Core Values of Microfinance Under Scrutiny: Back to Basics?

Reinhard H. Schmidt*

1 What I Want to Address

During the past decade, what has for a long time been called microfinance (henceforth MF) has changed in a fundamental way. The reality of MF has changed, the terminology has changed¹, the discourse about microfinance has changed, the reputation of MF with the general public has changed, and last but certainly not least the ethical foundations of MF have also begun to change. What has once started as a purely value-driven development aid activity has turned into a new field of business in which commercial values seem to play a much larger role than traditional ethical and developmental values. The various aspects of change are closely connected, and this interplay certainly merits a careful consideration. It is the purpose of this paper to provide a starting point for the discussion of how to assess these changes and whether such an assessment warrants rethinking the ethical foundations of MF and to provide a conceptual structure for this discussion.

Many participants from within the “microfinance community” and even more observers who look at it from the outside seem to believe that “the dark side of microfinance” has recently become visible, that the traditional model of microfinance has been discredited and “needs to be replaced by a new one”, that “heroes have turned into villains” and that even the entire concept of microfinance is ill-conceived.² The main reason for their change of view is related to the ethical underpinnings of microfinance. Recent developments suggest that this foundation is no longer as firm as it used to be. If this is really the case, what does it imply, and

* Professor, University of Frankfurt.

¹ From rural finance (in the 1970s and 80s) to microcredit (in the 1980s) to microfinance (in the 1990s and into the new century) to access to finance (since the middle of the 2010s) to, most recently, inclusive finance. In spite of these terminological modernizations, I continue using the term microfinance to denote the entire topic.

² The sources referred to are, respectively, Business Week (2006), FAZ (2011), Sinclair/Stanford (2012) and Bateman (2010).

would it require going “back to basics”, at least as far as the role of values or even the entire approach to MF are concerned?

During the past five years, developments in the reality of microfinance and the debate about microfinance go more to the roots than comparable debates of past decades. Before 2006, when Muhammad Yunus and his Grameen Bank were awarded the Noble Peace Prize, there were already lively debates about MF. However, they referred more to the question of whether the approach to microfinance that was epitomized by Yunus and his bank is more appropriate to reach given social and developmental goals than what has been called the commercial approach to MF. Today, in contrast, the goals or objectives and the values themselves are under debate.

The paper starts out in section 2 by discussing two different notions of value that play a role in microfinance. Then, in section 3, it addresses the goals or objectives of microfinance according to different views, taking up a debate that confronts the approach that Yunus and the Grameen Bank seemed to represent and the so-called commercial approach. Section 4 is dedicated to the question if and why the ethical orientation of MF may have disappeared. In section 5, I want to restate why I think that a firm ethical or value foundation of MF is still needed in spite of the advances brought about by the commercial approach, and how a microfinance institution (henceforth MFI) can try to make sure that it does not lose its value base even though it may seek access to the capital market. The concluding section 6 provides my answer to the question of the subtitle, that is, whether all of this suggests going “back to basics”.

2 The Dual Notion of “Value” and the Role of Values

2.1 Two Concepts of “Value”

The term “value” has at least two meanings. I want to call them Value 1 and Value 2, respectively. Both are relevant for MF, and as I will argue, it is important to understand how they are related and what their relative importance and their substance have been in different phases of the development of MF.

The concept of Value 1 is taken from standard economic theory. Generally speaking, something, which may be an action, a decision, a transaction or a firm or similar organization, creates value if it generates a flow of net economic benefits to a certain person or group of persons. Thus, claiming that “MF creates value” (Value 1) means that MF is, by some standard, economically beneficial to a somehow defined group of people.³

³ In a more technical sense, value (and thus Value 1) is defined as a stock measure that express the current value of a flow of benefits such as, for example, the net present value of the cash flows resulting from undertaking an investment. This concept goes back at least to the work of Irving Fisher (1904).

The concept of Value 2 refers to an ethical or social or political assessment. People's attitudes and conduct or certain activities or social institutions are candidates for being assessed as valuable in the sense of having or showing Value 2. For instance, an activity can be said to have Value 2 if it is guided by noble, possibly altruistic intentions or if it can be assumed to have positive consequences for some other people than those who undertake it. One can also apply the term Value 2 to certain motives and even to people whose conduct is shaped by these motives. Thus, the claim that "MF has Value 2" means that microfinance activity is inspired by the intention of people or organizations, such as development aid organizations, of benefitting others or creating Value 1 for others than those who undertake this activity and/or that it is good for some people that MF activities are initiated and implemented. Thus, Value 2 of those who fund or provide MF services is based on the assumption that MF benefits or creates Value 1 for those who will obtain these services.⁴

The main focus of this paper is on Value 2, since it seems that the formerly solid ethical foundations of MF, its Value 2 orientation, has eroded in the recent past. However, all debates about the ethical attractiveness and the ethical foundations of MF – i.e. its Value 2 – have always been closely related to controversies concerning the benefits that it really brings to people and nations, that is, to its Value 1. Thus Value 2 and Value 1 considerations are closely intertwined.

2.2 Why Values Matter in Economics, Business and Finance in General ...

Value-1 is at the core of economics, business and finance in general. It is generally assumed that all economic activity is driven by the aspiration to create benefits for those who undertake or initiate it and that competitive markets and the liberty to enter a contract have the function of transforming the individual agents' quest for their own advantage into benefits for all parties involved.⁵ The extent to which this transformation is successful depends on a number of conditions that are laid out in any economics textbook.

In the radical version of conventional neoclassical economics, the role of finance is largely neutral. Value 1 creation only depends on the availability of factors of production, technologies employed by firms and know-how available for the transformation of inputs into outputs and thus into economic benefits. Financial institutions and money facilitate welfare enhancing exchange between eco-

⁴ An attentive reader of an earlier version of this paper suggested using the terms "economic value" instead of "Value 1" and "ethical value" instead of "Value 2". I have decided not to adopt his suggestion because I consider Value 2 to also be an eminently economic concept that is linked to Value 1.

⁵ Under certain conditions, voluntary transactions even benefit an economy as a whole. As is well known, the idea goes back at least to Adam Smith.

conomic agents, but this role is considered not to be critical. Thus, there is no need for Value 2 in business and in finance.

In the perfect neoclassical model world, any consideration of fairness, equality, cultural advancement etc, is left to governments, possibly assisted by private philanthropy or charity. While for them Value 2 considerations are of central importance as a means of expressing collective or personal preferences, in the business world, Value 2 is largely irrelevant. Since markets are assumed to be perfect and deviating from unrestricted profit maximization would be sanctioned by economic extinction in the form of firms' bankruptcy, there is also no room for Value 2. As Friedman has said, it is the ethical mandate of firms to maximize their profit.⁶

However, the real world is not like the model world of neoclassical economics. Agents may not be completely rational and markets are not perfect. One of the reasons why markets are imperfect is the uneven or asymmetrical distribution of information between the parties which might enter into a contract. One party to a potential contract may have better information than the other one and the less informed party may be aware of his or her informational disadvantage and therefore refrain from entering into that contract.⁷ The second reason is that real-world contracts are almost never complete. Incomplete contracts leave room for later decisions, which the contract party that is better informed can use to her advantage.⁸ Broadly defined, institutions are sets of rules that shape agents' decisions by imposing constraints on the actions that people can undertake and by providing sanctions and rewards.⁹ To some extent, institutions serve to mitigate the negative consequences that may arise from the asymmetrical distribution of information and the incompleteness of contracts. Institutions include governments, courts, firms, laws and much more.¹⁰ However, not only markets are imperfect. Also governments, judicial systems and other formal institutions do not function perfectly and therefore cannot create an "ideal" world like the one that is assumed to exist in the model world of elementary economics textbooks.

