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ABSTRACT

Since its development in 1976, microfinance has impacted the lives of millions of people around the world through the provision of small loans. Microfinance loans are primarily utilized to generate business income and reach personal goals, resulting in improved financial sustainability for poor individuals and families. As microfinance continues to expand around the world, many ethical issues arise in the quest to maintain sustainability and move towards a for-profit model. The major ethical concerns in microfinance relate to the transparency with clients, excessive interest rates and questionable collection policies. It is imperative to take these ethical concerns into consideration in the future development and growth of microfinance institutions.

MICROFINANCE IN THE MODERN WORLD

ISSUE IDENTIFICATION

The popularity and reach of microfinance has been increasing on a global scale, both geographically and in the quantity of loans distributed. Issues relating to sustainability and the move to for-profit business models create several ethical concerns within microfinance. The hidden fees, high interest rates, and alarming collection policies of many microfinance institutions highlight the ethical concerns in this expanding industry (Ghate, 2007). This paper will begin by discussing the history of microfinance and examining the major points in the development of the industry. Subsequently, the types of models in microfinance, as well as the advantages and limitations of microfinance will be discussed. A consideration of the ethical concerns arising from the limitations of microfinance, specifically transparency, high interest rates, and collection policies, will conclude the paper.

HISTORY OF MICROFINANCE

Microfinance is the provision of loans to low-income individuals who have limited funds and inadequate collateral to obtain financing through conventional loans. A major goal of these funds is to provide individuals with the ability to operate a business. Microfinance was initially developed in Bangladesh in 1976 by Muhammad Yunus (Campbell, 2010, pp. 1081-1090). Yunus, an economist and banker, offered small loans from his own income to poor women in Bangladesh, which ultimately led him to establish the Grameen Bank in 1983. Through his initiatives in economic and social development, he was awarded the Nobel Peace Prize in 2006 (Muhammad Yunus, 2011).

The Grameen model mitigates financial risk through implementing joint liability; funds are lent to a group of people instead of on an individual basis. Since all members of the group are held responsible for repayment, they are more likely to ensure that other members make payments, lowering the risk of default. The effectiveness of this model is depicted in Zambia, where only five percent of loans have defaulted, significantly lower than the US Small Business Administration rate (Campbell, 2010, pp. 1081-1090).

Modern Microfinance

Models in Microfinance

While microfinance was initially established through the Grameen model as a not-for-profit, for-profit models, such as Banco Compartamos in Mexico have become more prominent. For-profit microfinance models create controversy, as people question whether profits should be made at the expense of poor individuals (Campbell, 2010, pp. 1081-1090). As financial institutions became established exclusively for the provision of microcredit, institutions began to obtain funds through three major channels: deposits from clients (lenders), loans through commercial banks, and loans from foreign creditors (Mahjabeen, 2008, pp. 1083-1092).

Clients of Microfinance Institutions

According to Bayulgen (2008), a major goal of the Grameen model was to target women and act as a "liberating force in societies where women in particular have to struggle against repressive social and economic conditions" (p. 525). This goal of liberating women is advantageous in that it reduces their dependency on external support (Campbell, 2010, pp. 1081-1090).

Funds provided to clients generally consist of small, short-term loans for the purpose of working capital or to act as a small housing loan. The loans are generally provided as a group loan, which is a single loan provided to two or more clients or entrepreneurs (Mahjabeen, 2008, pp. 1083-1092). The size of microfinance loans in developing countries tends to be small in comparison to North American loans, usually ranging from US$25 to US$200 (Hertz-Bunzl, 2006, pp. 32-34).

Reach of Microfinance

Microfinancing has grown significantly since its inception in 1976, both geographically and through financial scale (Campbell, 2010, pp. 1081-1090). To date, microfinancing models have been implemented in 110 countries around the world (Craxton & Rathke, 2011, pp. 25-32). As a result of globalization, the number of microfinancing institutions has increased substantially (Mahjabeen, 2008, pp. 1083-1092). According to the World Bank, by 2006 direct and indirect impacts of microfinance reached over 30 million individuals around the world. It appears that current growth is sustainable, as microfinance institutions (MFIs) have only reached about four percent of their prospective market (Hertz-Bunzl, 2006, pp. 32-34). This growth, experienced even in financial downturns, resulted in many MFIs becoming public companies (Craxton & Rathke, 2011, pp. 25-32).

