1 Microfinance – banks – savings and cooperative banks

1.1 Microfinance: From humble beginnings to hype and disenchantment

What is today called microfinance is the outcome of a stunning process of institutional development and innovation that started in the 1970s and 1980s. The beginnings of modern microfinance – with a more social orientation in Bangladesh, a more commercial orientation in Indonesia and a more political orientation in Latin America – were shaped by high ambitions and noble intentions and spurred by the growing insight among experts that the old concepts of development finance, focusing on state-owned development banks, that had been favored by national and multinational aid donors since the 1950s, were unsuccessful, politically counterproductive, and economically inefficient.

However, calling microfinance new is not really correct, since it would merely reflect the rather one-sided perspective of an observer who comes from the Western world and is, moreover, not very conversant with the history of banking in the part of the world from which he or she comes. In truth, what is now widely known as microfinance has existed in almost all parts of the world for decades, if not for centuries, and has been the core business of savings banks and cooperative banks in Germany and a number of other European countries since the 18th and 19th centuries respectively. We emphasize the one-sidedness of the belief that microfinance is a new phenomenon precisely because it is one of the main objectives of this study to make our readers aware of the important role that savings banks and cooperative banks have played in the provision of microfinance services over the course of some two hundred years. However, two things are indeed new: firstly, the interest of policy makers and development experts in microfinance and in a policy of supporting microfinance in developing countries in a big way, and secondly, the use of the term "microfinance". Both of these new phenomena are addressed in more detail later on in this study. Given that there is a difference between older forms of providing financial services to relatively poor people and those that have emerged in the last half-century and are now called microfinance, we use the attribute "modern" for the latter where confusion might arise.

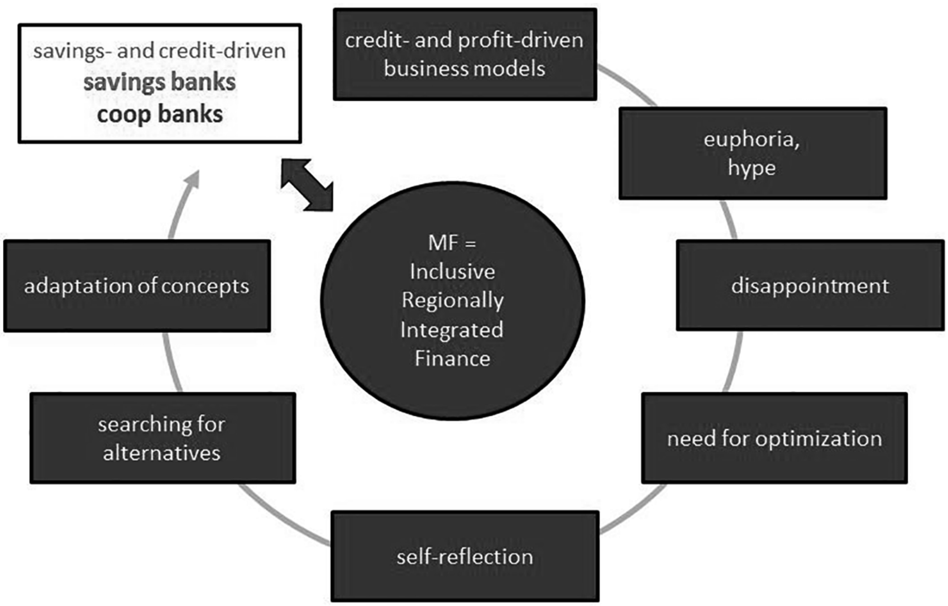
Early modern microfinance was not only ambitious, but by necessity highly innovative as well; new ideas, insights, and concepts were generated and tried out in practice. The idea that poor people are creditworthy, that they could take out loans, use them wisely and subsequently repay them was a new and hardly credible one for the advocates and practitioners of the old strategies of development finance that had been practiced for decades and for conventional bankers. But due to a combination of personal intelligence and charisma on the part of some of the protagonists, notably Muhammad Yunus; numerous important and convincing academic studies, notably those from a research center at Ohio State University; and favorable macro-political circumstances, notably a policy of lifting interest restrictions in most countries, the new form of development finance later called microfinance was given a chance.

However well-intentioned and heart-warming it may have been, early microfinance was not particularly effective. The scale of operations of most early providers of microloans and their high costs severely limited the outreach and impact they could achieve.

Microfinance matured in the 1990s and in the early years of the new millennium. The growth of microfinance in the years up to 2007 was part boom and part hype. It reached its peak in 2005, when the UN launched the International Year of Microcredit, and 2006, when the uncontested leading figure in microcredit, Muhammad Yunus of Bangladesh, and Grameen Bank, the poor people's bank that Yunus had founded, were awarded the Nobel Peace Prize for developing and implementing new ways of providing credit for the poor. What had made Yunus and his bank so well-known and so highly respected all over the world was his ambitious vision that microcredit would be able to eradicate abject poverty from the face of the earth (Yunus 2006/2007).