Here, Value 2 comes into play. Value 2 considerations such as a commitment to fair behavior, honesty, a fair sharing of benefits or the desires to reduce other people's suffering and helping them to exploit their human potential have a dual function. One is akin to that of philanthropy and charity in conventional neoclassical economics: it is an expression of what some people want to see implemented in this world. The difference to the neoclassical model is that the imperfection of markets may leave room for these interests being put into practical action within

⁶ See Friedman (1970) as the standard source.

⁷ See, e.g. the textbook by Tirole (2006).

⁸ The fundamental ideas concerning the role of contract incompleteness are very well presented in Hart (1995).

⁹ This is the definition of "institutions" used by Douglass North (1991).

¹⁰ See e.g., Furubotn/Richter (2002) on the "new institutional economics".

the business world. The second function of Value 2 is that it creates additional constraints and incentives for action. In his respect, Value 2 is akin to institutions.

2.3 ... and Especially for Microfinance and Small Business Finance

For MF and its variants¹¹, value has always been of overwhelming importance. However, the relative importance of Value 1 and Value 2 and the specific content that they take on have changed over time. Therefore, a first step in characterizing their role requires a brief look at the history of microfinance. One can distinguish two periods in the development of microfinance. In the spirit of the name of this conference (“Towards Microfinance 3.0”), I call them MF 1.0 and MF 2.0. Alternatively, one could also call them traditional and modern microfinance, respectively.

What marks the transition from MF 1.0 to MF 2.0 is the advent of the concept of commercialization, which occurred towards the end of the 1990s. Initially, commercialization was understood to simply mean that a MFI should strive to cover its full costs and be financially self-sustaining and independent of donor support. In MF 1.0, cost coverage and financial self-sustainability were not considered as an issue, whereas in MF 2.0 it has become a central topic. It needs to be added that in the early years of MF 2.0, almost all MFIs were NGOs and their capital was mainly provided by foreign donor institutions, whereas in the later years, registered and regulated banks in the legal form of corporations became more important and to an increasing extent funding came from private investors.

In MF 1.0, Value 1 was almost exclusively understood as benefits for the clients of MFIs. Donors and local MFIs were assumed to intend creating Value 1 for their clients by making small loans at favorable terms available to them. The term “beneficiaries” that was typically used for the borrowers or clients at that time clearly indicates that benefitting others was the main concern of relevant aid donors. Even at the level of the local MFIs and possibly also of the foreign consultants who were involved in many cases, MF was assumed to be mainly motivated by an intention to help, a clear manifestation of Value 2.

During the MF 1.0 phase, one crucial assumption was regularly made: MF creates Value 1. Getting small loans from an MFI at favorable terms was seen as a benefit for those who were fortunate enough to receive these loans. Whether it really improves their lives was hardly ever asked.¹² While reaching and benefitting the target group members played the key role, hardly any concern was given to what the whole undertaking meant for the local institutions that were used as a

¹¹ Such as small enterprise or small business finance, inclusive finance etc.; see note 1 above.

¹² A second assumption underlying this approach was that being able to show that the earmarked development aid funds had really reached the so-called target groups was sufficient in terms of success for the donor institutions. Accomplishing what they were supposed to achieve constituted a form of creating Value 1 for them. But given the deep pockets of foreign donor institutions, this assumption was of lesser concern.

channel for the foreign funds, and for the people working in these institutions. More or less implicitly, it was assumed that they were also motivated by good intentions and thus by Value-2 considerations.

With the advent of the commercial approach in the mid-1990s, the relative weights and the specific forms and contents of Value 1 and Value 2 started to change. However, two things did not change. It was still assumed that MF would have the dominant purpose of creating Value 1 for clients and that it would indeed have this effect. Thus MF was still driven by the Value-2 consideration of foreign donors, consultants and local MFI staff.

The new element concerned the local MFIs that served as conduits for funds from foreign donors and lenders to poor local borrowers. It was now deemed not only legitimate but also important to assure that playing this role would strengthen the local MFIs as institutions or, in other words, that it would create Value-1 for the local MFIs as organizations.

In the early years of modern microfinance, most MFIs were NGOs in the legal form of a foundation or an association. But relatively soon, it became apparent that the legal forms of an NGO, and thus the lack of a true owner, was more of a burden than a blessing since it was no longer considered to be conducive to the overarching objective of benefitting certain target groups. Therefore, during the time between 1995 and 2005, several local NGOs were converted into corporations as the legal basis for an MFI that would be a more professional institution, and MFIs were converted into licensed and registered target group-oriented specialized microfinance banks.¹³ Only a little later, donors and consultants started to create microfinance banks “from scratch” or, as it is also called, as “greenfield investments”.

The newly created entities had owners who had invested capital, and what used to be distribution channels for foreign funds turned into genuine financial intermediaries. Several among them started to take deposits. All of this expanded the range of stakeholders who had claims to receiving some benefit, or Value 1, in return for their contributions. Value 2 alone was no longer considered to be enough to drive MFI activity. As was intended by the advocates of MF 2.0 and the commercial approach, the agendas and the operations of many MFIs became more and more shaped by Value 1 concerns for themselves. This was, by and large, a positive development, as without a stronger orientation to Value 1 for all parties, the new MFIs of the MF 2.0 era would hardly have been able to expand and provide services at a much larger scale and with much lower costs than those of the MF 1.0 era.

However, one should not overlook the role that Value 2 continued to play. Modern MF looks at transactions as voluntary deals that must create Value-1 for all sides of the transaction. But positive Value 1 for all parties involved is only a necessary condition for the development of MF. It is not a sufficient condition. Some Value 2 was also required for MF to continue being regarded as ethically

¹³ The technical term for this conversion was „upgrading“. See Nair/Von Pischke (2007) on the limited success of upgrading as a type of institutional development.

valuable and receiving the donor support that was still needed to get commercially oriented MFIs started, and the public support that backs generous donor funding for MF. Similar considerations apply to the people active in MF in their respective roles. Many of them have better-paid outside options for instance in conventional banks. Therefore one can assume that also for them Value 2 still played a role. Moreover, the underlying idea of the commercial approach is not that the interests of the clients should matter less, but rather that commercial microfinance can provide more benefit for the clients because it operates according to a different business model. Thus, over the longer period, the concern for Value-1 for clients and that for the interests of MFIs as institutions complement each other. This sounds like “perfect harmony”, but unfortunately this is not the whole story.

In the later part of the MF 2.0 era, private capital has become an essential element of MF, and this has in some cases led to severe negative consequences. Two such cases are particularly noteworthy: the IPO of the Mexican MFI Compartamos in 2006 and that of the Indian MFI SKS in 2010. I will discuss these cases in detail below. In both cases, a large part of the shares that were issued were taken up by private institutional investors.

As these two cases demonstrate, the intrusion of private investors, who can be assumed to be only interested in their own profit, into the domain of MF changes the relative importance of Value 1 and Value 2 as well as the substance of Value 1. At least in these cases, the interests of private investors, the creation of Value 1 for them, seem to have come to completely dominate the former interest in the Value 1 creation for clients or target groups, and Value-2 has been completely sidelined. This far-reaching change in the value orientation of MF poses a challenge for the ethical appeal microfinance. As it seems, the two cases are not going to remain exceptions. As the Indian Financial Economic Times reported on Oct. 5, 2012, “Private Equity Firms Woo Indian Microfinance Institutions” to an extent that can only be called stunning.¹⁴

To sum up this section: In MF 1.0 (or traditional MF), Value 2 considerations were the driving force behind efforts of foreign donors and the local MFIs that were their partners to create Value-1 for the target groups.