Individual MFIs have also experienced substantial growth. For example, Banco Compartamos increased from 60,000 to 800,000 clients, due to its transformation to a for-profit MFI (Campbell, 2010, pp. 1081-1090).

By 2009, approximately 1,955 MFIs existed having substantial loan portfolios in excess of 65.9 billion dollars in aggregate.. These loan portfolios are being held by over 91 million micro-borrowers (Craxton & Rathke, 2011, pp. 25-32).

ADVANTAGES OF MICROFINANCE

Microfinance allows for individuals who live in developing countries and are unable to obtain financing through traditional means to be extended credit. This credit is important for individuals, as well as underdeveloped societies as a whole. Not only does credit allow entrepreneurs to obtain the required working capital to run a small business, but it encourages them to become more self-sufficient (Campbell, 2010, pp. 1081-1090).

With a substantial amount of microfinancing loans being extended to females, these individuals can become more independent and provide more financial support to their families. Credit gives individuals a better opportunity to access technology, healthcare, and innovative farming techniques (Campbell, 2010, pp. 1081-1090). Evidence shows that the children of female borrowers are less likely to experience starvation or be exposed to diseases. Additionally, these children are less likely to be illiterate, due in part to increased access to education. With the development of MFIs, governments can work towards eliminating poverty, increasing employment and reducing the divide between the rich and poor (Mahjabeen, 2008, pp. 1083-1092).

MFIs often enhance the communities they operate in through the provision of various services. In addition to financial services, MFIs inform individuals about education, hygiene, and disease prevention (Mahjabeen, 2008, pp. 1083-1092).

MFIs offer additional benefits in countries where fraudulent government practices are common, such as in many African countries. MFIs can work towards theft prevention, allowing clients who are not served by traditional financial institutions to deposit money at a nearby location. Micro-loans have the potential to impact individuals in many ways, including helping borrowers attain their personal goals, such as receiving an education (Hertz-Bunzl, 2006, pp. 32-34).

With continuous technological advancements, MFIs have been able to further grow and expand operations. Certain MFIs, such as kiva.org utilize the internet to connect lenders and borrowers online (Campbell, 2010, pp. 1081-1090). The growth of the internet leads to increased competitiveness amongst MFIs. With increased competition, MFIs may provide more ethical services in order to maintain or expand their client base.

LIMITATIONS OF MICROFINANCE

As microfinance continues to expand throughout the world, several limitations of the model have been recognized. One notable limitation of the system, identified by United Nations Secretary-General, Kofi Annan, is that individuals who qualify for microfinancing may not have the necessary proficiencies and capabilities to succeed as an entrepreneur. This is a major concern, as individuals in developing nations may not have access to technology, adequate markets or counselling, which are a vital component in successful microfinancing operations (The Power and Limits of Microfinancing, 1999) and developing the necessary skills to succeed.

Another limitation of microfinancing models, as stated by the United Nations Capital Development Fund, is that only one percent of MFIs have developed into stable, selfsustaining operations. Since the majority of MFIs are not self-sustainable, this has resulted in high interest rates and fees in an attempt to reach financial stability. It is difficult for MFIs to establish an appropriate interest rate that allows them to meet all of the organizations' operating expenses. While this is applicable to both not-for-profit and for profit models, it is especially apparent in the for-profit model of microfinance (Hertz-Bunzl, 2006, pp. 32-34).

For MFIs to operate successfully, collateral must be obtained on the loans. In developing countries, collateral options are limited, often coming in the form of a farm animal. This poses a challenge for MFIs, as collateral in the form of goats or cows is difficult to collect. If loans are not paid and collateral cannot be collected, the number of new loans that can be distributed becomes limited (Hertz-Bunzl, 2006, pp. 32-34).

A further issue with the current microfinancing system is that clients must travel to the institution to make payments. Since this travel time for the micro-borrowers is very costly, resulting in lost productivity, MFIs may have difficulty obtaining collections if they are not strategically located (Hertz-Bunzl, 2006, pp. 32-34).

The limitations of the microfinancing models lead us to identify several ethical concerns.

