“Future of Microfinance” Review

Future of Microfinance is a collection of essays by leading thinkers[1] in the financial inclusion space. The book highlights the urgency needed for the microfinance sector to stay relevant and impactful, which would entail moving from “financial access” to “financial inclusion” i.e. moving from the quantitative question of “How many people can be reached with formal financial services?” to the qualitative question of “How can the constraints that inhibit the most vulnerable from using financial services be removed so that those services are incorporated into their daily lives?”. This will manifest as offering a variety of cheaper, faster, and demand-driven services at lower costs of delivery, all while being delivered in a responsible and sustainable way.

It’s important to note that the book’s recommendations were made principally for larger, more profitable and more stable MFIs than the ones WPF typically partners with. Also, the pieces were written just prior to covid and therefore don’t include perspectives on microfinance in the face of a pandemic. The main takeaways were the following.

Lessons regarding MFI business models

- **Client centricity**:
  - One of microfinance’s key comparative advantages is that it’s not an algorithm. Knowing customers and their needs is a core competency of microfinance, but many institutions don’t think about how to maximize the knowledge that sits with loan officers by turning it into business intelligence.
  - MFIs strong commitment to responsible financial practices and social missions differentiates MFIs from many digital competitors. Both MFIs and digital finance providers were repeatedly criticized for not starting with learning clients’ economic and social realities and molding financial services to their needs based on what would create value for them. Digital finance providers especially so regarding serving more niche and vulnerable segments.
- **Culture:**
  - With the emphasis on digitization, the human element can’t be forgotten, and staff need to be fully integrated into any organizational transformation. Buy-in and involvement from existing staff as well as consistent communication and training are equally important to more technical aspects when developing a digital strategy. It’s critical to have a sound change management strategy.
- **Skills:**
  - In addition to the historical jobs held within MFIs, MFIs need to find staff/consultants with strong digital skills to assess tech-driven solutions and lead their implementation will be important. But these skills are scarce and expensive. It is also worth reflecting whether the institution has other skills that may be affected by a transformation, i.e. negotiation skills to strike favorable deals with the platform players; risk management; treasury; etc.
- **Counter the digital divide:**
  - Ensure customer protection is a foundational focus and that digital solutions help marginalized groups, not aggravate their situation.

[1] Including from CGAP, Grassroots Capital, Symbiotics, Financial Access Initiative, LeHigh University, BBVA, International Finance Corporation, Center for Financial Inclusion, Boulder Institute of Microfinance, World Bank Group, PAMIGA.

- **Collaboration**:
    - MFIs should partner with entities that can bring scale and lower costs. They should also proactively work closely with regulators and policymakers. MFIs and investors need to make advocacy central to their work as the lack of appropriate and proportional regulation over microfinance could remain a constraint in many markets as interest rate caps restrict the supply of credit.

Lessons regarding partnerships

- **Partnerships are key for scale**:
    - MFIs pursue different forms of partnerships but will generally have one of three objectives: (1) expand the MFIs product offerings, (2) extend reach, (3) provide access to data.