In MF 2.0 (or early modern microfinance), the Value 2 considerations and the Value-1 aspirations of clients are complemented by what one can call the Value-1 interests of the MFIs that play an essential role in creating and distribution MF services for certain target groups, and the people and institutions backing these new-type MFIs.

In recent years, the trend towards increasing commercialization has, at least in some cases, changed the substance of the value orientation of MF. Clients’ Value 1 does not seem to count so much anymore. In its place, investors’ Value 1 has become the dominant concern; and one might worry that in a number of MFIs all traces of Value-2 are about to disappear.

¹⁴ See Financial Times of India, Oct. 6, 2012.

3 Traditional Objectives and Values of Microfinance and How They Were Discussed and Implemented

3.1 Two Competing Approaches to Microfinance and Small Business Finance

The term ‘objectives’ indicates what a social activity, such as that of MF, is intended to achieve according to a widely shared view among experts or the general public or competent decision makers. At least as far as ultimate or highest ranking objectives are concerned, it is almost impossible to clearly distinguish objectives from underlying values. On a lower level of abstraction, objectives can be considered as a way of expressing different views about how the overarching objectives can best be reached. With the term “traditional values” I refer to values and objectives held at the time until 2006, the year in which the Noble Peace Prize was awarded to Yunus and his bank and the year of the first IPO of a MFI and the beginning of what I call excessive commercialization.

At the highest level, there was a general agreement that MF was meant to benefit clients. However, already at the next level of generality, experts disagreed on almost any aspect of what this meant in practice. More specifically, there was disagreement about

- the definition of the target groups that MF was meant to directly benefit: really poor people vs. micro and small enterprises and their owners and their employees;
- the definition of the overall objective: poverty alleviation vs. improving the economic environment in which poor people live and in which small and very small firms operate;
- the kinds and the scope of services MFIs should provide to the target population: all those services that poor people need vs. merely financial services;
- the importance attached to the requirement that MFIs cover their full costs and become financially self-sustaining after a brief initial period vs. the disregard for such considerations;
- the directness of efforts to ultimately benefit the target population: reaching poor people and providing immediate benefits for them vs. strengthening the institutions that would provide financial services to those who formerly lacked access to financial services, or even to strengthening the financial system of certain countries

Combining these features one arrives at the main “battle line” of the 1990s and the early years of the new millennium. On the one side, we have the position of those who opted for immediate and comprehensive support for poor target groups combined with the objective of alleviating poverty. One can call it “the poverty alleviation camp”. As it presented itself until 2002, the Grameen Bank was the leading

example of a MFI in this camp, and Yunus was its best known proponent. On the other side, we find the advocates of a more indirect support for the target population and a more focused “finance only” approach. This “commercial camp” emphasizes institution building and financial sector development and a commercial orientation of MFIs. The village bank units of Bank Rakyat Indonesia (BRI) and the MFIs supported by ACCION and IPC were the prime examples for this camp of MFIs.

3.2 Outreach and Its Dimensions

As said before, during the 1990s, the debate between these two camps did not refer to the overarching objective of MF but rather to different view concerning how this objective can best be reached. One way of framing this controversy was by using the vague, but intuitive and highly plausible concept of “outreach”. Outreach has two dimensions. Having a “deeper outreach” means that an MFI reaches and serves poorer clients; and having a “wider outreach” means that more relatively poor clients are reached.¹⁵ At an early stage of this debate, it was widely believed that there would be a trade-off between depth and width of outreach, and the two camps held contrasting views concerning which dimension of outreach is more important. The inhabitants of the poverty alleviation camp put priority on depth while those of the commercial camp were more concerned about a wide outreach.

The preference ordering of depth versus width touches on several aspects. One aspect is a simple, straight-forward difference in value judgments. The proponents of poverty alleviation regard poverty alleviation as more important than establishing viable financial institutions or strengthening the financial sector; and for many of them it is even ethically unacceptable to make poor borrowers bear the full costs of the financial services offered to them.¹⁶ The advocates of the commercial approach argue that MFIs which emphasize poverty alleviation and follow a soft approach can hardly cover their costs and become stable financial institutions and therefore cannot provide loans and other financial services to their clients on a permanent basis. In their view, the ability to provide services on a permanent basis is of paramount importance for their clients, even if this requires the MFIs to charge slightly higher interest rates.

Another point of disagreement refers to the scope of operations that MFIs of the two types can achieve. Poverty oriented MFIs are notoriously dependent on foreign subsidies and soft loans provided by international financial institutions on concessionary terms, whose availability is limited. This inevitably restricts the scope of their lending business. In contrast, commercially oriented MFIs find it easier to expand. Once they have reached financial self-sustainability, they can take deposits from local clients and access international funding from develop-

¹⁵ See e.g. Gonzalez-Vega (1998).

¹⁶ See e.g. Hulme/Mosley (1996) and Waller et al. (1999).

ment finance institutions and even from commercial sources. With a larger scale of operations, they can make more loans and thereby have a larger positive impact on the lives of the people whom they aspire to benefit. Thus, there is in fact no trade-off between depth and width of outreach once the time span and the scope of operations are considered. The impact of MFIs that follows the commercial approach is larger, and this benefits their really poor and also their relatively poor clients.¹⁷

A third aspect refers to the question of who the main target groups of MFIs should be. For the poverty alleviation camp, really poor people are the preferred clients of MFIs. The inhabitants of the commercial camp find it more important that their loans go to small and very small businesses. The main reason for this preference for micro and small business finance over the direct financing of really poor people is that this ultimately benefits even the really poor more since small enterprises have a capacity to create employment and income from which also the really poor can benefit.

3.3 The Economic Rationale of the Institution Building Approach to Microfinance

There is more substance behind the commercial approach to MF, that one can alternatively call the institution building approach or the financial sector approach, than the mere assertion that it generates a stronger impact than the poverty alleviation approach. It can also be supported by a strong economic argument, which has been developed by Ingo Tschach in his dissertation entitled “the theory of development finance”. I find his argument important enough to present it briefly here.¹⁸

Financial markets do not function like the textbook model of a commodity market in which supply and demand curves intersect and jointly determine a price at which the market clears. Financial markets are strongly affected by information and incentive problems; and this is particularly so in the case of markets for loans to very small and small businesses in developing countries. As Stiglitz and Weiss have shown in a seminal article, information asymmetry leads to moral hazard and adverse selection, and this in turn leads to credit rationing.¹⁹ Credit rationing means that potential borrowers do not get the kind of loans they demand even though they may have economically valuable projects for which they request external financing. Evidently, credit rationing is a pervasive feature in those markets in which MFIs are active. A generalization of the argument developed by Stiglitz and Weiss provides an economic rationale for microfinance in the spirit of the institution building approach.

In any developing country, we find firms of vastly different sizes. Typically, small firms are endowed with little capital, not only in absolute quantities but also relative to the quantity of labor they use. The smaller firms are, the less capital

¹⁷ For a simple numerical illustration, see Schmidt (2010).

¹⁸ For details and additional references see Tschach (2002).

¹⁹ See Stiglitz/Weiss (1982).

they tend to have; and therefore the higher the marginal return to capital is for them. This is an empirical fact that has often been observed. As a simplification one can assume that firms want to obtain loans whose size corresponds to firm size.

