionally guarantor</li> </ul>	<ul style="list-style-type: none"> <li>• None – based on moneylenders' local knowledge of borrowers</li> </ul>
<b>RANGE OF FINANCIAL PRODUCTS</b>	<ul style="list-style-type: none"> <li>• Normally narrow: <ul style="list-style-type: none"> <li>–Savings driven (range of products depends on type of group)</li> <li>–Credit (small loans, rigid terms)</li> <li>–Sometimes some form of solidarity insurance</li> <li>–May be possible to link to formal financial institutions to access other products</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Broader: <ul style="list-style-type: none"> <li>–Savings normally voluntary, different products available</li> <li>–Credit (larger loans available, with longer loan terms)</li> <li>–Other products offered (e.g. insurance)</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Very narrow: credit at high interest rates</li> </ul>
<b>SIZE OF OUTREACH</b>	<ul style="list-style-type: none"> <li>• Small – typically five to a few hundred members</li> </ul>	<ul style="list-style-type: none"> <li>• Normally large – typically thousands of clients</li> </ul>	<ul style="list-style-type: none"> <li>• Small – usually limited to local community</li> </ul>
<b>SIZE OF GEOGRAPHIC COVERAGE</b>	<ul style="list-style-type: none"> <li>• Normally small: individual groups cover a single community/village (unless part of a network)</li> </ul>	<ul style="list-style-type: none"> <li>• Wider: large branch infrastructure and points of sale</li> </ul>	<ul style="list-style-type: none"> <li>• Narrow: since based on local knowledge and proximity to borrowers</li> </ul>

Source: Adapted from IFAD (2014a: 2), plus author.



required management skills by NGOs and it is common practice to change leaders annually to build capacity and empowerment. SHGs have aims beyond providing financial services, such as poverty reduction, awareness raising, increasing literacy, and promoting family planning. SHGs are especially prevalent in India.

#### 4.2.3 Large community-based cooperative groups

These are generally larger than time-bound or accumulating savings groups and have more formal management and governance structures. They are savings driven, though depending on the type of group, savings can be voluntary or compulsory. Members own a cooperative through buying shares or by paying membership fees. They are democratically controlled by members who appoint the board and annually review performance. Examples are **self-managed village savings and credit banks (CVECAs)**,<sup>12</sup> **savings and credit cooperatives (SACCOs)**, and **credit unions**.

- **CVECAs** require members to pay a fee to join rather than buying shares. Savings are voluntary. Instead of paying dividends to members, the annual surplus is reinvested in the CVECA or in the village.
- **SACCOs** are organised so that each member who buys one or more shares has one vote. Rural SACCOs will have between 50 and a few hundred members; they focus on one village or even a segment of the village population (e.g. women). Interest can be received on deposits, and a dividend is usually paid out of the SACCO surplus; interest is charged on loans.
- **Credit unions** in rural areas can have between 50 and a few hundred members (more in urban credit unions). Membership is based on a common bond such as belonging to the same community or place of employment. Each member buys one share and has one vote on board election, irrespective of amount of savings. Good rates of interest are paid on savings. While sometimes supplemented by external funds, credit unions largely rely on members' savings and shares to finance loans, on which interest is charged. Large credit unions offer a full range of financial services, including remittances and insurance. They usually have a part-time manager, reporting to the elected board,

and are regulated by the central bank or registrar of credit unions or cooperatives.

### 4.3 Strengths of CBFOs

CBFOs have a number of key advantages (IFAD 2014a: 7–8, 2014b: 7–8; Ritchie 2007):