Lessons regarding digitization

- **The benefits of fintech are not materializing quickly** in many microfinance markets because Fintechs depend on institutions to develop proprietary screening models that are tailored to certain markets. Fintechs on their own are not usually in a position to easily acquire clients, so instead they must acquire MFIs. Large MFIs or banks can provide both clients and balance sheets to finance the loans screened by the fintech. Scaling fintechs and proving the model's viability is both costly and takes time.
- **Done right, tech can help MFIs serve more customers** at lower cost, understand customers better, build products that meet clients' needs responsibly, and help them grow their customer base. But there are also strategic, operational, reputational and implementation risks related to new technologies that have to be carefully managed.
- **To date, the most common digital services provided by MFIs are** payments (person-to-person; business-to-person; government-to-person); and other over-the-counter transactions by agents, followed by mobile access to savings accounts to increase deposits and in limited cases: digital loan products
- **Technology trends:** Artificial intelligence, automation, big data, distributed ledger technology, and machine learning are accelerating the pace of innovation in financial services. New entrants including MNOs, payment service providers, merchant aggregators, retailers, fintech companies, neobanks, and superplatforms are leveraging these technologies and altering the competitive landscape for financial services.
- **Strategic, technology, and competitive risks** faced by MFIs are greater than ever which creates tremendous opportunities for innovation by MFIs to reduce costs, improve efficiency and productivity, dramatically increase outreach among underserved and underbanked populations, and improve customer engagement and retention. The key challenge is determining the appropriate strategy given each MFIs goals and business model and customer segments, internal capacity and resources, potential technology partners, + the local operating environment
- **4 main ways that technology can be used as MFIs transform:**
    1. **Channels:** For social distancing, convenience and services that reflect their needs, MFIs need to build alternative channels including expanding the use of agent networks, remote customer on-boarding and enhanced use of call centers. This trend will continue, either through integration with larger platforms or building the institution's own channels. It is risky for an MFI to invest in their own proprietary technology though and many cannot afford this investment without donor support.

2. **Use of data:** The ability to gather and use relevant data is central to the changes MFIs need to compete, from risk-based pricing to effective credit risk management, from new product design to customer relationship management, from improving operational efficiency to growing the portfolio over time. Need to make better use of customer data as it is highly predictive and can offer important insights into customers. Need to transition from paper records asap…even if they can't start digitizing historical data today, need to start building better data management structure now.
3. **Product diversification:** MFIs will either need to broaden the services they offer in a way that meets customers' demands and enhances loyalty or find a way to make the services of third parties available without losing the customer relationship. Clients stick around more when offered a range of complementary services. But to achieve product diversification, MFIs need better data, as well as more sophisticated back-office capabilities and technology skills.
4. **Flexible core systems:** Need to build more flexible core IT and data management systems, which have traditionally been a weakness for MFIs. With cloud computing and Banking as a Service (BaaS) providers now meeting this demand in the banking industry, shared IT solutions could become a game changer for the microfinance industry. MFIs would need to invest in some skills and infrastructure, but a vendor solution would require less investment than transforming on their own.

- **Larger, stable MFIs should invest** in information technology like IT systems that connect with each other and have the flexibility to grow with the business; in good IT staff and consultants; should choose simple, low cost systems that build in flexibility for the future; look at more established solutions like putting their systems in the cloud, building more flexible connectively between different IT systems through APIs and investment in improved data mining and analytics capabilities.
- **It's an investment but there is a business case for digital financial services (DFS):** For example, transactions through agent networks cost 25% less to provide than branch teller transactions (one study found) and the opportunity to source deposits from a broader market can have a positive impact on cost of funds. Other research shows that the ability for clients to repay loans anytime, anywhere improves portfolio quality by ~10%. But often, expectations for DFS are higher than what reality permits. So, MFIs need to develop business models tailored to their specific market conditions and unique capabilities. They also may need to layer and cross-sell products and services to be viable.
  - Book recommends using agents to increase outreach and improve efficiency but warns that it (1) increases operational risk and (2) is expensive to manage agent networks. One report says that MNOs pay out 52% of total revenues from mobile money operations in agent commissions alone, not including the cost of training agents, liquidity management, or branding. Thus, focus should be on active agents, not on overall agent numbers. Common mistake is to try to grab market share by engaging many agents at once. Donors contribute to this mistake by providing incentives to scale up rather than insisting on sustainable business model. Should start small and focus on usage.
- **Microfinance's digital strategies must clearly define what it wants to accomplish** and how the market and environment as well as internal factors can facilitate or hinder implementation. MFIs must first clarify if they are digitizing to reduce costs, enhance customer experience, expand market share, become more competitive against other market entrants, etc.

Lessons regarding impediments to digitizing

- Weak governance, difficulty attracting technical expertise, inadequate resources, rigid business models, and a heavy reliance on manual processes
- Other risks:
    - Unfair pricing, nontransparent disclosures, weak financial awareness or capacity, over-indebtedness, lack of customer recourse, loss of funds or access due to fraud, data breach, blacklisting, system errors due to weak DFS infrastructure.
    - Lack of preparation - an MFI may think it is just introducing a channel or a data scored credit product as a tweak to its business, but such changes are likely to ripple through the organization in unexpected ways. And so, the core business model must evolve.