If markets were perfect, the smallest firms would be those that offer the most attractive applications for loanable funds. However, for two reasons, this is not the case in reality. One reason is that the transaction costs of granting small and very small loans to firms of correspondingly small size are high, and they can be assumed to be the higher the smaller the loans and the loan seeking firms are. The second reason is that it is difficult for lenders to properly assess the credit worthiness of the very small and small firms that would like to obtain loans. These simple considerations permit deriving a demand curve relating interest rates and loan/firm size.

If one looks at the supply side of the loan market in a typical developing country, one can distinguish two segments or two parts of the existing overall supply. One segment is that of the informal and semi-formal loan supply, most of which comes from money lenders. Money lenders can be assumed to be able to assess the credit worthiness of very small and small firms. However, their transaction costs are very high and their capital is limited. Therefore, they can only offer very small loans to very small businesses at very high interest rates. The other segment is the loan supply of conventional banks. These banks offer loans to large firms that are not particularly difficult to evaluate, e.g. because they have collateral and audited balance sheets, and they demand moderate interest rates which would be sufficient to cover their costs including transaction costs. In contrast to money lenders, conventional banks do not have the know-how that would be required to evaluate very small and small firms and their projects. This is why they do not offer loans to them even if these loans would carry higher interest rates.

Combining the loan demand curve and the two segments of loan supply generates a segmented market. This market has three segments. The first segment is that in which money lenders provide very small and very costly loans to very small firms that can take out these costly loans because of their very high marginal return on capital. The third segment is that of large firms getting large loans from conventional banks at moderate interest rates. The second segment is the one in the middle composed of small firms with high, but not very high, returns on capital, which would like to obtain small, though not very small loans. However, the cost of money lender loans is too high for them, and the banks do not finance them because they lack the necessary techniques to assess their credit worthiness. The loan demand of these firms is not met by the two types of suppliers considered so far.

This is where MFIs can find an appropriate and also financially attractive market niche: Since they have more capital available for lending than the typical money lenders and some relevant know-how to assess small firms, which the banks typically lack, the middle segment of small firms is their natural domain. Ideally, they can meet the demand of firms in the middle of the firm and loan size spectrum.

The importance of this role of MFIs in financing small firms goes far beyond simply filling a gap between the loan supply of money lenders and banks and simply funding a class of small, but not extremely small firms that typically do not

receive the loans they would need. If the gap were not filled, it would create a serious obstacle to growth and thus also to additional employment and income for all those who would work in the small firms. To see why this is so, consider the case in which the gap is not filled. In this case, the owners of very small firms would be aware that the gap exists, and they would anticipate that if their firms grew they would run into the trap of their business being too large for money lender loans and too small for loans from conventional banks. As a consequence, they would refrain from even trying to make their firms grow, and they would therefore not create employment and income.

This is, in my view, the most convincing argument why MFIs should follow the commercial approach, aspire to become financially viable establishments and aim at financing not the economic activities of the extremely poor but rather those small businesses that are still too small to get normal bank loans. In doing this successfully, they remove a severe obstacle to economic growth and development and thus have a substantial impact on the general economic development. Though only indirectly, this would also lead to a substantial improvement of the situation of really poor people, who could then find employment and derive income from getting newly created jobs.

3.4 The Meta-ethical Debate

It is not enough to argue that the inhabitants of the poverty alleviation camp and those of the commercial camp differ in terms of whether they find poverty alleviation or financial institution building and financial sector development more important and what they believe serves poor people better. There is another dimension in which the two approaches differ, and this dimension refers explicitly to ethical values.²⁰

In the general philosophical debate about what constitutes ethical or moral value of human conduct, there are two fundamentally different positions. One of them is a position which was widely spread among German and European philosophers and their followers in the general public in the 19th and early 20th century and which can be traced back to the writings of the eminent 18th century philosopher Immanuel Kant. According to this position, which was later given the name “*ethics of conviction*” (in German: *Gesinnungsethik*) by Max Weber, we call conduct ethically good if it is based on ethically valuable intentions and principles that would be suited to serve as general rules of conduct and as the basis of the legal system in an ideal state.²¹ In accordance with this view, MF can be called

²⁰ I have addressed this issue in Schmidt (2010) and therefore only briefly summarize it here.

²¹ On page 85 of his highly influential book “Politik als Beruf” (politics as a vocation) from 1919, Max Weber describes this position and introduces the term “*Gesinnungsethik*” for it, which is by now widely adopted. His implicit reference is to Kant (1788). Later authors, such as Kohl (1990), question whether this is a fair representation of Kant’s certainly more complex view, but finally concur with Weber.

ethically good primarily because, and if, it is based on ethically valuable principles like that of aspiring to help those in need. Evidently, MF aiming at poverty alleviation has this appealing feature and can be regarded as a manifestation of the Kantian ethics of conviction.

The competing position is that developed and propagated about one hundred years ago by the equally eminent sociologist and economist Max Weber in an explicit confrontation to the conventional view of Kant and his followers. He called his approach to practical ethics *the ethics of responsibility* (in German: *Verantwortungsethik*). As he argues, human conduct can and should be called ethically good if, and only if, it is based on careful planning and the expectation of achieving effects that can themselves be called good according to some appropriate standard, whereas ethically valuable intentions and underlying guiding principles are less important. Weber criticized the ethics of conviction for ignoring the question of what the effects of adhering to valuable principles really are as long as these principles are considered ethically sound.²² In a Weberian perspective, MF appears to be ethically good – or have Value 2 – if it can, upon careful analysis, be expected to create net benefits – or Value 1 – for its clients or their countries.

Applied to the debate about MF²³ one can say that the poverty alleviation approach largely conforms to Kant's ethics of conviction. As Yunus has argued in innumerable speeches, what makes MF such an ethically attractive proposition is exactly that it is based on ethically valuable principles and intentions. For him, compared to principles and intentions, facts and figures carry much less weight. The most important issues that he has regularly ignored in his speeches, and often even brushed aside as largely irrelevant, are the questions of what the true impact of the kind of MF is that he advocates, how this impact can be measured in a reliable way and what his concept implies for the role and strategies of MFIs.

Being mainly economists or social scientists, most experts and practitioners in the commercial camp would rather subscribe to Weber's ethics of responsibility. For most of them it is straight forward that consequences are more important than principles. The meta-ethical controversy would strengthen their position, as long as the stronger impact of commercial MFIs can indeed be assumed to exist²⁴ and as long as the commercial orientation does not go at the expense of ethical principles.

²² See Weber (1919), *loc. cit.*

²³ For details, see Schmidt (2010).

²⁴ The condition that the consequences are predictable is essential. Weber's position rests on the assumption that the consequences of the conduct that is to be assessed can be predicted. If this is not the case, his meta-ethical argument is much weaker, and correspondingly the Kantian position is stronger in relative terms. In an earlier paper, I have provided one argument why one might question the predictability of the impact of commercial MF. This argument rests on the impossibility to predict the effects of innovations. See Schmidt (2010). Another argument that works in the same direction is that it is much less clear than had formerly been assumed that MF provides direct benefits for poor households, as Roodman (2011) and others argue.

4 The Perceived Loss of Ethical Appeal and Reputation

4.1 Relevant Changes in the Reality of Microfinance

During the past six years, microfinance seems to have fallen from a peak of reputation into a deep trough. Relevant changes that have caused this downfall have occurred on two levels at the same time: in reality and in the discourse about MF.

The most visible events that have gravely damaged the reputation of microfinance are the IPOs of two large and well known MFIs. Both cases and the controversies surrounding them are so well known that it may suffice to briefly recall their main features.