- **Greater outreach** – As shown above, CBFOs are capable of achieving considerable outreach in remote areas at a relatively low cost compared with more formal financial institutions such as MFIs. Since they are in close proximity to their members, are self-managing, and can operate with a relatively low membership, they can be established in remote areas with low population density, involving people who normally lack access to other financial services and products.
- **Local ownership and empowerment** – CBFOs commonly generate a strong sense of ownership among members. Due to the local character of the organisations, many of the members know their fellow villagers and local operating conditions; therefore, it is likely that they will take a considerable interest. The groups often include and empower more marginalised individuals (such as poor people or women) who sometimes use the group to become involved in other community initiatives. In addition, local knowledge and local ownership enable members to assess whether potential borrowers will be able to repay the loan and reject attempts by problematic individuals to join a CBFO.
- **Encourage savings culture** – CBFOs are predominantly compulsory savings-based organisations. Not only can this requirement help encourage linkages with the formal financial sector, it can also promote long-term sustainability. Additionally, compulsory saving helps individuals build equity, create reserves, smooth consumption and mitigate risks. They thus avoid the risk associated with microcredit through MFIs that already vulnerable poor people will become highly indebted through access to credit.
- **Allow replication** – The simplicity of the models makes it relatively easy for neighbouring villages to replicate and develop their own informal financial sector.

12 Caisses Villageoises d'Epargne et de Credit Autogerees.

- **Possibility to link to formal financial sector** – The typical member of a decentralised CBFO is poor and lives in a remote area, making him/her less interesting to the formal financial sector. However, 20–30 individuals working as a group to establish mature savings operations could provide the economies of scale necessary to make service provision financially worthwhile. The typical CBFO becomes more attractive to a bank or large credit union if linked to a network of decentralised self-managed groups that can be serviced as one entity. For members of CBFOs, linkages to formal financial institutions can mean access to larger loans and other financial products and services. Rural populations that have access to the more formal financial sector will often choose to retain linkages with CBFOs both to diversify their incomes and reserves and to reap the social benefits CBFOs bring.

#### 4.4 Weaknesses of CBFOs

However, CBFOs have their limitations (IFAD 2014a: 8–9, 2014b: 8–9; Ritchie 2007):

- **Limited ability to generate a big pool of funds** – CBFOs often operate in remote regions and have relatively small memberships with limited savings capacity. As a result, savings generated by CBFOs are relatively small, which constrains their capacity to mostly micro or small business and consumption activities.
- **Restricted range of products and services** – The low savings capacity and remoteness, as well as lack of skilled personnel, also means the range of services that rural CBFOs can provide to their members is limited. As such, many only provide basic savings services and a few loan products.
- **Higher interest rates compared to formal financial institutions** – CBFOs often charge higher interest rates than commercial institutions. It may seem that, since the amounts loaned are small, the high interest rates would encourage short-term borrowing, resulting in high repayment rates because borrowers would not want to accumulate high interest fees on longer loans. However, it has been found that high interest rates discourage poorer members of CBFOs from taking such loans. In the absence of other external cash inflows to repay high-interest loans, members who take high-interest loans for consumption can end up poorer at the end of the business cycle.
- **Need for technical assistance and monitoring** – Typical decentralised financial institutions are self-managed and require a considerable amount of technical assistance and training at the outset in order for the CBFO to manage itself in a sustainable manner. Furthermore, they require close monitoring and oversight for two to three years after their establishment to help them become sustainable.
- **Lack of financial management capacity and weak governance** – Many CBFOs are managed by members who have little or no financial management skills. Fostering management skills takes time and requires people with leadership skills who are committed to championing the group development process. However, it is often difficult to find such people in rural areas. Many CBFOs' 'staff' volunteer their time on a *pro bono* basis. Without a salary, the level of accountability can sometimes be compromised, resulting in mismanagement of CBFO funds. It is, therefore, recommended that CBFOs aim for salaried staff in order to improve financial management skills, and have a system of checks and balances to control governance and management.
- **Vulnerability to elite capture** – CBFOs are often established in small villages with a strong hierarchical structure and power relationships. Given the attraction of accessing 'free money', local elites are often tempted to take over CBFOs for their own ends, with the risk that the CBFOs collapse and members lose their savings.
- **Sustainability not guaranteed for externally funded groups** – CBFOs that receive external credit funds from governments or donors often fail. Poorly planned and executed, externally funded CBFOs often risk attracting a non-socially cohesive membership whose sole purpose is to access 'free money' rather than encourage their members to save and strengthen the group over time. Even though savings are compulsory, members are likely to view these CBFOs as a way to access loans rather than an opportunity to build a savings habit, which would be beneficial to both the members and the group to ensure liquidity and sustainability.



