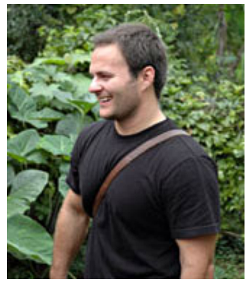
Due Diligence: An Impertinent Inquiry into Microfinance, by David Roodman



Review by: Steve Wanta

David Roodman has completed a thorough investigation of microfinance which has drawn interesting parallels from today's industry with the history of financial services. As an academic, he relies heavily on research much of which he discredits for its lack of rigor. Coupled with what appears to be a modest amount of field research, Roodman arrives at the conclusion that the net impact of microfinance on poverty is zero, not necessarily positive but also not negative. Very clearly he comes to the conclusion that microfinance is in fact good but for three seldom cited reasons.

1. Microfinance effectively smoothes incomes but is ineffective at helping the poor escape from poverty: Microcredit typically funds subsistent activity if invested in business at all. Microcredit is better suited for income smoothing which in it of itself is important.

2. Development as Freedom: Economist and philosopher Amartya Sen argues that the essence of development is expanding freedom, meaning greater control over one's circumstances. Poor people use financial services precisely in order to gain more control over their financial lives. And microcredit is often said to empower women by giving them more say over family finances. On the other hand, debt can entrap, reducing freedom.

3. Development as Industry Building: The most powerful force against poverty history has been industrialization, the process of churning that continually introduces new products and new ways of making old ones, along the way generating jobs and profits. [5] Within economics, this conception of development is associated with Joseph Schumpeter, who popularized the term "creative destruction." From the point of development as industry building, support for microfinance has succeeded, not in turning clients into Schumpeterian entrepreneurial heroes, but in building microfinance institutionsand industries that cater to poor people, create jobs, that enrich the national economic fabric.

Roodman Opinion: He summarizes his beliefs in the statement,

"For microfinance insiders, I side with the philosophy of the American network group Acción International and the German ProCredit group, a holding company of microfinance banks; I question the Microcredit Summit Campaign in its push to get microcredit to 175 million of the world's poorest people by 2015. For potential funders of microfinance… I advise against directly financing microcredit portfolios."

At a very high level, I agree with the three broad statements. As you dive into each point more deeply, I disagree fundamentally with key elements of his first two points. First, Roodman wants to de-emphasize credit in general and advocates against lending to the poorest through group lending. He cites the potential negative elements of peer pressure imposed by members of a group. In this regard, Roodman does not demonstrate the same statistical rigor for the potential adverse effects as he does for the positive effects of community building reported by the industry. Roodman uses the same anecdotal methods to demonstrate negative aspects of microfinance.

The reality of poor communities around the world that Roodman overlooks is that access to a consistent opportunity, credit or a job does not exist. There remain still, hundreds of millions of people without access to reliable financial services. To be clear, many of ACCION and ProCredit affiliates admittedly are not interested in serving a large section of the very poor that are in need and capable of managing credit. *See Pro Mujer Nicaragua.*

With access to credit, the poor have an opportunity to tap into their potential to provide for their family. As is very clear in the BRAC model and other similar organizations, credit is the carrot that begins to create a community fiber. The social capital that is created by knowing you are not alone in poverty; the support and friendship by commiserating with your neighbor, and countless other positives of sharing as a group are all real benefits but difficult to quantify.

Without a doubt, there are issues with the group process. Primarily the potential burden of defaulting members, the time consuming meetings, and the lack of dynamic products that may not be offered are a few of the issues we have seen in the field. What is missed by Roodman and dangerous in his assertion to abandon the group model is that these negatives appear over time. When groups are properly formed, there is a newness and excitement about getting credit (the carrot) for the first time. This is the easiest way (both for the client and the institution) to offer fast credit with little to no requirements while being accessible to the very poor with little to no assets.

So the argument is better made that microfinance institutions would be advised to continue to innovate, create graduation programs for successful centers, and continue to offer new, more, and better services. In both the Philippines and Vietnam, major MFIs CARD and TYM have transitioned to the ASA model (explicit individual loans within the center structure) in order to address client retention.

This is a healthy evolution for the client and the institution. Put simply, we must crawl before we can walk and then eventually run.

In Roodman's second argument, Development as Freedom, he concludes that the group method may in fact create less freedom for the poor. Because of debt and potential obligation for the debt of another group member, the poor are at risk of losing control of their freedom. Roodman uses Sen's analysis of freedom without recognizing another critical freedom made famous by Milton Fiedman, the freedom to choose. Borrowers choose to enter into a relationship with the MFI and acknowledge their responsibilities, both as an individual and group. For the millions without access, they do not have the benefit of a choice.

The critical aspects of microfinance that effectively targets the very poor are the organization's mission, approach, and commitment to putting the client first. The responsibility to know the client's situation, their business, and the local context are critical to offering an appropriate amount of credit. Over-indebtedness is an issue in some parts of the world so caution is always required.

All industries and every successful organization need to continue to evolve. Microfinance in particular cannot rest on its past accomplishments. The responsibility to continue to offer new, more, and better services to the poor is too important.

NOTE: I found the citation of Helen Todd's research from Bangladesh in the 80's as particularly interesting. My interpretation is that Roodman uses Helen's findings to demonstrate microfinance is different than it purports to be. Her research is used to build the case for the negative effects of group lending. Roodman never spoke to Helen and did not mention that she later went on to found Moris Rasik, Timor Leste's largest microfinance institution.