In 2006, the Mexican MFI Compartamos went public. 30 percent of the outstanding shares were issued to American and Mexican investors, and the Compartamos shares were listed on the Mexican stock exchange. In the course of the IPO, no new shares were issued and no new capital was raised for Compartamos. Most of the shares that were sold had been held by managers of the MFI and two important development oriented institutions, the World Bank's private sector arm IFC and ACCION, the world's largest and most highly regarded microfinance support organization.

The IPO of the Mexican MFI was very successful in financial terms. The issue price of the shares was very high. Valued at the issue price of the shares Compartamos had a market value of approximately 1.5 billion USD. Some observers and especially the founding shareholders of Compartamos hailed the IPO as an important step showing that microfinance had finally arrived at the "real financial market" and stood its test there.

Others saw it differently and supported their critical view by pointing out that the high issue price could only be a reflection of the enormous profitability of Compartamos as an enterprise during the past six years since the time when the former NGO was transformed into a corporation, and the expectation that it would maintain its profitability in the foreseeable future by sticking to its policy of charging exorbitant interest rates. Yunus and others commented that this IPO demonstrated the moral decay of some players in MF. A feature that appeared as particularly worrying is that a large fraction of the shares were sold to American hedge funds, allowing the sellers, which included IFC and ACCION in a prominent position, to pocket financial profits unheard of in MF before.²⁵

In 2010, the largest and fastest growing Indian MFI SKS also undertook an IPO with similarly spectacular financial success. In this case, it were not exorbitant interest rates but extremely high growth rates which seem to have inspired investors to pay a very high price for the shares. The issue price was indeed so high that it could only be explained by the assumption of investors that the unbelievable growth of SKS will continue for an extended period of time. Also in this case,

²⁵ For details and an equally critical assessment see Rosenberg (2007).

purely profit oriented investors were involved in the financing of this MFI, and top managers used the opportunity to pocket substantial profits for themselves.

The highly problematic aspect of this IPO is that SKS and a handful of other large Indian MFIs seem to have pursued policies of granting loans and of enforcing repayment from its clients that have nothing in common with responsible micro lending. As is well known, a large number of borrowers who were unable to repay the excessive loans that they had obtained from SKS and its peers committed suicide. As is equally well known, this led to a general microfinance crisis in Andhra Pradesh.²⁶

Unfortunately, these were not the only events that caused a loss of reputation for MF on a worldwide scale. Other problematic aspects are that, after 2005, a number of purely commercial banks invaded what they called the microfinance market. But instead of granting loans that were in some way related to income generating activities of their clients, they pushed outright consumer lending and thereby caused serious problems for their clients. In addition, in a number of countries, the supply of very small loans to poor clients expanded at a very rapid pace, leading to over-indebtedness of clients and rising default rates of MFIs.

Last but not least, there was a controversy around the activities of the personality who had represented the former positive side of MF like no one else, Noble Laureate Mohammad Yunus. The role of his bank and of other firms in the Grameen Group of enterprises became the topic of very critical reports and comments in the media casting doubt on the ethical and developmental merits of the ever growing range of the group's business activities and of a stunningly close cooperation with large multinational firms. In part fuelled by these accusations, the government of Bangladesh forced Yunus in 2011 to retire from his position as the CEO of Grameen Bank and claimed the right to determine the future CEO of the bank. Even though many of the accusations turned out to be ill-founded, casting a shadow over the most highly respected representative of MF also affected the reputation of MF in general.²⁷

²⁶ For details, see Chen et al. (2010).

²⁷ At least as a footnote it should be added that also another aspect of microfinance changed in a negative way. It concerns the attractiveness of MF for retail investors. Until the middle of the past decade, MF was considered to be particularly attractive for them because the profitability of MFIs and of MF investment vehicles was largely uncorrelated with general economic and stock market developments. Therefore, MF investments were considered as valuable instruments for portfolio diversification (see Krauss/Walter 2009). During the past years, MF has become much more connected to the general financial system. As a consequence, the financial returns of MF investments started to be highly correlated with general market developments and therefore lost an important part of their appeal for investors. For empirical evidence, see Wagner (2012).

4.2 Relevant Changes in the Discourse About Microfinance

While the Compartamos IPO and its problematic aspects did not have a great deal of impact in the general press, the events surrounding the SKS IPO and the ensuing Indian microfinance crisis and the intrusion of purely commercial lenders who pushed consumer lending under the misleading name of MF made headlines in the press. One very prominent American business magazine published several articles about the “dark side of micro lending”; the highly respected German newspaper *Frankfurter Allgemeine* bluntly declared that the model of microfinance had failed, and others declared that microfinance would be almost dead, at least as far as its ethical appeal is concerned.

Even more important is the change of attitude in the more specialized microfinance-related literature. For the sake of brevity, I only want to briefly comment on three widely read and discussed recent books on MF.

The first one is “Confessions of a Microfinance Heretic” by Hugh Sinclair (2012). As the title suggests, this book is highly provocative in its tone and content. The author recounts his negative experience with several MFIs and MF support organizations for which he had worked. He demonstrates that these organizations and the leading people behind them are irresponsible, profit and power seeking and not in the least socially and developmentally responsible. Of course, there are institutions and individual people in the MF business that deserve to be criticized in the way Sinclair does it in his book and related publications and public appearances. And it is justified to point out that the former MF hype may have encouraged the entry of shady characters into MF. However, Sinclair refrains from explicitly generalizing what he documents for individual cases. Therefore, one might say that he was unfortunate to run into black sheep several times in his career as a MF consultant. But apart from his caution of not explicitly making very sweeping statements, his book conveys the impression that what he reports represents a general feature of today’s MF and that there are many black sheep. In this sense he contributes substantially to the current trend of putting MF down.

The second book is more important and richer in substance. In “Why Doesn’t Microfinance Work?” Milford Bateman (2010) attacks what he considers to be central weakness of the relatively new breed of MFIs. The subtitle “The Destructive Rise of Local Neoliberalism” suggests what his answer to the title question is. In equally strong words like those of Sinclair, Bateman attacks aid-supported MFIs and donor support for these “new style MFIs” as cementing underdevelopment and poverty instead of fostering development and making a contribution to poverty alleviation, as has again and again been claimed by thousands of MF enthusiasts. As a conclusion, he recommends to simply discontinue the policy of supporting MF with technical and financial assistance from the advanced countries.

I see two main arguments in this study. The first one is that modern MF is a manifestation of a neoliberal policy that grossly underestimates the role that government interventions can and should play for economic development. Much of modern MF is indeed inspired by anti-government and pro-private sector

thinking.²⁸ However, if he had been more versed in the history of development finance and development aid policy Bateman would most probably also have noticed how problematic the kind of government interventions can be that he so strongly advocates.²⁹ In other words, I tend to accept his diagnosis on this point and still disagree with his conclusions and recommendations.

His second main argument refers to the kind of economic activity that, according to his view, many “new-style MFIs” aspire to support with small loans. As he argues, the economic activities of the very poor do not generate sufficient income to warrant the application of development aid funds. Development would be strengthened and thus also the economic situation of large segments of the population would benefit more if funding were directed to small and medium-sized firms with some growth potential instead of informal and other micro-enterprise activity. With his second argument Bateman is not alone among microfinance experts and, based on similar ideas, some important players in MF have already adapted their strategy to the insight that more development impact can be generated by financing small firms rather than informal and micro-scale economic activity or even pure consumer lending.³⁰ Moreover, a large part of the commercially oriented MFIs have not or only half-heartedly subscribed to the poverty alleviation rhetoric of Yunus and his followers. It is therefore difficult to understand why Bateman arrives at the sweeping indictment that “microfinance does not work”.

