The Reason to Pay Back:

Elements Contributing to the Success of Microfinance in Developing Nations

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Over the past thirty years, activity in the microfinance industry has seen a dramatic uptick. This has come with an impressively successful rate of return, specifically in the area of microlending. Considering that these microloans are made to borrowers without any requirement of collateral by the lending institutions, the highly successful rate of return is quite intriguing when compared to finance in the Western tradition. The idea that people can be given money and be trusted to pay it back in full, plus interest, on the agreed-upon deadlines is foreign to Western society. According to the prominent microfinance institution (MFI), Bangladesh Rehabilitation Assistance Committee (BRAC), 94% of the clientele meet their payments on time, and only 4% of the assets are currently at risk (Khondoker). From a Western viewpoint, such a small level of risk is unimaginable. How, then, can such trust be met with such reaffirmation? Why do clients of these microloans pay back?

In viewing the success of microlending, several social factors stand out. These factors affect both who is selected to qualify for the loans, as well as what motivates the selected individuals to meet their scheduled payments. These factors stem from the general pressures of living within a small, tightly knit community to maintain the respect of one's neighbors. This pressure, combined with the efficiency with which the MFIs structure their payment methods, result in the success and thriving nature of today's microfinance.

Primary sources and much, but by no means all, of the research contained in this examination will be from, and relate to, the central east African country of Uganda. Uganda is considered one of the most successful examples of the microfinance industry at work on the African continent (Carlton 10).

The economic state of Ugandan people makes them prime candidates for the services of microfinance. Because microfinance deals in small monetary amounts, clients of MFIs must be in an economy where, due to high poverty levels, these small amounts still have buying power. Such economies are primarily occupied with the activities of "micro and small enterprise (MSEs)" (Carlton 12). For Uganda, about 80% of the firms are considered to be MSEs, and only around 10% are labeled as large firms with annual sales surpassing $500,000 USD (Carlton 12). In the nation's capital, Kampala, 80% of business activity is estimated to take place within the informal sector, predominantly composed of self-employment (Carlton 12). Additionally, 31% of the population is considered below the national poverty line of approximately $1 USD per day (Khondoker).

The microfinance industry, while relatively new, has done quite well in Uganda with a clientele base of approximately 150,000 (Carlton 15). Many of the institutions in Uganda are within reach of, or have already obtained, financial sustainability (Carlton 10). "A series of impact studies conducted in Uganda in the past years have demonstrated that the provision of microfinance services contributes to reduced client vulnerability to economic risks, results in strengthening linkages of clients and their households to the agricultural sector, and enables clients to acquire valued skills" (Carlton 10). As a successful operation, analysis of its qualities and the general conditions by which it operates is helpful in gaining a basic understanding of how the microfinance industry as a whole has been successful.

To understand the reasons why microfinance clients are so remarkably reliable in making their repayments, it is important, first, to understand the methods by which MFIs determine who qualifies for the loans and the way in which they allocate the money. Within the Grameen model,[1] a group of five persons comes together and submits themselves to the bank. Each member of the group must complete a minimum of seven days of education on the bank's policies and pass an oral examination to demonstrate his or her understanding of these policies. The underlying idea, aside from ensuring the clients comprehensively understand the terms of the arrangement, is that the effort required in the process will discourage those who are not truly in need of the loans from applying (Yunus 63-64).

However, the Grameen model is not without problems. Having the groups form on their own does present some issues, especially in attracting and holding female clientele. Due to the more conservative and male-focused social order of many of these counties, women are often discouraged from seeking financial independence. Countries with strong Muslim cultures abide by the *purdah*. The *purdah* dictates cultural practices based on the teachings of Quran with the intent of preserving the "modesty and purity" (Yunus 74) of women. In extreme cases, women are restricted from going out in public or being seen by any man who is not an immediate relation (Yunus 74). As a result, the level of courage and initiative required to convince and organize four other women to deviate from these strict, dominating social norms would often deter women from seeking out loans from Grameen (Yunus 63).

This hesitance is particularly problematic because women are often the preferred customers when it comes to offering microcredit—ironically enough, because of these same cultural standards. These societies place a heavy emphasis on women to obey authority figures and to never deviate from their duties. As a result, women are generally more honest than their male counter-parts. If bank authorities tell a woman to show up at a certain time with a certain amount of money to repay her loan, she will do it (Bitature).