### Box 3: Characteristics of sustainable CBFOs

IFAD lists the following characteristics of a sustainable CBFO:

- Mobilises sufficient savings to provide a good range of loans to its members;
- Pays near market rates of interest;
- Follows best practice in management and governance;
- Has a well-written constitution and sound rules and regulations;
- Shows strong commitment by members to the success of the CBFO as witnessed by good attendance at meetings, low to no loan defaults, and effective management and governance;
- Provides control against elite capture;
- Uses an external auditor for annual financial statements; and
- Remunerates its management.

Source: IFAD (2014a: 10).

#### 4.5 Case study: CARE's Village Savings and Loan Association (VSLA) model<sup>13</sup>

Over the past 28 years, CARE International has developed, extensively tested, and replicated a community finance model, the Village Savings and Loan Association (VSLA). It provides the rural poor with a secure place to save, the opportunity to borrow in modest amounts, and convenient access to these services. It is transparent in its operations, is inexpensive to set up, and can be managed by local people. Evaluations have shown it to be an effective solution to meet the needs of poor people who live in communities that cannot be reached by banks and MFIs.

Originally developed in Niger in 1991, VSLAs now operate in 26 African countries, eight Asian countries, and Haiti (CARE 2016: 2). Globally (as of 2016) there were over 200,000 VSLA groups, with five million members (over 70 per cent of them women) generating over 350m financial transactions per year (*ibid.*). Moreover, their loan repayment rate was 99 per cent (*ibid.*). CARE's experience with the VSLA model has matured over the years. Beginning with a basic approach designed for impoverished and uneducated rural women, it has evolved to be a suitable option for literate and non-literate people. Numerous development agencies, including IFAD, Oxfam, Plan International, World Vision, and Catholic Relief Services, have now adopted the model.

VSLA is a group savings and loan system in which, after training and practice, groups of between 10 and 30 people have the capacity to govern and manage their savings and loan activities. Rules are simple, transparent, and easy for every group member to understand. Group members either (1) contribute a small fixed amount on a weekly basis, or (2) at every meeting, buy between one and five shares that have a fixed purchase price. The amount of the contribution or the share value is set by the group. After several weeks, the group begins making loans to members, with the loan term and interest rate decided by the group. Most of the loans are used for income-generating activities. The groups use their own savings as the source of loan capital and *there is no external long-term dependency either for technical support or loan fund capitalisation.*

At the end of the first year, the savings and interest collected on loans are distributed to the members; some may be retained to start the next annual cycle of loans at a level that avoids waiting for the slow build-up of a useful sum. The main reasons for distributing the funds are to keep the size of the funds within the management capacity of the group members and to allow the members use of their accumulated funds at a time of year when a large sum of money is needed, such as for agricultural inputs or education expenses. The groups then restart their operations, after allowing members who do not want to continue participating to leave and others to join.

<sup>13</sup> This section is largely based on 'Annex 5. Village Savings and Loan Association Model' in Ritchie (2007: 56–58).

#### Box 4: Women's CBFO in Yangon, Myanmar

The Yakhine Yo Ley neighbourhood would not exist if it were not for a group of women who came together to escape the clutches of loan sharks. In recent years, the community of a few dozen households has sprung up on what used to be fields on a strip of land in Yangon's Hlaing Tharyar township, and the families, although burdened by poverty and debt, funded it all themselves. Their secret was simple: in 2009 a group of women who lived in flimsy bamboo shacks nearby started pooling their money – just a few hundred kyats a week – into a savings fund. When the pot grew big enough, they started taking out small loans. Because they collectively managed the fund, they were able to set interest at well below the often extortionate rates charged by Myanmar's informal moneylenders. The families can take out loans twice a year, often used to pay off outstanding debts, to buy stock for their businesses, or for children's education.

The project was started by Women for the World (WFW), a local non-profit organisation that took its cue from similar projects that had worked well in Thailand. Myanmar's formal financial sector is only just beginning to recover from decades of economic mismanagement. But while banks are expanding their presence and foreign microfinance enterprises have set up shop, access to fairly priced credit remains beyond the reach of a large proportion of Myanmar's citizens. Schemes like the one in Yakhine Yo Ley offer a way for communities to generate finance without relying on the country's expensive informal lenders or its still-decrepit banking infrastructure.

