Microfinance

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This policy brief outlines the key policy takeaways from our VoxDevLit on **Microfinance***. VoxDevLits are living literature reviews that summarise the evidence base on topics in development economics.*

The role of microfinance

Microfinance has become a widely used tool to provide credit to areas and populations that traditionally lack access to conventional banking services. Originating as a poverty alleviation mechanism, microfinance has grown in scope and design as a larger means of improving financial inclusion.

Despite the increase in access for new borrowers, much of the existing evidence has failed to find transformational effects on key outcomes such as profits and income. However, results are subject to significant variation across geographies, programme design and beneficiaries, and the heterogenous effects do lead to significant gains for certain populations.

The scope of microfinance

This brief uses the term 'microfinance' to refer to the provision of formal financial services to poor and low-income individuals, as well as other people systematically excluded from the financial system[1]. While microfinance is often targeted at microentrepreneurs, it is also commonly used for non-business purposes, such as consumption smoothing or for financing household expenses.

Microfinance is a broad concept; this brief focuses throughout on microcredit, leaving for another day the other various forms of microfinance (in particular, microsaving, microinsurance, and microequity).

Key takeaways

There is no 'grand unified theory of lending', or ideal form of microcredit contract.

Nonetheless, there are some general lessons for policymakers from the huge volume of research.

The 'traditional' model of microcredit does not have transformative effects on its borrower pool, though that class of contract may nonetheless be valued by microfinance clients for its provision of liquidity and its implicit insurance. Further, it may be possible to find substantial sub-groups for whom that kind of contract is valuable; in particular, for example, it may be valuable for clients with prior business experience.

Group lending was a prominent feature in early microfinance interventions, designed to mitigate adverse selection and moral hazard through joint liability for borrowers. However, empirical evidence has found joint liability to not be a prerequisite for high repayment rates compared to alternative incentives for borrowers.

Incentives for borrowers have been proven useful in improving repayment and default rates. Making access to future loans conditional on successful repayment of previous loans, for example, has been shown to increase repayment and reduce risky behaviour of borrowers.

Microfinance loans are subject to intra-household dynamics, and **interventions targeting women** specifically need to be sensitive to gender norms and inequalities that favour aggregation of resources into male hands. For this reason, contracts that allow clients greater autonomy over the use of the lump sum – in particular, contracts designed for women – may prove particularly beneficial.

Frequent repayment periods are often desired by microfinance institutions for their assumed benefit of providing financial discipline for borrowers. Following the evidence, however, highlights that spacing out repayments doesn't increase default rates, and allowing sensitivity to seasonal liquidity constraints can improve outcomes for borrowers.

Likewise, **flexibility in contracting and repayment timelines** can yield significant benefits for borrowers in terms of profits and income. Instituting 'grace periods' or allowing short-term deferrals in borrowers' repayment plans allows them to better allocate loans towards bulky investments or in case of external shocks - for many clients, a key attraction of microcredit is the opportunity to accumulate a lump sum. For this reason, microcredit contracts with an initial 'grace period' are likely to be valuable in a wide variety of contexts.

For **graduated borrowers**, at least, it may be that existing microfinance contracts are simply too small; 'strongly backing' such borrowers with contracts that provide for much larger lump sums may be a very useful innovation. Asset-based microfinance is one promising method by which a microfinance institution might viably do this and shows promise in yielding high returns across settings. Borrowers are able to acquire more expensive assets that can be used immediately compared to traditional microfinance loans, with built-in collateral for microfinance institutions in the assets provided.

At a broader **macroeconomic** level, microfinance can have positive impacts on wages and consumption; although the long-run impacts are small on average, the vast majority of the population experiences welfare gains, including poor and marginal entrepreneurs.

1 CGAP (Consultative Group to Assist the Poor) (2012), "A guide to regulation and supervision of microfinance." Available here.

Promising avenues of future research

Given the evidence that the effects of microcredit vary across borrowers, and that different contractual forms can work in different contexts, an open research question is how microcredit can become more flexible/tailored while retaining the advantages of its more basic forms – such as transparency, simplicity, the ability to keep costs low through group disbursement and collection, and the harnessing of social capital to promote repayment.

Different microcredit contracts clearly have different uses for different borrowers – in particular, some microcredit provides for business expansion, while much goes to consumption. There may be valuable contractual innovations in designing microfinance products that more effectively provide for business investment – and conversely, other products that more directly serve a consumption need (for example, products that are intuitive to the borrower and that incorporate appropriate consumer protection).

For a deeper dive into the research underlying these broader takeaways, check out the full VoxDevLit here.