The third and by far the most important recent book is David Roodman’s “Due Diligence” of 2011. The subtitle “An Impertinent Inquiry into Microfinance” could create the expectation that this is one more book containing a full blown attack on microfinance. Fortunately, this expectation is not justified. The book offers a very serious and thoughtful, indeed “diligent”, account of modern MF and a careful assessment of its merits. The standard against which MF is assessed are frequently made claims on what MF could achieve. And by this standard the outcome of the intellectual exercise is somewhat disappointing. One claim, and probably the one that has gained the greatest popularity, is that MF is an ideal instrument to alleviate or even to eradicate poverty. Roodman looks at the facts and on recent econometric studies that seem to support the poverty alleviation claim and comes to the conclusion that there is no evidence that being clients of a MFI does indeed help people get out of poverty. This finding should, however, be taken with a large grain of salt. What Roodman and the researchers whose work he

²⁸ See many of the contributions in Levitsky (1990). This book summarizes the proceedings of the first World Microfinance Conference in Washington in 1989, that is, during the presidency of Ronald Reagan.

²⁹ See for instance the collection of articles about the old policy of directed credit contained in Adams et al. (1984) with the informative title “Undermining rural development with cheap credit”. What Bateman recommends has stunning similarities to the policy that is so forcefully criticized in the book by Adams et al. and similar publications by the same group of authors in the early 1980s.

³⁰ See, for example, the latest Annual Report of ProCredit Holding (2012).

analyses look at, are immediate and very short-term effects. If such effects cannot be shown, it does not at all imply that MF does not increase welfare of large parts of the population, and thus also including the poor and the very poor. If one looks at the effects that, for instance, German savings banks and cooperative banks have had since the time they were created in the 19th century, one can hardly question that they have had a very positive effect. But this effect took decades to materialize, and the mechanism through which these financial institutions that opened up the access to finance for formerly excluded clients are more complex than what the recent econometric studies can capture.

The second claim investigated by Roodman is that MF creates empowerment. Here his assessment is similarly skeptical. No immediate effect of empowerment can be identified in serious econometric studies. However, as in the case of poverty reduction, the argument is relatively weak in so far as the pertinent studies can only capture short-term and readily observable effects.

Up to this point, one could say that both the developments in the “reality” of microfinance and the popular and academic debate about MF point in the same direction: MF does not, and cannot, keep its promises and therefore has lost a great deal of its appeal. However, this assessment would disregard that Roodman also considers a third claim. It is the claim of those who advocate financial institution building and financial sector development in the direction to more inclusive finance. On this account, his assessment is unambiguously positive. Unfortunately, he does not delve into the question to which extent the positive developments in what he calls “microfinance as industry building” have a positive impact on broad segments of the economically active population in developing and transition countries over a longer term. The general literature on the finance-and-growth nexus provide ample reason to think much more positively about MF including its welfare effects for the general population.³¹

5 The Renewed Debate About Objectives and Values of Microfinance

5.1 Values for “Microfinance 3.0”

The recent developments and the widely perceived loss of ethical appeal of MF, as it has been practiced up to now, requires reconsidering the question why values and especially what I have called Value 2 above is important for finance in general and microfinance in particular. The general answer to this question is that values and ethics play a role because they provide orientation and can shape the behavior

³¹ For an overview, see World Bank (2001) or Levine (2005). The „theory of development finance“, summarized in section 3c above supports the view that good microfinance has the potential to generate not only growth but also a broad-based economic and social development.

of economic agents where markets and politics fail to give unambiguous orientation, lead to undesirable outcomes and leave room for discretion. Real-world (financial) markets do not function as standard economics textbooks suggest. They invite exploitation and other forms of unethical behavior and lead to exclusion and discrimination. Policy interventions (regulation, state banks, etc.) cannot compensate this „market *cum* policy failure“, leading to a void which needs to be, and can be, filled by „Values 2“ in the forms of personal integrity, professional ethics, etc. The debate about the role of ethics in general banking and finance after the financial crisis has made this point sufficiently clear: Profit making without ethical restraint has done damage, and even the largest investment bank of this world, such as Deutsche Bank, are now trying to revive their corporate culture in a way that puts more emphasis on responsible client service, transparency and fairness, not least because this would be good for the banks itself.

This applies even more so to development finance, MF and small business finance (henceforth SBF). Endeavors in these fields have always been inspired by the idea that unrestricted markets do not function as one would hope and that therefore some intervention is required that is itself guided by Value 2 considerations.³² These considerations are based on value judgments and beliefs that

- opportunities should be distributed equitably,
- poor people and those excluded from access to finance need support;
- better access to finance fosters economic growth and broad based development and ultimately also democracy and peace; and that in most cases,
- host-country authorities do not support broad based finance enough.

As I have argued above, in order to be effective, MF and SBF require the existence of solid and stable institutions. In order to be effective for a long time, these institutions must follow a commercial approach. If they are not profitable they cannot survive and grow and create „Value 1“ for anybody. But there is the danger that the commercial approach can go too far. The economically sound and ethically legitimate aim of making a profit or, in other words, to cover their full cost including the cost of equity, may suggest profit maximizing behavior. However, outright profit maximization would be contrary to the logic why MF and SBF are created in the first place, since all profit maximizing financial institutions tend to discriminate, exploit etc if they have the opportunity to do so, as the cases in Mexico and India clearly show. Therefore, it is particularly important for commercially oriented MFIs and small business banks that they are solidly based on values in the sense of Value 2. Values are an antidote to an excessive commercial orientation.

Given that values are very important for sound, commercially oriented MF and SBF institutions, one needs to take a closer look at what these values and the ob-

³² The conditions under which market failure justifies interventions in markets can be found in Besley (1994).

jectives of MFIs are today: The dual objective of outreach/impact/benefit (or Value 1 for clients) and institutional sustainability (or Value 1 for the institutions) remain relevant. But this needs to be made more operational for an upcoming age of “Microfinance 3.0”. One can distinguish three types of objectives/values:

1. Rules of conduct: Fairness and transparency to clients and other partners; responsibility in lending; transparency to providers of funds, regulators and donors. In particular, the responsibility of MFIs for preventing that their clients borrow more – from one MFI or from different MFIs – than they would ever be able to repay deserves emphasis, since this commitment to responsible lending has been grossly neglected in the recent past. A firm commitment to the value of responsible lending implies that MFIs should avoid getting involved in consumer lending that does not produce economic benefits and in any transaction take extreme care in making sure that their clients are capable of bearing the debt burden they incur when they take out loans.
2. Traditional objectives of MF such as benefitting clients e.g. by expanding the set of options they have, instead of claiming to directly alleviate or even eliminate poverty (since this is not achievable) and strengthening the respective financial system and combating financial exclusion; and
3. fostering economic growth by improving the access to finance for very small, small and even mid-sized businesses that are capable of creating income and employment and that so far do not have access to credit at reasonable terms.

Value considerations in the form of a sound balance between Value 1 for clients and other stakeholders and Value 2 are not only important for those who govern and manage MFIs. They are also criteria that investors and donors should use in their decisions on how to support MFIs with loans, equity and technical assistance. Last but not least they should play a prominent role in the selection, training and evaluation of those who work in MFIs.