[1] The Grameen model was developed by Muhammad Yunus in Bangladesh in the late seventies and early eighties. It is largely considered the originating innovation of modern microfinance.

One such case of female obedience involved a young girl named Momma Jessica. Her immediate family had all been killed due to AIDS and she was staying with relatives. Her relations required that Momma Jessica make some contribution to the family in order to compensate for her room and board and demand that she find a source of income. Momma Jessica had no education or training of any kind. However, she was very good at making chapati, a thin flatbread similar to a tortilla originally from India and popular in Ugandan cooking. She applied to a MFI to receive a loan equivalent to about $100 USD in order to start her own business making and selling chapatti. The bank manager explained to her that she needed to make weekly payments of 70,000 Ugandan schillings (~$35 USD) every Friday. Momma Jessica was able to start her own chapati business and returned to the MFI every week to make her payment without fail (Bitature).

Whereas his wife's life is based around tending to the daily wants and needs of the family, men of these societies are free to live a very independent lifestyle. Without much social obligation to tether him, these men gain a rather self-focused perspective of the world, and their decisions are more often made in their own interest. This self-focus is intensified in cultures such as Uganda where polygamy for men is condoned. Men with multiple families have a larger group to spread their attention among. There results a certain level of detachment on the part of the father from the family unit. The woman has only one family and is primarily responsible for raising and caring for her children. When it comes to receiving a microloan, the woman will invest that money into a business of her own as a means of providing for her children (Kayizzi). The average Ugandan MFI client is a married woman ranging from 30 to 39 years of age with seven children under her care (Carlton 19).

A similar group, BRAC, which has five branches throughout Uganda, follows a method it describes as the "target group approach" (Khondoker). The bank workers first travel out to the villages and meet with the village elders to discuss which members of the community would qualify for the loans. They ask the elders which villagers are in need and which are already working with other MFIs. Bank personnel determine a person's level of need based on BRAC's poverty score card. This assesses applicants based on personalized criteria, such as the number of goats they own, whether they have shoes, and/or how much land they have for farming. The institution makes no effort to advertise its services or encourage people to seek out its services. Instead, by seeking out clients in lieu of advertising, the bank better ensures that only those who will be approved are considered for a microloan (Khondoker).

In speaking with the village elders, bank employees gain an understanding of the community culture and which individuals can be considered trustworthy. Because the clientele have never had access to any kind of documentable financial activity, a kind of informal credit score is developed based on a person's social rather than financial history. This need to comprehensively understand the dynamics of a community is the reason why MFIs cater to smaller, tightly knit communities. These rural villages tend to have high levels of social capital and close, frequent interactions among their residents.

Mr. Ibrahim Kayizzi and Mr. John Guweddeko are farmers and prominent figures within their village of the Kasawo Township. Kasawo, as a whole, has a population of approximately 30,000 people, but it is subdivided into five village structures (Kayizzi). As a result of the small population, people generally know each other and their reputations very well. They develop close relationships and a sense of family. Both Mr. Kayezze and Mr. Guweddeko described the importance of the family structure in their community. At the time of their interview each man was caring for their many grandchildren, putting them through school and seeing to their raising (Kayizzi). Mr. Guweddeko, likewise, following the death of his father, was raised by his grandfather, who ultimately paid for Guweddeko's college education in agriculture (Guweddoko).

The two explained that, apart from the strong multi-generational family ties that exist, the villagers band together in raising the children. Were a child to act out in a delinquent manner, a resident would see it as their duty to discipline the child, even if they may not be biologically related to him or her (Guweddeko).

Because of this sense of close-knit communal family, community members place great importance on maintaining one's reputation and a certain level of honor. Were a person to seriously disgrace him or herself to the community, he/she would almost certainly be ostracized from the society. Once trust is lost, the person is completely rejected from the society. He/she will never be given any position of responsibility or power and will have tremendous difficulty in finding a spouse (Kayizzi). In ruining his/her own reputation, the individual also stains the reputation of his/her family. The person's offspring will have great difficulty in finding spouses (Kayizzi). This damaged reputation will follow the disgraced person for up to 20 miles in every direction from the village (Guweddeko)—which, when considering the lack of modern transportation and subpar road conditions in Uganda, is a great and rather inescapable distance.