Source: Adapted from 'Yangon Women use Group Savings to Escape Clutches of Loan Sharks', *Myanmar Business Times*, 30 April 2017, [www.shwemyanmar.info/news\\_detail\\_m.php?id=4456&type=2](http://www.shwemyanmar.info/news_detail_m.php?id=4456&type=2)

A variety of studies of the VSLA programme have indicated that members who operate small economic activities tend to keep their businesses in operation throughout the year, have a bigger say in household decisions, enjoy better nutrition, invest more in their children's education, and enjoy a higher social status than non-members. There is a significant increase in small household and livestock assets, usually those controlled by women. The loans given out by the groups tend to be used almost exclusively for income-generating activities, such as purchasing inventory for a small store, feeding livestock, and petty trade. The shared-out funds from the savings groups tend to be used primarily for food, clothing, school fees, and life-cycle events.

Unlike most ASCAs and many other community-based programmes, members can withdraw their savings at any

time throughout the cycle, if in need. The loss of accrued interest earnings is a disincentive to do so, especially late in the cycle, but access to savings has become an important principle of VSLAs.

Many of the strengths of the VSLA model lie in what it is not. It is not complicated. It is not expensive. It is not donor driven. It is not dependent on rigid structures or outside investment. Most important, it does not depend on long-term technical support, which distinguishes it from most other community-based microfinance methodologies. The model is easily replicable, inexpensive to establish, and requires minimal training. Successful implementation does not need highly trained experts, large budgets, and long time frames to reach sustainability. It is a model that has the potential to be massively scaled up,

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*Section 5:*

# **ROLE FOR DEVELOPMENT PARTNERS**

## 5 ROLE FOR DEVELOPMENT PARTNERS

### 5.1 Support for microcredit provision

#### 5.1.1 Donor programme evaluations

Microfinance and microcredit has been a significant area for donor support. The argument put forward by Muhammed Yunus that giving poor people credit could help them earn money and lift themselves out of poverty had huge appeal – which was backed by huge investment. Among the biggest supporters of microfinance has been the World Bank, which describes itself as:

a leading innovator in microfinance, promoting developments in technology, financial products, and business practices to help financial institutions reach more poor people, more cost effectively. We help build the institutional capacity of a whole range of providers, from banks and microfinance institutions to credit unions and self-help groups. As these institutions become stronger and more financially sound, they can extend their reach, improve their efficiency, and increase the range and quality of services they offer.<sup>14</sup>

It is beyond the scope of this review to look at the full range of individual donor programmes supporting microfinance (microcredit). Instead a selection of evaluation findings are given here: (1) an overall evaluation of World Bank and UNDP microfinance projects; (2) a synthesis of microcredit impact evaluations; and (3) an evaluation of a European Union programme in Africa, the Caribbean and the Pacific.

Rosenberg's evaluation covered 66 UNDP microcredit projects (almost all funding retail credit activity) that were active in 2003 or had ended in 2001 or 2002, and 69 lines of microcredit approved by the World Bank<sup>15</sup> between 1993 and 2002 (Rosenberg 2006: 3). The evaluations focused on levels of loan repayment and cost recovery (since these were easier to measure than client welfare). They revealed a disappointing picture: in both agencies, less than a quarter of the projects that funded microlending were judged successful. The rest failed, or appeared unlikely to produce long-lasting results, i.e. retail institutions and programmes that could continue to offer clients quality financial services over the longer

term without losing their capital and needing continuing infusions of money from governments or development agencies (*ibid.*: 1). In both agencies, Rosenberg attributed the problems to agency environments and systems that did not give staff the right incentives, information and resources for microcredit (*ibid.*). The report noted that both agencies had made changes in response to the findings.