Ethical Concerns in Microfinance

Microfinance provides many benefits for the micro-borrowers they finance; however, the system also has many limitations as previously discussed.. Opinions diverge in regards to the impact of microfinance on developing societies. Some propose that microfinance acts a as a “micro-band-aid” (Campbell, 2010, pp. 1081-1090), and putting poor individuals in debt results in more complicated economic problems in the future.

Those who advocate for microfinance believe that the development of MFIs results in sustainable progress. Supporters of microfinance believe that temporary aid in the form of microfinancing will lead to an increased level of productivity through entrepreneurial practices and growth. As productivity spreads, individuals are able to pay back their debt, with excess financial growth being reinvested, saved, or invested (Campbell, 2010, pp. 1081-1090). Regardless of which opinion on microfinance is correct, there are numerous ethical concerns underlying MFIs and microfinance practices around the world. The most significant ethical issues are discussed below.

TRANSPARENCY

Transparency is a significant issue in microfinancing institutions around the world. In many areas micro-borrowers are not aware of the hidden costs or repayment periods and the effective interest rate is often much higher than they expect. For example, in Indian MFIs in the Krishna district individuals who prepaid loans to obtain a larger loan were charged with interest on the new loan, in addition to interest on the prepaid loan for the entire period (Ghate, 2007).

Several microfinancing institutions, with a major concentration on growth, forgo transparency with their micro-borrowers at the expense of expansion. In addition to the lack of transparency, the focus on growth results in many MFIs not reinvesting for future sustainability. This lack of transparency was very evident in the Krishna district of India, where the government went to the extent of temporarily closing down MFIs. In this region, the lack of transparency required over 18 percent of micro-borrowers to obtain a loan from a moneylender to meet the payments for their MFI loan. Moneylenders are a type of financer that offer loans at relatively high interest rates for short periods of time; resulting in the micro-borrower paying interest on the loan from the MFI, as well as the loan from the moneylender. One of the major issues when MFIs focus solely on growth is that excessive loans are extended, with individuals unable to meet repayment terms (Ghate, 2007). Additionally, when striving for growth, MFIs may seek to extend credit to the largest amount of people, not necessarily the people who are right for the loan.

INTEREST RATES

Interest rates are a major ethical concern in the development of MFIs around the world. While the average interest rate on microfinancing funds is 26 percent, this rate changes considerably amongst different MFIs. While the Grameen Bank provides interest rates at ten percent annually, most MFIs exceed this rate. Banco Compartamos, for example, has annual interest rates at 73 percent (Campbell, 2010, pp. 1081-1090). This poses a significant problem, as many individuals in developing countries who obtain microfinancing do not fully understand interest rates or how interest rates impact their loan repayments (Craxton & Rathke, 2011, pp. 25-32); therefore, many individuals may enter into loans without realizing the extent of money they will have to repay in excess of the base amount of the loan. In comparison, prime rates in Canada over the past four years have averaged at or below three percent. From 1975 to 2009 the average prime rate was eight percent (Prime Lending Rate or "Prime Rate in Canada"). In addition to high interest rates, generally ranging from 25 to 55 percent annually, the effective interest rates at MFIs are further increased through a variety of repayment terms and extra costs (Craxton &

Rathke, 2011). Extra charges are applied to loans, including administrative costs, forced deposits, and forced savings. Forced savings occur when MFIs force individuals to leave a certain portion of the loan in their bank account, while charging interest on the full loan. Due to lengthy repayment terms, with individuals not allowed to repay loans early, the interest expense is further increased (Craxton & Rathke, 2011, pp. 25-32).

While MFIs imply their interest rates are lower than the other options provided to individuals in developing countries, such as moneylenders (whose interest rates often range from 100 to 200 percent), further analysis suggests otherwise. While moneylenders have higher interest rates, the loans tend to be for shorter periods of times. Alternatively, MFIs offer lower interest rates than moneylenders, but the inability for early repayment and long loan terms make the overall cost of lending quite high (Craxton & Rathke, 2011, pp. 25-32).

Collection Policies

The procedures used by some MFIs to collect loan payments from micro-borrowers is quite concerning. For instance, in the Krishna district of India, some micro-borrowers were believed to have left their homes, while others committed suicide due to the repayment practices of MFIs (Ghate, 2007). In India alone, approximately 80 individuals were reported to have committed suicide due to repayment pressures (Craxton & Rathke, 2011, pp. 25-32). Some of the repayment practices utilized by these MFIs include significant fines and compulsory attendance at meetings (Ghate, 2007).