MFIs that practice group lending use this honor-driven aspect of the culture in selecting or approving group members to receive loans. By relying on the village residents to designate which individuals can be trusted, they ensure that their loans are given to honorable, reliable persons. The village residents are incentivized to nominate truly trustworthy people as a part of the group so they can rely on them to pay back their portion of the payments and not leave slack for the others to pick up.

The group structure is an important part of the microfinance industry and the reason behind many of the motivations for microcredit clients to meet their payments. Group members have each other to rely on in times of unforeseen tragedy as a kind of support system (Yunus 62). Because each member has a vested interest in the success of the other members, in the event of an injury or illness in the family of one of the members, the other members will often help that member run her business (Guweddeko). This openness and sharing creates a strong family-like bond amongst the members.

At the same time, the group works as a system for accountability. It relies on the before-mentioned social pressures of preserving one's reputation within the community. Members of a group live in the same small villages as the other members. Members see each other on a frequent and regular basis. They know where each member of the group lives. They are easily capable of checking in with the others to see how everything is going and if the week's payment is going to be met. A type of group peer pressure is developed, strongly discouraging any member from defaulting on her payment less they face a horrific shame (Nabeta); the pressure not to disappoint others who are closely and personally bonded to them is immensely powerful.

This group dynamic is so essential to the microfinance industry that it has become the general practice of the industry. Though some MFI's will grant individual loans, they do so only after a person has first established herself with the institutions as a reliable and trustworthy person through her time as part of a group (Khondoker). This is also a primary difference with the practices of Western banking. MFIs make a great effort to establish personal connections with and amongst their clients, whereas in the West, with its reliance on formal credit history, the relationships between lenders and borrowers have become impersonal and transactional. One could argue that this lack of human connection gives Westerns this guilt should they choose to default on a loan payment.

Apart from such social pressures, borrowers also feel pressure to maintain the trust they have established with MFIs and to maintain the privilege of their valued services. MFIs cater to people who do not qualify for the services of a traditional bank. If the clients lose the MFI's trust, and thus lose access to the MFI's services there are no other comparable options. In maintaining this trust, clients have the incentive of being able to receive future loans, with possibly larger principals (Nabeta). Recipients are concerned more with having access to financing than with the requisites and obligations of repayment.

This reverence toward access is particularly prevalent among women who have spent much of their lives within their culture as second-class citizens. Most of these women have never even seen as much money as they receive in these microloans, let alone been trusted to handle it. It is uncommon for these women to be entrusted with such responsibility and they see it as a great honor (Yunus 64-65). Normally, if a woman goes to a traditional bank requesting a loan, even if she is of a well-to-do family, the bank manager speaks down to her like a child and will not give her approval until he has determined that her husband has first approved of the loan (Yunus 71). The financial services provided by the MFIs are necessary for these women to properly care for their children—to afford to feed and clothe their children and put them through school. These women have so few means by which to seek independent financial action that they cannot afford to lose access to the MFIs.

The manner in which the MFI operates is dually important in eliminating default on these microloans—specifically, the manner in which the payments are collected. Most MFIs require their clients to make weekly payments (Khondoker). According to MFI workers, the difficulty in successfully implementing a more traditional monthly payment schedule has, in large part, to do with the way such loans are perceived by clients. Due to a lack of immediacy in the loan payments and the clients' general inexperience with traditional finance, loans that are structured on a monthly schedule are often seen by clients as gift for which they are not really expected to repay (Khondoker).

However with a weekly payment schedule there are several advantages. The week offers enough time for some flexibility in the client's business while being short enough a time span for the payment to remain forward in her thoughts and keep her reminded of her obligations. It is not a deadline that occurs so frequently that payments are viewed as a burden, nor is it some far off duty that it can be ignored or forgotten (Nabeta). The clients of these MFIs often live lives of hand-to-mouth. They do not have the comfort or the assurance that their short term needs will be met. Their focus is on solving the problems of the moment and meeting their current needs in order to make it through to the next day. A month requires far too much long-term planning and saving for people who have grown up with little to no financial education. They have never had a need before to understand long-term finance, and for them to suddenly enter into the terms of a long-term loan would be too drastic a shift. Many of the MFIs offer resources to better educate their clients on concepts regarding more long term planning, but, in the beginning, clients have a very limited understanding of these concepts.