DANIDA's<sup>16</sup> synthesis of microcredit impact evaluations is a little more recent (Kovsted *et al.* 2009). In contrast to Rosenberg's evaluations, these studies do focus on the impact of microcredit on poverty reduction, measured in terms of consumption and income. The evaluations reviewed in the synthesis comprised: those in peer-reviewed international journals; those by NGOs; and those by both bilateral and multilateral donors (*ibid.*: 5). The latter comprised 23 impact evaluations and five surveys (*ibid.*: 19). Most of the studies included were from either South Asia or Latin America, reflecting the prevalence of microcredit in those regions. With the exception of one study, the impact evaluations conducted by bilateral and multilateral donors found positive effects of microcredit on household income or expenditure (the positive effects were even more significant for evaluations by NGOs) (*ibid.*: 31). [This was in contrast to the peer-reviewed journal studies which found more ambiguous effects.] However, the donor evaluations found that the microcredit programmes never reached the stated target audience of the poorest of the poor – suggesting that they benefit the wealthier more (*ibid.*). The report also notes that microcredit programmes continue to rely on donor subsidies (*ibid.*: 38).

The final evaluation assesses the performance of the European Union's African, Caribbean and Pacific (ACP) Microfinance Programme, which ran from 2005 to 2010 (European Commission 2012). The programme focused on capacity building and good practice dissemination across the ACP regions, and deployed a total of €15m (*ibid.*: i). Overall, the evaluation concluded that the programme clearly contributed to progress in the ACP microfinance sector, in terms of building capacities of MFIs and also, in particular, of strengthening the knowledge and practices of the overall microfinance community. However, this overall positive assessment was somewhat tempered by the fact that long-run sustainability was questionable for some programme results. In particular, the evaluation found that second-tier

14 [www.ifc.org/wps/wcm/connect/industry\\_ext\\_content/ifc\\_external\\_corporate\\_site/financial+institutions/resources/the+world+bank+group+and+microfinance](http://www.ifc.org/wps/wcm/connect/industry_ext_content/ifc_external_corporate_site/financial+institutions/resources/the+world+bank+group+and+microfinance)

15 As well as funding credit lines, the World Bank also supports microfinance through policy work and technical assistance, but these activities were not included in the evaluation.

16 Danish International Development Agency.

**Table 2: Financial system levels and role of donors and investors**

	<b>Level of the financial system</b>	<b>Role of donors and investors</b>
<b>MICRO LEVEL</b>	A wide range of financial and non-financial institutions, including NGOs; savings and credit cooperatives; private and state-owned banks; postal banks; member-owned community organisations; non-bank intermediaries, such as finance or insurance companies; and other suppliers (moneylenders, agricultural traders, etc.). The micro level is the backbone of the financial system.	Strengthen financial service providers to achieve financial sustainability, which is essential to reach significant numbers of poor people and to realise long-term social returns, support experimentation, and provide capital to expand the reach of retail financial institutions when the supply of commercial financing is limited.
<b>MESO LEVEL</b>	Locally available market infrastructure and services, including auditors, rating agencies, networks and associations, credit bureaus, transfer and payments systems, and information technology and technical service providers.	Strengthen the capacity of meso-level actors and extend their services to microfinance – include microfinance in the mainstream, rather than marginalise it.
<b>MACRO LEVEL</b>	A conducive, stable macroeconomic and policy environment provided by the appropriate government entities.	Support interest rate liberalisation, inflation control, and prudential regulation and supervision of deposit-taking institutions. Donors should not support the direct provision of credit by governments.

Source: CGAP (2006: ix).

MFIs and networks would have difficulties because of their need for ongoing grant and technical support.

The literature shows a clear tendency to attribute at least some responsibility for the shortcomings of microcredit (discussed in Section 2) on the donor agencies which have promoted MFIs, in particular the World Bank. Milford Bateman is a long-standing critic of microfinance as a mechanism to bring about poverty reduction. In a 2017 paper, he targets the World Bank, accusing it of pushing microcredit and thereby of failing the poor. He cites the example of Cambodia, which saw:

expansion of microcredit after 2009 thanks to a flood of foreign investment and technical support, including that provided by the Bank and its private-sector arm, the International Financial Corporation (IFC). The IFC has, rather opportunistically, made a major capital gain from taking an equity stake in ACLEDA, the country's largest microcredit institution. Yet ultra-rapid growth driven by

spectacular profitability has brought the sector to the verge of meltdown, and the Cambodian government has been forced into taking a series of aggressive and costly measures of late in order to limit the inevitable damage (Bateman 2017: 3).