5.2 Assuring Value Orientation of MFIs That Want to Access the Capital Market

Still today, there are millions of economically active people and very small and small businesses in this world that do not have access to the kind of financial services they need and want and that would have a positive effect on their personal situation and their countries’ development. Therefore, the institutions that provide these services have a moral and developmental obligation to expand the scale of their operations. This complements the requirement for MFIs as business entities to grow in order to be attractive for staff and for their own creditors and investors. For financial institutions that are regulated and supervised as banks, growth cre-

ates the need to increase their equity in parallel to their loan portfolios and the level of deposits they may want to mobilize. However, equity is difficult to get, even for formal financial institutions.

One source of equity is self-financing or retained earnings. But given the pace at which most MFIs have grown in the recent past³³ and at which they will hopefully continue to grow, retained profits are typically not enough, especially if the institutions find it important under ethical and developmental aspects not to make as much profit as they would need if they had to rely exclusively on internal financing to satisfy their growing equity needs. Another source of equity are national and international development finance institutions. Their resources are also limited and not enough to meet the equity needs of the growing MFI sector. Therefore, it is inevitable to raise equity from private sources. Here, we first find the type of private “social investor” who want to be rewarded with a financial and a “social” dividend and might be prepared to accept a lower financial dividend if they can count on having the feeling that they contribute to an ethically valuable undertaking. But also this source of equity is limited, especially since it is difficult to organize the external financing from a large number of “social investors”. Ultimately, there is hardly a way of avoiding the step of turning to private and institutional investors for whom financial interest dominates social or political interests.

At least for large and growing MFIs, an option worth considering is to address the general market for equity capital by issuing shares in the format of an initial public offering (IPO) and then having their shares listed and traded on an organized stock market. Having the shares issued to the general public (as opposed to a private placement) is important because it provides liquidity for investors and thus makes MFI shares more attractive as an investment.³⁴

However, this is not as easy as it may appear. This is not so much the case because an IPO is always a difficult process, especially for firms that have an unconventional business model and operate in a line of business with which the capital market is not familiar. A more important reason is that equity in a public exchange listed company brings with it certain rights for the new shareholders and the legal obligation for the issuing firm to protect their interests and, at least to a certain extent, follow a strategy that conforms to their interests. An IPO changes the character of any institution in a fundamental way. In the case of an institution with a social and developmental mission, it can imply that this mission is lost.

Assuring the lasting social and developmental orientation, which has typically been a driving force behind the original creation of a MFI or a similar organiza-

³³ Disregarding cases of excessive and unhealthy growth as it has recently occurred in a number of countries and regions, notably in the Indian state of Andhra Pradesh.

³⁴ Moreover, having shares traded on an organized market may be important for development institutions like the IFC which have in many cases served as early investors in commercially oriented MFIs and which are required by their internal regulation to exit their investment after a given time span.

tion³⁵, is a challenge. If after completing an IPO a sufficiently large fraction of the equity is held by the general public or even by institutional investors with purely financial interests, there is a considerable chance – or rather a considerable danger – that the power derived from holding shares will be used to transform the nature of the MFI in a way which would conform more to the financial interest of outside shareholders. For instance, powerful outside shareholders could exert pressure to the effect that a MFI becomes more profit oriented than it had been before, e.g. by raising interest rates, as in the Compartamos case, or by expanding operations faster than would be compatible with the rules of responsible lending, as in the SKS case. Or outside investors might transform a micro and small business oriented MFI into a consumer lending institution, as it recently happened in a number of countries.

Those who have once created a MFI with a social and developmental orientation and who might still lead it face a dilemma if their MFI is set to grow so much that it needs equity capital from outside private investors³⁶ in order to expand. If they turn to the capital market and thus ultimately to investors whom they cannot hand-pick they endanger the ethical orientation of their MFI. If they therefore avoid attracting outside equity, they forgo the opportunity to expand the operations and limit the positive impact for their potential clients they might otherwise have. However, the decision to go public and to look for outside equity capital and thereby grant decision rights to investors who might not share their developmental orientation is not an all-or-nothing decision. There are several ways of limiting the possibly negative effects of going public.

What comes to mind first is to limit the fraction of the shares sold to outside investors. Another option is to make sure that the shares held by others than the anonymous outside investors are, to use finance terminology, “in stable hand” of investors who can be expected to stick to the original social and developmental mission. A part of this strategy would be to place large blocks of shares with reliable “anchor investors”. The third option is to find a legal form for the shares that are issued which entails weaker ownership rights for the outside shareholders than ordinary shares. Non-voting preferred shares are one among several options that can be chosen if the applicable legal regime provides this possibility.

Of course, it has to be anticipated that those who might acquire newly issued shares would understand the implications of any attempt of the incumbent owners or managers of an MFI to restrict the influence they can have on the orientation and strategy of the institution in which they might invest. For instance, they would

³⁵ Such a “similar organization” could be one that owns or controls local MFIs without itself being an MFI. Since by now there are several important networks of MFIs with central institution which might go public, the case of “similar organizations” is of substantial practical importance in the present context.

³⁶ This is even more so if a MFI tried to satisfy its equity needs by inviting private equity firms or hedge funds to become outside investors. Their business model relies to a large extent on their ability to re-orient a firm in which they invest.

understand that an outright conversion of a small business-oriented bank with limited profitability into a more profitable firm focused on consumer lending would be very difficult if not simply infeasible or that it would be impossible to acquire a sufficiently large majority to take over the entire firm and integrate it into an existing large commercial banking group.

Seeing these restrictions, potential outside investors might refrain from buying shares or they would pay less for the shares than in if there was the option of converting the MFI into a more profitable but ethically or developmentally less valuable financial institution. This is a price to be paid by the present owners – and de facto also by its potential clients since it limits the possible expansion of the MFI's operations. But it might be worth paying this price especially in view of the unpleasant consequences that the de facto take-over by purely profit oriented investors and the ensuing strategic reorientation seem to have had in those two cases mentioned above, in which hedge funds and private equity firms have, respectively, become the dominant shareholders. The price may be so high that an IPO becomes outright impossible. However, some relevant recent experience suggests that this might not be the case and that there would be enough investors who would be willing to take equity positions with limited rights and opportunities to reshape a development oriented MFI.

6 Back to Basics? – Yes and No

The question in the subtitle of this paper³⁷ is whether the recent events suggest returning to “Basics”. I interpret this as meaning a possible return to the former values and their role in MF, SBF and related fields within the broader context of development finance. For space considerations, I cannot extensively address the more general questions whether and to what extent a more general “back to basics” might be required. However, a few sentences on this may still be appropriate, even if this mainly serves the purpose of pointing out a difference. As far as most features of MF in the style of the early 1990s are concerned, the idea of going “back to these basics” would be highly undesirable. This refers most of all to

- the very limited scope of services formerly provided by MFIs – credit only;
- the older methodology of lending – predominantly group lending;
- the predominant institutional form of MFIs – NGOs rather than corporations;
- the status of credit-granting NGOs as unregulated financial institutions;
- the low efficiency and the high costs of providing MF services³⁸;

³⁷ Title and subtitle of the paper were assigned to me by the organizers of the conference.

³⁸ See Schmidt/Zeitinger (1996) for empirical evidence.

- the very limited scale and outreach of MF operations and, finally
- the complete dependence of MFIs on the “generosity” of donors.