Lessons regarding risk management

- **Uncertainty demands strong risk management frameworks to achieve objectives:** Most effective strategies include call centers to track, monitor and predict eventualities; using strong reconciliation and settlement processes to reduce potential losses; taking partnerships seriously to ensure that partners are held accountable.
- MFIs also need to pay attention to:
    1. **Pricing, transparency and financial well-being** which are essential to establishing customer resilience (note: a 2018 study showed that institutions certified by the Smart Campaign had fewer non-performing loans and greater overall portfolio growth)
    2. **Data privacy and data security** are fundamental to maintaining customer trust in digital financial services
    3. **Strong customer relationships** are critical for future of financial inclusion: can add technology innovation but need staff to strengthen relationships, particularly for the structurally underserved
    4. **Risk and internal audit processes**
    5. **Governance** also remains top risk facing MFIs
    6. **Global trends** around natural disasters, climate, migration, changes in the nature of work, youth unemployment, economic instability.

Lessons regarding governance

- **Need to ensure governance and IT governance** to ensure the appropriate structures and processes in place to ensure long term viability; introduce internal structures and processes to build confidence with investors and improve reputation with stakeholders, increase operational efficiency by establishing a framework to manage risks, reduce vulnerability to crises with quicker and more effective responses.
- **IT governance** is also needed to avoid strategic, reputational and financial consequences for MFIs. Will be challenge to attract talent at board and management levels with required experience.

Lessons regarding product diversification

- **Housing loans**
    - A good example is Enlace of El Salvador which partners with Habitat for Humanity. Successful due to:
        - Village banking methodology

        - To qualify, a client needs to have been with Enlace for more than a year
        - Interest rate is lower than business loans
        - Legal framework under which it operates does not have strict rules governing private transactions between willing private parties, meaning the housing product has not been hampered by regulatory issues.
    - Main obstacles to growth of the product: overleveraged clients and the high levels of violence/insecurity in the country.
    - This product also does well in Peru too where there's no caps on IRs, a smooth approval process for non-brank intermediaries, and a national environment of innovative loan products. Mibanco (privately owned, regulated MFI bank) also partnered with Habitat for Humanity to develop program called MiCasa. Bank promotes, originates, and books the corresponding loans while Habitat offers technical assistance.
- **Student loans**
    - **Challenges**: Examples show that it demands much more customization than anticipated. Additionally, profitability takes time as reasonable volumes are needed to achieve economies of scale. Also, often have much lower returns than the high rates associated with working capital microloans. Finally, there are technical challenges related to the level of difficulty (i.e. risk managers will see as very risky and be inclined to impose barriers to product implementation; marketing and promotion strategies will need to be adjusted; data processing as well as incentive systems for credit offers will need to be modified).
    - **But there is a double bottom line** and the intangible value associated with the product helps the MFI reach its social objective/mission.
    - **To implement:** De-risk the product offering particularly if this is with new customer segment. De-risking = job market research, refining creditworthiness by analyzing future cash flows or income-sharing approaches, identifying guarantors, adapting marketing strategies, assigning an institutional product champion, partnering with large potential employers and educational institutions;
- **Insurance**
    - **Trends:**
        - **Health insurance, ag or product insurance, etc. need a structured market development** process that brings together the full range of stakeholders, from regulators to ministries, industry associations, insurers, and distributors is necessary for future insurance developments.
        - **Product evolution:**
            - Over past decade, microinsurance has been scaled best by bundling it with other items – loans, savings, seeds, etc. This revealed a lot to the market: that that are new market segments that are profitable. This will lead to greater supply of/ demand for insurance by poorer people.
            - Challenges: (1) Clients who have access to insurance don't always know they have coverage; (2) Embedded insurance has to be extremely inexpensive or it will make the core purchase (i.e. the loan/seeds/etc) uncompetitive. Thus, the bundled insurance doesn't necessarily provide useful benefits for clients.