The practices listed above are utilized by many MFIs; however, the MFIs in the Krishna district also employed other more questionable practices. In these areas, individuals' overdue payments were applied against security deposits, weekly meetings were held in front of the home of the person who had defaulted on a payment, and MFI employees were reported to have sat outside of the home of the defaulter. Additionally, MFI employees used offensive language when speaking to micro-borrowers who had late payments. Another threatening practice exercised by MFIs in the Krishna district was to post ‘loan overdue’ notices by the homes of defaulters to further embarrass them (Ghate, 2007). In developing nations the utilization of these tactics has a huge impact on the emotional stability of micro-borrowers and their perception within the community.

GROUP LENDING

In excess of 90 percent of people in developing countries lack access to credit facilities, making it difficult for individuals to operate businesses and become self-sustainable. In order to combat this, many MFIs utilize a group lending policy, which incorporates joint liability to improve collection rates (Woolcock, 1999, pp. 17-42). Joint liability occurs in group lending practices, where the whole group is responsible for repayment; if one individual defaults on a loan, the group is responsible for making the payment (Ghate, 2007). Group lending acts as a form of ‘social’ collateral for MFIs; while it has the advantage of increasing the repayment rates it puts a lot of pressure on the micro-borrowers. Group lending has the potential to destroy family and friend relationships, with many MFIs not loaning additional money until all individuals in a group have paid off their debt (6 Ethical Concerns in Microfinance: Not as Simple as it Looks, 2010).

IMPACT ON THE BUSINESS ENVIRONMENT

MFIs have difficulty finding the balance establishing interest rates to meet the operating needs of the organization. Even with high interest rates and questionable transparency among clients, the majority of MFIs have difficulty developing and maintaining self-sustainable operating practices without financial support from outside sources. A major issue of sustainability is that MFIs offer many loans of smaller scale, resulting in high administration costs. In order to develop sustainable growth, operating costs will need to be managed effectively. MFIs are financed through investments and public commitments; in 2009, 3.2 billion dollars in funding came from cross-border funding, while a total of 21.3 billion dollars was committed to microfinance in the year. With all of the funding and subsidies, it is believed that only five percent of MFIs would exist without the external funding (Craxton & Rathke, 2011, pp. 25-32).

As more MFIs become for-profit, the related investors and shareholders will expect a reasonable return on investment (Craxton & Rathke, 2011, pp. 25-32). This moves microfinance from a method of creating a sustainable future for the poor to a profit-generating institution that seeks to make money off of the poor. As MFIs continue to gain popularity around the world, measurement tools to evaluate the effectiveness will help determine the most appropriate models and procedures.

FUTURE RESEARCH

Microfinance is becoming more and more relevant in society due to the substantial growth within the industry. Since microfinance is a relatively young industry, there are still numerous areas to be researched and developed. Some areas for future research include establishing the difference between the types of microfinance models (for-profit and not-for-profit), and identifying whether any differences are substantial. Additionally, more research could be conducted on whether not-for-profit microfinance models are inherently more ethical than for-profit models. There are a variety of ethical concerns relating to microfinance in developing countries, therefore, it will be vital to research and develop the most appropriate types of regulation for the industry. This regulation may be developed by a stand-alone regulatory body or a regulatory body already in existence; however, it should have the ultimate goal of eliminating the ethical issues, while allowing for self-sustainable practices.

SUMMARY

Microfinance has impacted millions of people in developing countries since its development by Yunus in 1976 (Muhammad Yunus, 2011). As MFIs continue to expand and develop throughout the world, the majority of the institutions are not self-sustainable. Sustainability issues, in addition to the move to for-profit organizations lead us to question the ethical standards used by MFIs (Hertz-Bunzl, 2006).

The significant ethical issues associated with microfinance, such as transparency in lending, excessive interest rates, questionable collection policies and group lending have a huge impact on developing nations. Moving forward these ethical concerns must be analyzed, to balance the related benefits and limitations. In the future, if MFIs continue to move towards a for-profit model and growth is a primary concern, an appropriate course of action must be taken to instill sufficient regulation to protect the interests of poor individuals and developing countries as a whole.

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