In the 1990s and the early 2000s, lending technologies were developed that were new to development experts and bankers and that really made it possible to reach poor clients and to get back the money lent out in the form of loans, and ways had

Figure 1: Circle of microfinance sentiments – "old" role models – "new" role models



been found to lower the cost of providing loans to the poor and to their small business undertakings. Moreover, a number of institutions that had formerly only granted small loans funded by governments and foreign donors also began taking deposits from their clients and offering payment transfer facilities – in other words, they were converted from microcredit institutions into genuine microfinance institutions (MFIs) offering both savings and credit facilities and other financial services as well. Based on these developments, microfinance expanded greatly in scope and sophistication and started to have an impact that was really worth talking about.

During these years, a new concept of managing MFIs emerged that became known as the commercial approach. Its early message was simply that the cost of granting very small loans can be reduced substantially by introducing appropriate operating procedures, and that it is possible to charge interest rates both high enough to cover the full costs of the institutions that provide the small loans and low enough to be borne by the typical microcredit client.

For the early advocates of the commercial approach, it was clear that microfinance has a dual objective: achieving strong social and developmental impacts, and at the same time establishing MFIs that are profitable and stable ("sustainable") and therefore able to expand their services and generate yet more developmental impacts. This was a grand vision, but it appeared to be realistic. By the middle of the 1990s a few MFIs had indeed achieved financial sustainability of their ongoing operations – a great success by any standard[1] Not surprisingly, the success of these showcases of efficient and sustainable MFIs raised the interest of policy makers, investors, and the general public and led to more funds flowing into microfinance. Early success was feeding ongoing success. This positive feedback cycle, which reached its peak in 2007, the point at which the financial crisis broke out, led to the widely held conviction that if done properly, microfinance can be both socially valuable and at the same time profitable.

However, the early triumph of the commercial approach to microfinance around the turn of the century also had negative effects at a later point in time. Some established banks and MFIs seem to have only seen the profit potential, forgetting the development side of the equation. As far as targeting and reaching poor clients was concerned, they did start to imitate what genuine MFIs with a dual objective of developmental impact and financial sustainability had done. But these new players had only one objective: to serve their own financial interests.[2]

Two MFIs that went public by issuing shares to institutional investors and the general public are particularly noteworthy examples of an excessive emphasis on a commercial orientation. One of them is the Mexican MFI Compartamos, which

1 The first institution to adopt this approach very early on, in the mid-1980s, was BRI in Indonesia in its micro-banking units.
2 See Business Week (2007).

undertook a financially very successful initial public offering (IPO) in 2007. This IPO triggered strong criticism among microfinance experts, because the high price at which the shares were issued was most probably due to very high profits generated by exorbitant interest rates. As Muhammad Yunus put it, institutions like Compartamos were taking over the role of loan sharks instead of fulfilling what he regarded as the supreme mission of MFIs, namely to drive the loan sharks out of the market and to eliminate exploitative interest rates for the poor.[3]

The other case was the microlender SKS in India, which went public in 2010. Like a few other private MFIs, SKS had expanded at an unprecedented and clearly unsustainable rate. Many poor families served by the institution ended up borrowing much more than they could ever repay. This microcredit institution reacted by using strong-arm methods to enforce repayment. Under the pressure exerted by the institution's money collectors, a number of borrowers committed suicide. These tragic events attracted worldwide attention and started a process of rethinking the economic and ethical merits of microfinance.

Possibly alerted by these two cases, microfinance experts started to undertake a thorough and critical investigation into the reality of microfinance,[4] and they found further grounds for concern. A one-sided and excessively commercial orientation, microlending that served to finance consumption instead of income-generating activities, multiple borrowing by clients and consequent over indebtedness were found to be more widespread than had previously been thought. Moreover, a number of academic studies questioned the ability of microfinance to pull microfinance clients out of poverty, as Yunus had made the world believe[5]. Other critics argued that the typical expenditures that most MFIs finance do not contribute to economic development in the respective countries, but rather keep them trapped in underdevelopment.[6] Then came a book that reported extensively and in a highly critical tone on certain MFIs whose management and staff were allegedly cynical and incompetent, and some of their supporters even more so.[7] Though the author did not explicitly say so, this book created the impression that deficient organizations were a widespread problem in the world of microfinance.