- Solutions: (1) Ensure policyholders and clients know they are covered through additional outreach and reminders; (2) invest more in efforts to cross-sell top-ups to basic insurance to convert clients to voluntary coverage
- Lesson: Insurance won't cover everything. So, can expect financial service providers to start offering integrated solutions that bundle different forms of protection (such as an emergency loan) that are unlocked when risk events happen.

- **Agriculture and Climate insurance:**
  - The Global Risks 2017 report ranked extreme weather events and natural disasters as top risks in terms of both likelihood and impact.
  - Smallholders take more risk and invest more in their farms when they know they have protection…this leads to higher-risk, higher-return production.
  - Bundling agriculture insurance with services like credit and farming inputs makes insurance more tangible, results in better social outcomes, and enables systems to scale more quickly
  - The International Labour Organization is facilitating a learning platform that enables members governments to share their experiences about how to make ag and disaster insurance more accessible and responsive. They also created the PACE assessment tool to consider product from client's perspective.
- **New players and business models:**
  - Can expect to see a trend away from stand-alone micro insurers and toward dedicated "emerging consumer" teams within insurance companies (orgs like Britam in Kenya and Pioneer Insurance in the Philippines do this).

Lessons regarding financing

- **Microfinance has shifted from depending on donor/institutional support to attracting commercial capita**l, an indicator of the sector's momentum. The subsidy level has reduced substantially, and the industry is largely financially sustainable. Under covid, we will have to see how the sector emerges from the current crisis where, in time, significant restructuring assistance might be required.
- **To transform the industry as needed would require additional investment** and taking risks, and to achieve that, the funding ecosystem needs to start playing like a team again. This means focusing on what each can uniquely contribute:
  - **MIVs**: encourage greater resilience through their commercial investments; demand more from their investees in terms of risk management and reporting capabilities; think creatively about using loan covenants to incentivize a focus on enhanced resilience.
  - **Equity investors**: influence through governance; encourage continuing the digitization journey. There is a role for specialized equity funds, like the one Accion is raising, to invest in MFIs that have compelling digital transformation plans in place.
  - **DFIs**: push the sector further by embracing digital transformation; inject lessons from fintech into traditional MFIs and back their technical advice with investment funding; build solutions to the really hard problems i.e. making local currency facilities more available in tough markets through blended finance instruments, guarantees for local currency lending by local banks and helping to underwrite local currency bonds (for digital transformation to happen, they will have to accept some of the costs and risks that it entails, leveraging their donor relationships to help support riskier investments)

- **Donors**: While in recent years, returnable capital has become a priority for many donors seeking to make their aid budgets go further, donors can take risks that no one else can. The more donors focus their limited resources on mimicking what investors are doing, the less they can invest in the vitally important undertakings that help build an inclusive finance sector.
- Donors can also help shape responsible finance by incorporating commitments like these:
  - **Promote responsible investment in digital finance**: support MFIs that expand the range of financial services to underserved groups with goal to reduce their vulnerability; encourage board governance and management
  - **Manage risks comprehensively with growth of digital inclusion**: ensure that the risks that emerge from innovation are felt just by those that are equipped to absorb them (i.e. not by the end customer); work with MFIs that identify risks for clients in their business model
  - **Encourage legal and regulatory frameworks**: support prudent legal and regulatory frameworks and ensure compliance to existing regulations; engage with policymakers to reflect customer protection concerns and commercial concerns
  - **Facilitate interoperability and infrastructures for DFS ecosystems**: encourage investees to take responsibility for the actions of agents, employees and third-party service providers across the value chain
  - **Establish customer identity, data privacy and security standards**
  - **Promote fair and transparent pricing**
  - **Promote improvement of disclosure of terms and conditions for customers**
  - **Encourage improvement of customer services for problem resolution and product innovation**
  - **Prevent over-indebtedness, strengthen digital literacy and financial awareness**
  - **Track progress to mitigate risks and expand DFS opportunities**