Even though the MFIs of the early 1990s may have appeared more exotic and more romantic to journalists, politicians and other outside observers than the small business banks of today that look almost like any other bank, a return to these “basics” would go at the expense of those millions of clients who would not be able to obtain financial services if the MF industry were again transformed into the amateurish cottage industry of 20 years ago. There has been progress in MF, and this is good for the large number of clients of most MFIs who now have much better access to financing. Many MFIs are now “universal banks” offering various kinds of credit, savings accounts, money transfer and many other services. Group lending has been replaced by individual lending in most cases. Several MFIs have been transformed into corporations and have become regulated and supervised financial intermediaries. In most cases, MFIs have greatly expanded the scale of their operations, a factor that made the cost of intermediation fall below 20%, a rate that appeared utopian only 20 years ago. Finally, many MFIs are no longer dependent on donor financing or have at least reduced their dependence considerably.

Is “Back to Basics” recommendable as far as the importance of values, especially Value 2, is concerned? Here my answer is unambiguously Yes. There are certainly many more cases of MFIs than those which Hugh Sinclair describes in his book in which Value 2-orientation is completely missing. But even apart from such extreme cases, there might be a tendency in a number of MFIs to rely less on a commitment to moral values than it used to be the case 20 years ago. Optimists would probably say that the general financial crisis and the microfinance crisis in India and a few other countries have ushered in a renaissance of value orientation. In a growing number of MFIs and in networks of MFIs, for instance that of the ProCredit Banks, efforts are made to strengthen the awareness among staff members that development finance aiming at poorer people and small businesses has a social, developmental and thus ultimately also immensely political role. Pertinent elements now play an increasing role in their staff training programs.

Of course, one should not ignore that thousands of MFI managers and tens of thousands of staff members have always had a clear ethical orientation in spite of the doubts that some observers have expressed with respect to MFIs from the commercial camp.

But there are also important differences between the situation of 20 years ago and that of today. The necessity to adopt a clear commercial orientation and the stronger connections that have developed between MFIs and the “normal” financial system have given Value 2 a more important role than it had in the past. These relatively new features of MF are a threat to the value orientation of MF, and this creates the need to take precautions that the Value 2-orientation does not get lost.

Today it is necessary to integrate a strong role for Value 2 into the corporate culture, the organizational structure and the governance and ownership structure of complex MFIs and MFI networks. Ways must be found and corresponding

rules must be implemented that protect MFIs and their managers and staff from the temptation to disregard or even completely forget their ethical commitment in the face of growing day-to-day pressures. It is not enough to leave sufficient room for value-driven conduct, but there must also be firmer commitments that values remain important. What I have described above when I discussed the problems of MFIs going public is just one example of this kind of commitment.

So, at a structural level, we cannot go back to basics and to the former role of values. Today, good intentions and the right attitude and personality are no longer enough. There must be institutional features in MFIs and their governance and ownership structures that assure a strong role for ethics and Value 2. Even though this might make the access to capital markets more difficult, a responsible MFI must by all means be restrictive concerning to whom they sell their shares. In almost any legal systems, there are ways of doing this, for instance by including relevant clauses in the contracts they conclude with the investment banks that are involved in the IPO process.

References

- Adams, D., Graham, D., Von Pischke, J.D. (eds.) (1984) *Undermining Rural Development with Cheap Credit*. Boulder: Westview Press.
- Bateman, M. (2010) *Why Doesn't Microfinance Work?* London: Zed Books.
- Besley, T. (1994) How Do Market Failures Justify Interventions in Rural Credit Markets. *World Bank Research Observer* 9:27–47.
- Business Week (2007) The ugly side of microlending, Dec. 24, 2007 (US edition).
- Chen, G., Rasmussen, S., Reille, X., Rozas, D. (2010) Indian Microfinance Goes Public: The SKS Initial Public Offering. In: CGAP FocusNote No. 65, Washington D.C.
- FAZ (2011) Alternativen zur Mikrofinanz gesucht. *Frankfurter Allgemeine Zeitung*, June 17, 2011.
- Financial Times of India (2012) Private Equity Firms Woo Indian Microfinance Institutions (published Oct. 5, 2012 and downloaded from the homepage of Symbiotics, Oct 20, 2012).
- Fisher, I. (1904) *The Nature of Capital and Income*. New York: Macmillan.
- Friedman, M. (1970) The social responsibility of business is to increase its profits, *New York Times Magazine*, September 13, 1970.
- Furubotn, E., Richter, R. (2002) *Institutions and Economic Theory: The Contribution of the New Institutional Economics*, Ann Arbor: MichUniv Press.
- Gonzalez-Vega, C. (1998) Do financial institutions have a role in assisting the poor? In: M.S. Kimenyi et al., *Strategic Issues in Microfinance*. Aldershot: Ashgate, pp. 11–26.

- Hart, O. (1995) *Firms, Contracts and Financial Structure*. Oxford: OUP.
- Hulme, D., Mosley, P. (1996) *Finance Against Poverty*. London-New York: Routledge.
- Kant, I. (1788) *Kritik der praktischen Vernunft*. Riga, reprinted Erlangen 1984.
- Kohl, H. (1990) *Kants Gesinnungsethik*. Berlin: de Gruyter.
- Krauss, N., Walter, I. (2009) Can Microfinance Reduce Portfolio Volatility? *Economic Development and Cultural Change* 58:85–110.
- Levine, R. (2005) Finance and Growth: Theory and Evidence. In: Aghion, P., Durlauf, S. (eds.) *Handbook of Economic Growth*. Amsterdam.
- Levitsky, J. (ed.) (1989) *Microenterprises in Developing Countries*. London: ITDG.
- Nair, A., Von Pischke, J.D. (2007) Commercial Banks and Financial Access. In: Barr M.S., et al. (eds.) *Building Inclusive Financial Systems: A Framework for Financial Access*. Washington: Brookings, pp. 89–116.
- North, D. (1991) Institutions, *Journal of Economic Perspectives* 5:97–112.
- ProCredit Holding KGaA (2012) *Annual Report 2011*, Frankfurt.
- Roodman, D. (2011) *Due Diligence: An Impertinent Inquiry into Microfinance*. Washington: Center for Global Development.
- Rosenberg, R. (2007) CGAP Reflections on the Compartamos Initial Public Offering: A Case Study on Microfinance Interest Rates and Profits. CGAP Focus Note 42, Washington, D.C.
- Schmidt, R.H. (2010) Microfinance, commercialization and Ethics. *Poverty and Public Policy* 2(1):99–137.
- Schmidt, R.H., Zeiting, C.P. (1996) The efficiency of credit granting NGOs. *Savings and Development* 20:353–385.
- Sinclair H. (2012a): *The Dark Side of Microfinance, A conversation with Hugh Sinclair*, Knowledge at Wharton: Finance and Investment, July 18, 2012.
- Sinclair, H. (2012) *Confessions of a Microfinance Heretic: How Microfinance Lost its Way and Betrayed the Poor*. San Francisco: Berrett-Köhler.
- Stiglitz, J.E., Weiss A. (1981), Credit Rationing in Markets with Imperfect Information, *American Economic Review* 71:393–410.
- Tirole, J. (2008) *The Theory of Corporate Finance*. Princeton: Princeton Univ. Press.
- Tschach, I. (2002) *The Theory of Development Finance – How Microcredit Programmes Alleviate Credit and Labour Market Segmentation*. Frankfurt: Peter Lang-Verlag.
- Wagner, C. (2012): From Boom to Bust: How different has microfinance been from traditional banking? *Development Policy Review* 30:187–210.

Weber, M. (1919) *Politik als Beruf*. Berlin: Duncker und Humblodt.

Woller, G., Dunford, C., Woodworth, W. (1999) Where to Microfinance? *International Journal of Economic Development* 1(1).

World Bank (2001) *Finance and Growth: Policy Choices in a Volatile World*. Oxford: Oxford University Press.