All of this did great damage to the former uniformly positive reputation of microfinance. At the least, it made microfinance look much less promising than before. Whether these recent developments are merely the sobering realization that the former hype was excessive and that former expectations were overblown, or whether they have put an end to microfinance or microcredit as it has been

3 In Business Week Online, December 2007, Yunus was quoted as having said, "Microfinance was created to fight the moneylender, not to become the moneylender."
4 See the programmatic title *Due Diligence: An Impertinent Inquiry into Microfinance* of Roodman's influential book from 2012, which addresses these issues at great length and in a very balanced way.
5 See Roodman and Murdoch (2009) and Roodman (2012).
6 See Bateman (2010, 2011 and 2013) and, even earlier, Dichter and Harper (2007).
7 See Sinclair (2012) and a number of related publications by the same author.

known to date, remains to be seen. However, even though the hype is over and some of the criticism is justified, most observers remain convinced that microfinance is a positive phenomenon.

1.2 Banks as providers of microfinance services

One consequence of the transformation of microfinance in the late 1990s – from a well-intentioned but extremely small-scale and amateurish development aid activity to an important element of the financial sector of the respective host countries – was the need to find suitable forms for the institutions involved. How could they best provide financial services to people who formerly did not have access to financial institutions? Building good financial institutions suited to providing microloans and other financial services was a great challenge during these years. Acknowledging the importance of this challenge gave birth to what has been called the institution-building approach, a conceptual twin of the commercial approach which looks so similar that an observer might hardly see a difference, since in order to pursue a commercial approach you need an appropriately structured and managed MFI, and any sound MFI must operate in a commercially sound way.

Once a certain degree of liberalization in the host countries made it possible, several MFIs that had formerly been organized as not-for-profit institutions or non-governmental organizations (NGOs) were incorporated and converted into formal and licensed banks, while in other cases new MFIs were set up as banks from the start.[8] There are many reasons why MFIs should become licensed banks subject to normal banking regulation and supervision. The most important one is that only licensed, regulated and supervised banks can take voluntary and withdrawable deposits, thus providing an important service to their clients and at the same time attracting funds that can be converted into small loans[9].

Several years after the beginning of the most serious banking crisis since the Great Depression, one may wonder whether the move towards corporations and formal banks that are completely and exclusively driven by shareholders' interests in profit maximization is really all that convincing. Have not banks lost much of their former clout and credibility in the crisis? And is the integration of microfinance into the larger context of financial markets[10] too dangerous for a type of financial activity that traditionally did not aspire to be under too much pressure to be profitable? Don't the Compartamos and SKS IPOs argue against the exposure to capital market pressure, given that in both cases hedge funds and private equity

8 See Chapter III, section 4 on different ways in which this institution-building problem has been resolved.

9 In some countries, there are by now special rules and regulations for MFIs that are permitted to take deposits, and these are typically more restrictive than those pertaining to non-deposit taking MFIs.

10 Wagner and Winkler (2013) have recently shown empirically that this integration has already gone very far over the past few years.

firms have played a highly problematic role?[11] These questions must be answered with great caution. Strong capital market pressure may indeed lead to a one-sided focus on profitability and the erosion of social and developmental concerns. However, if they aspire to have an impact and to serve their clients well, MFIs must grow and remain stable at the same time. To do so, they need to raise deposits, since a strong deposit business makes them relatively independent of funding by international financial institutions such as the World Bank, regional development banks or other investors. A lesson worth remembering from the peak of the financial crisis is that the resources of public and private banks are limited and that in times of crisis their support may prove less reliable than funding via a stable deposit base – which presupposes the formal status of a licensed deposit-taking bank. Furthermore, an earlier crisis, the Asian financial crisis of 1997/98, already taught the important lesson that appropriate regulation and effective supervision are crucial for any financial institution, and this benefit can best be achieved if MFIs are formal banks or other licensed deposit-taking financial institutions.

The new microfinance or small business banks that started to become important players in microfinance during the 1990s and before were all meant to have two features in common: Firstly, they should be target group-oriented, that is, they should focus their activities on a clientele of small businesses and relatively poor people in general who formerly did not have access to financial services from existing banks. And secondly, they should pursue the dual objective of achieving a substantial social and developmental impact and at the same time operating as stable and profitable enterprises. In other words, they would have to be profit-oriented but not profit-maximizing. Profit making should not be their only objective. The burning question was what legal and institutional forms, what legal regime and what ownership structures were available to banks with a social and developmental mission, and which of them would best facilitate the provision of microfinance services?

1.3 The relevance of savings banks and cooperative banks

Evidently, there are several institutional forms with various possible ownership and governance structures that can be considered for microfinance and small business finance. Among the financial institutions that have always pursued a dual objective and that were at one time created with intentions quite close to those that inspired the creation of MFIs over the past 40 years, two are particularly noteworthy: savings banks and cooperative banks. J. D. Von Pischke (2009), an early advocate of microfinance and the commercial approach, started a recent state-of-the-art survey article with the following words:

11 The lawmakers in Indonesia had anticipated this lesson when they passed a law on rural banks in 1988 which barred local microfinance banks (BPR) under central bank regulation and supervision from accepting foreign investments.