In the context of this review, which is interested in whether microcredit can combat high-interest informal lending, it is important to note that this is not mentioned as a performance indicator or outcome in any of the impact evaluations of donor microcredit programmes. As outlined above, these are judged either on the basis of MFI financial sustainability (cost recovery), or on a client's income/expenditure.

### 5.1.2 Good practice guidelines

The Consultative Group to Assist the Poor (CGAP) was set up by the World Bank in 1995, initially as a three-year initiative.<sup>17</sup> Still going, CGAP is a global partnership of 30 leading development organisations

17 [http://siteresources.worldbank.org/INTEMPowerment/Resources/14872\\_CGAP-web.pdf](http://siteresources.worldbank.org/INTEMPowerment/Resources/14872_CGAP-web.pdf)

that works to advance the lives of poor people through financial inclusion. Members include the World Bank, UNDP, UK Aid, Global Affairs Canada, USAID, the European Commission, and the Bill and Melinda Gates Foundation.<sup>18</sup> Table 2 summarises the role that donors and investors can play at each level of the financial system in relation to microfinance according to CGAP.

CGAP (2006: i) has developed good practice guidelines on microfinance for donors. Those directly relevant to microcredit are as follows:

- **Microfinance means building financial systems that serve the poor. Microfinance will reach its full potential only if it is integrated into a country's mainstream financial system.**
- **Microfinance is about building permanent local financial institutions that can attract domestic deposits, recycle them into loans, and provide other financial services.**
- **Microfinance can pay for itself, and must do so if it is to reach very large numbers of poor people. Unless microfinance providers charge enough to cover their costs, they will always be limited by the scarce and uncertain supply of subsidies from donors and governments.**
- **Interest rate ceilings hurt poor people by making it harder for them to get credit. The cost of making many small loans is more than making a few large ones. Interest rate ceilings prevent MFIs from covering their costs, and thereby choke off the supply of credit for poor people.**
- **The job of government is to enable financial services, not to provide them directly. Governments can almost never do a good job of lending, but they can set a supporting policy environment.**
- **Donor funds should complement private capital, not compete with it. Donors should use appropriate grant, loan, and equity instruments on a temporary basis to build the institutional capacity of financial providers, develop support infrastructure, and support experimental services and products.**
- **The key bottleneck is the shortage of strong institutions and managers. Donors should focus their support on building capacity.**
- **Microfinance works best when it measures – and discloses – its performance. MFIs need to produce accurate and comparable reporting on**

**financial performance (e.g. loan repayment and cost recovery) as well as social performance (e.g. number and poverty level of clients being served).**

- **Microcredit is not always the answer. Other kinds of support may work better for people who are so destitute that they are without income or means of repayment.**

## 5.2 Support for CBFOs

### 5.2.1 Donor programme evaluations

Rosenberg's evaluation of World Bank and UNDP microcredit programmes included support for community-managed revolving funds, i.e. CBFOs. He found that these were increasingly popular but, despite having easier standards than those for MFIs, had low ratings. Fourteen UNDP projects were revolving funds, of which not a single one got a 'Good' rating; the World Bank had 23 such projects of which only one was rated 'Good' (Rosenberg 2006: 5–6). For both agencies, loans to group members were financed mainly by an upfront capital injection by a donor or government. 'This kind of project practically never works well: most of the revolving funds don't revolve for very long, because defaulters expropriate the resources that were meant to fund lending services for all group members over time' (*ibid.*: 6). He cites a subsequent CGAP study of 70 revolving funds financed by various agencies, which produced similar results (*ibid.*). The only successes were found in savings-based groups and self-help groups. In the former, members lent out funds raised through their own deposits, rather than external funds, and hence were more careful with lending and collection. In the latter, groups began by collecting and then lending out their own savings, but some later got external loans from formal banks – while some of these self-help groups worked well, the majority were weak (*ibid.*).

### 5.2.2 Good practice guidelines

Bateman calls for donor agencies like the World Bank to support CBFOs rather than commercialised MFIs:

The local financial system in the global South needs urgent change: it needs a reboot in the direction of community-owned and controlled financial institutions, such as credit unions, cooperative banks and municipal development banks, that by

18 [www.cgap.org/about/member-organizations](http://www.cgap.org/about/member-organizations)



design lock-in the priority to promote sustainable development and equitably serve the poor, not simply maximise profit for a narrow spectrum of already wealthy supporters (Bateman 2017: 4).