Another advantage of using a weekly payment schedule is the size of the payments that are made. Because there is a higher count of scheduled payments, each individual payment is significantly smaller than if it were monthly payments. These smaller payments are psychologically more agreeable to clients (Nabeta). It is easier for a person to part with these smaller amounts than larger lump sums. The total payment is spread out and perceived as less significant. At the same time, less pressure is placed on the client to meet the payment. Smaller amounts are (or are at least are perceived as) more manageable.

Psychologically, the weekly payment schedule is similar to the example of the daily cost of a cup of coffee. Most Americans will stop by the nearby Starbucks or local coffee shop to get their daily caffeine fix before heading off to work for the day. The overwhelming majority would never think twice about paying $3.50 USD or so per cup, because it is a relatively small amount of money and the caffeine is often really needed. However, people would likely be considerably more resistant if, at the end month, having delayed the payment, they would be met with a bill upwards of $105 USD. Some might even rethink their caffeine-fueled lifestyle.

The more successful and effective MFIs take additional efforts to assist their clients in making weekly payments. In developing countries, it is very difficult for the majority of citizens to travel. In the case of Uganda, road infrastructure has been significantly neglected, and few within a village have access to an automobile. To counteract this difficulty, institutions send employees out to the villages to collect payments (Nabeta). This is feasible to those institutions employing group lending practices. Each visit puts the MFI employee with a number of clients. MFIs are thus able to improve repayment rates through this convenience without running a deficit on operations.

As part of the weekly payment requirements, BRAC requires that its clients, in making their weekly payments, also attend group education sessions with the other members. Each group meeting is tailored to the members' needs and their businesses. Classes are provided on subjects relevant to businesses of the membership. BRAC offers training programs on agriculture and farming techniques (64,000 participants), health related matters (1.6 million participants), and livestock handling and care (19,620 participants). The organization has also made efforts to build and organize silos within reach of their clients and other area farmers so that locals can have the benefit of storing their grain. This gives farmers some ability to time the market and wait to sell when prices are their most optimal (Khondoker).

BRAC is one of only a few institutions in the increasingly commercialized industry of microfinance whose focus extends beyond servicing the company's finances. Microfinance has surprisingly become a very profitable business. Default rates are generally below 5% and monthly interest rates compound to approximately 22% annually. Growth in the industry has extended access of financial services to many individuals in desperate need and forced MFIs to compete on the quality of these financial services. However, few MFIs today operate from the mindset of serving the community as a charitable nonprofit. Institutions like BRAC not only aim to provide their clients with financial services but, also, to move them out of their impoverished state and into a financial secure and prosperous state.

In a more cynical interpretation, one might say that, in ensuring the growth and longevity of their clients' businesses, BRAC is simply protecting its investments. In a way this is true; with more prosperous businesses, clients are more able and more willing to meet their payments. But, while the services BRAC extends in aiding its clients help the clients afford the weekly payments, it also helps the clients break free from a multi-generational cycle of poverty. Hopefully as the industry becomes more competitive, more MFIs will begin to place a similar importance on customer service.

Western critics often express a concern with MFIs for charging an interest rate that often compounds to ~22% annually. Many critics suggest that the practice is exploitative, especially when considering that the only other viable option for financing are the local moneylenders who serve as kind of loan shark, charging 22% interest monthly (Khondoker). Realistically, the borrowers' limited options make them more amenable to the relatively steep terms.

To understand the higher interest rates, it is useful to examine the situation from the position of the lender. The institutions offer loans to clients without requiring any show of collateral. Despite the societal factors previously discussed, the lender assumes significant risk and places itself in a financially vulnerable position. The trust MFIs extend their clients is a commodity in its own right, and its cost must be compensated.

Also, one must consider just how much 22% of a microloan actually is. One of the largest difficulties that all MFIs struggle with is covering even their most basic costs of operation with the interest of such small principals. The reason these interest rates are not the same as the interest rates in Western culture is because the loan principals are not the same as the loan principals of Western culture. The higher rate is necessary for MFIs to operate so that they can continue to offer their services.