Microfinance has developed steadily and rapidly over the past 20 years. Its antecedents include cooperative and community endeavors in Germany and elsewhere in Europe. Today these institutions and their offspring around the world continue to provide a large volume of credit and other financial services to households and tiny businesses. These inspirations are reflected in the objectives of microfinance, which include the use of credit and savings to create better lives for the poor and others of modest means, and a certain style of leadership by activists and social entrepreneurs.

Interestingly, Von Pischke not only mentions the tradition of German savings banks and cooperative banks of being “dual bottom line” institutions, with both a financial and a developmental and social mission, but also the specific leadership and governance features of these institutions. Therefore it seems highly appropriate that we intend to analyze in this study whether savings banks or cooperative banks may be suitable legal and institutional forms for microfinance vehicles. Of course, this question cannot be answered with a simple yes or no. We therefore discuss which of their features might be worth incorporating into the design of MFIs. For this purpose, we try to systematically determine whether lessons for the design and management of today’s MFIs – and if so, what lessons – might be drawn from the history of savings and cooperative banks in Germany and other parts of Europe during the so-called long 19^{th} century. Their history will be described in detail in Chapter II, and lessons will be derived there and developed in more detail in the concluding chapter of this study, Chapter IV. As we will point out in Chapter III, which covers current developments in microfinance, there have already been numerous adaptations of the German models in many parts of the developing world.

Analyzing the possible role of savings and cooperative banks as they emerged in Germany in the 19^{th} century as a model, or at least as a source of inspiration, presupposes a precise notion of what constitutes a savings bank and a cooperative bank. As we will show in more detail in Chapter III, establishing a precise definition turns out to be a challenge, especially in the case of savings banks. Suffice to say here that both savings banks and cooperative banks in Germany are formal financial institutions that share four main features:

1. They are locally rooted financial institutions with a high degree of local autonomy.
2. They are “inclusive” institutions in that they cater to broad segments of the population, including those who may have, or at least had, serious problems of access to the well-established, privately owned and predominantly profit-oriented banks.
3. They pursue a dual objective which includes being profitable as business enterprises and at the same time promoting the welfare and business success of their clients and the local area they cater for.

4. They are members of close networks of similar institutions, which enables them to combine the advantages of scale and of decentralization in a very specific way.

1.4 Conclusions and consequences

Irrespective of all definitional problems, we conclude and summarize this introductory section with the following statements and indicate our conclusions for the structure of our study:
1. Modern microfinance has evolved over the last 40 years as a promising option in the field of development and development policy.
2. Modern microfinance started about 40 years ago in a modest way and was initially driven by high ambitions of poverty alleviation. However, the early MFIs hardly achieved the scale and the efficiency of operations that would permit significant outreach and impact.
3. This started to change with the advent of the so-called commercial approach to microfinance. As part of this approach, a number of MFIs were converted into licensed and regulated banks or were even started as banks, and this conversion had very positive consequences for the clients that the institutions aspired to benefit.
4. However, the institutional form of a formal bank can also have drawbacks, especially if a microfinance bank is a corporation with private owners who are mainly or even exclusively interested in the profit generated by the bank as a business enterprise.
5. Therefore, it seems appropriate to investigate the potential of savings banks, defined broadly, and cooperative banks – or at least certain features and aspects of these types of banks – to serve as models or at least as a source of inspiration for designing and managing MFIs in developing countries and supporting them in the framework of foreign and international cooperation, as is the purpose of this study.

The structure of this study is based on these considerations. The topic of the next chapter is an account of the history of savings banks and cooperative banks in Germany in the course of the extended 19th century, that is, from the late 18th century, when the first savings banks were founded, to the beginning of World War I in 1914.

Chapter III is dedicated to modern microfinance and its potential and challenges. It starts with a brief classification of the various institutional forms of MFIs. We then present a series of detailed case studies giving examples of informal finance arrangements, local savings-led institutions, financial cooperatives, and banks focused on serving relatively poor people and small and very small businesses.

The chapter continues with a critical look at the various data sources available with regard to microfinance and inclusive finance and their main messages, and it concludes with a section on microfinance as a field of international aid and co-operation.

In Chapter IV we offer a brief summary and outline a set of tentative policy conclusions as to how microfinance should best be supported. The conclusions are, of course, based on our account of history in Chapter II, as well as on the lessons that can be derived from the case studies in Chapter III. They lead us to the overarching question that has motivated this study: Are savings banks and cooperative financial institutions suitable institutional forms for providing financial services to broad segments of the population in the less developed parts of the world, and if so, how and under what conditions can and should they be supported in the context of international cooperation?