In providing support to CBFOs the following points need to be kept in mind (IFAD 2014a; Ritchie 2007):

- **Access to external credit** – Providing quick access to external credit directly to CBFOs as a means to help them grow faster can be counterproductive. Experience has shown that poorly designed access to external credit damages the CBFOs because it reduces the incentive of members to save, skews the emphasis of the institution towards borrowers rather than savers, leads to weakened credit analysis and leads to neglected loan recovery.
- **External support to manage the CBFO** – CBFOs are intended to be community-owned and managed, and having external professionals undertake these tasks undermines their ownership and sustainability. However, in the early stages, CBFOs do need help: hence support should take the form of mentoring and capacity building. Some limited gaps may need to be externally filled where high-level professional expertise is not readily available.
- **Making the CBFOs supply driven** – Donors supporting CBFOs can be tempted to provide large amounts of technical assistance and support. However, it is important to be realistic about how much assistance CBFOs can absorb, and not pressure them to absorb too much just to meet donor disbursement requirements.

- **Monitoring and evaluation** – CBFOs should not be exempt from monitoring and evaluation (M&E), regardless of their size and informal status. An M&E system with clear key performance indicators (KPIs) on outreach and organisational performance needs to be built into any support project at the outset. The precise indicators will depend on the type of CBFO and the level of formality. Informal CBFOs can report less frequently and performance can be managed at an aggregate level, compared to more formal CBFOs which will require individual performance management and frequent reporting (e.g. quarterly).
- **Second-tier organisations** – Given that donors will typically be providing support to small, scattered CBFOs, it would be prudent to work with an existing second-tier organisation (e.g. unions, federations, NGOs). This arrangement can provide economies of scale (reducing per unit costs of technical assistance) and scope (allowing standard operating procedures to be introduced across a large number of CBFOs). However, CBFOs may have to sacrifice some local identity and control in working with a second-tier organisation, and being both local and networked can be challenging for governance.

IFAD does not support the creation of new CBFOs but rather identifies existing CBFOs that are likely to be successful and builds their capacities and outreach (IFAD 2014a).



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*Section 6:*

# **CONCLUSION**

## 6 CONCLUSION

High-interest informal lending has long had a bad reputation, and this literature review confirms that it is indeed associated with many negative traits: coercion, violence, bonded labour, debt traps, and so on. However, the literature shows that it can also serve a positive role for poor communities, providing a ready source of credit when needed.

Of the three main approaches to combating high-interest informal lending – increasing access to (formal) credit, legislation, and debt relief – only the first has been tried on a significant scale. Literature on legislative efforts and debt relief was very limited and indicates, in the case of the former, that implementation has been weak. MFIs are widely established in developing countries, and have shown some success in poverty reduction, empowering women, and promoting micro-entrepreneurship. However, this review highlights significant shortcomings with MFIs, in particular, as they become more large scale and try to achieve financial sustainability. In the context of combating high-interest informal moneylending, the evidence indicates that microfinance is not always the best approach and can even exacerbate the problem – with people borrowing from moneylenders to make MFI

repayments. CBFOs avoid some of the shortcomings of MFIs, but have their own constraints, notably in the financial products they offer and scale of lending. Furthermore, the literature provides scant evidence of the impact of CBFOs on use of high-interest informal moneylending. Overall, this review highlights the need for more research on how high-interest informal moneylending operates in different contexts, and what interventions could be effective in combating it.

For donors, appropriate support for MFIs and CBFOs can help increase access to credit for poor communities and thus reduce the need to turn to high-interest informal moneylenders. However, as with understanding of high-interest informal moneylending itself, much more effort and resources need to be put into assessing the impact of diverse interventions such as microfinance and CBFOs, and learning and applying the lessons for future interventions. Donors also need to think ‘outside the box’, and design interventions that more directly combat informal moneylending. Support for MFIs, for example, is largely aimed at bringing about poverty reduction rather than specifically to combat informal moneylending. A more targeted approach, based on a thorough understanding of how the practice works and what drives it, will help donors make more effective responses.

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