Second, it is important to understand the borrowers' position and the nature of their businesses. These are not sophisticated business structures. The capital expenditure for them is remarkably low. For nearly all of these businesses, all that is needed is a table or mat to display goods, a chair for the person to sit in, and maybe an umbrella for some shade. The rest of the loan goes to purchasing supplies. With this style of operation, there is nearly no cost of overhead. The sizes of microloans only allow borrowers to purchase so much in supplies, and often business owners are able to sell their full stock in one day. There is no need for inventory storage costs. These businesses, on average, generate a 300% return on investment (ROI) daily (Nabeta).

One study involving a carpenter's wife demonstrates the increased earning potential generated by microfinance. The carpenter would give his wife a small sum of money, 15,000

Ugandan Schillings (USC) (~$7.50 USD), and she would go to the rural areas and buy 10 clusters of bananas at 1,500 USC per cluster. She would bring them back to the city and sell the whole supply within the day at 3,000 USC per cluster. For transportation, her costs amounted to approximately 2,000 USC per day, and the cost of leasing the space for the shop was 500 USC per day. While this business model had a solid profit margin, it limited the growth of the woman's business.

She later entered a MFI microlending group and received a loan of 100,000 USC (~$50 USD), with which she increased her weekly banana purchase to 15 clusters. Before, when the woman was limited to a supply of 10 banana clusters, she could only generate a profit of 375,000 USC (~$187.50 USD) within the month, but, with the extra money she received from her microloan, she was a able to nearly double her monthly profit to 600,000 USC (~$300 USD) simply by gaining the ability to purchase five more banana clusters (Nabeta).

The substantial impact microloans have in financially advancing the lives of their borrowers is a very important issue to understand in analyzing the reasons why microfinance borrowers pay back their loans. The interest MFIs require from their clients is remarkably insignificant compared with what the clients gain from receiving their microloans. If a person is able to generate a profit six times that of the initial loan principal, he/she is able to pay back the loan without any hardship. The benefit of the client maintaining the MFI's trust and continuing to receive their services far outweighs the cost of making small weekly payments.

When one brings together all of these factors—the social pressures of group lending, the lack of financial alternatives, the frequency and convenience of repayment, the tremendous benefit these services present—a very clear system of incentives and deterrents becomes apparent. The people that these MFIs cater to have been turned away by the traditional financial system and are, as a result, extremely limited in their options. The benefits they receive from MFI services drastically improve their wellbeing and promote them to a place of financial security and independence. This benefit is so great in the context of the clients' lives that the pressures placed on clients to make weekly payments, which are relatively small amounts, are significantly minimalized. Lower demands on the client justify the above market interest rates, which are necessary for MFIs to cover their costs of operation and continue to offer their services.

Alternatively, if an MFI client considers defaulting on her payment, she would be met with the before mentioned deterrents. Because MFI clients live in such small communities, social relations and reputation are important aspects of an individual's standing within the community. Borrowers cannot afford to tarnish the community's view of them. Otherwise they will be ostracized from society and trouble the advancement of the entire family. By requiring clients to enter into group loans with friends and neighbors, MFIs are able to use this social pressure to create a system of self-accountability within the group. It is then apparent that the success of these MFIs is the combined result of these social pressures of honor within the community, the methods by which MFIs select clients and encourage repayment, and the overall benefit to the clients in continual access to these financial services.

These dynamics are interesting when one sets them against Western finance and culture. If a strong sense of community is the root of much of microfinance's success in these developing nations, it is difficult to see how such programs could be implemented in the West. In the example of the United States, many authors have remarked on the decline of social community. In hi well known 1995 essay, "Bowling Alone: America's Declining Social Capital," Robert Putnam demonstrates how many of the luxuries of Western culture have led to a decline in social interaction (Putnam). Western banks require formal demonstrations of trust from their clients, because there is little in the way of informal trust to ensure that loans are repaid. In comparing Western practices to those of MFIs in developing nations, one could conclude that the reason the West has been unable to match the returns of MFIs has largely to do with this lack of community prevalent throughout Western culture.

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