Towards Convergence Between the Banking Sector and Microfinance?

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Banking sector and microfinance interactions for financial and social inclusion are not new. 19th century Europe witnessed a cooperative movement in Germany and France, respectively. The movement had the objective of fighting financial exclusion. Both initiatives benefited from government support, and are now part of the regulated banking sector.[1] Microfinance institutions (MFIs) share the same objective. Unlike their 19th century European counterparts, however, MFIs' convergence process risks losing its social goal.

MFIs are either becoming commercial banks or are increasingly linked to the financial sector for funding. Moreover, traditional commercial banks are downscaling.[2] But commercialization and downscaling are a venue for convergence via *widening* financial inclusion. Promoting MFIs engagement in cross-subsidization and innovation with the support of governments and foundations instead, should help convergence via *deepening* financial inclusion.

Commercialization is controversial. Mexico's Banco Compartamos, for example, a former NGO, launched an Initial Public Offering (IPO) in 2007. Its number of active borrowers has quadrupled since.[3] It now offers a larger number of products ranging from group and individual loans to

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[1] See, Banerjee-Besley-Guinnane (1994), "Thy neighbour's keeper: The design of a credit cooperative with theory and test". Quarterly Journal of Economics 109 (2) (May); Armendáriz – Morduch (2010), *The Economics of Microfinance*, MIT Press; and http://www.credit-agricole.com/Le-Groupe/Histoire-du-groupe-Credit-Agricole on the origins of the Crédit Agricole.
[2] See, Delphine- Perón (2007), "Commercial Banks and Microfinance" in www.researchgate.net.

[3] Mix report http://www.mixmarket.org/mfi/compartamos-banco

deposits and insurance. This is a step towards convergence. However, the perils of commercialization are twofold.[4]

Relative to NGOs, commercial MFIs serve clients who are less poor, and have a larger number of men clients. [5] Crowding out women, and serving wealthier men clients supports financial widening at the expense of financial deepening, which in turn deviates from microfinance social objectives.

Downscaling banks are also a stepping-stone towards convergence. However, downscalers' operations in microfinance remain marginal because staff training costs are high; reluctance to expand in microfinance where regulatory environments are weak;[6] government intervention fears;[7] and uncooperative behaviour by MFIs, which fear losing staff and best clients to the banking sector.

Nonetheless, ongoing connections between the formal sector and MFIs involve synergies, which could resolve excessive widening over deepening. The microfinance industry can learn from the banking sector, especially with regards to risk management, productivity, and cost reduction.

Administrative costs are too high when lending tiny loans to the poor. To keep its strong social mission and attain self-sustainability, MFIs can have a profitable leg, which returns can finance investment activity in the other leg, namely that of poor clients requesting tiny loans. This cross-subsidization process can make convergence happen.

However, convergence is inconceivable without lowering the current interest rates charged by MFIs. The introduction of innovative technology can play an important role here. A wider and more effective use of the M-Pesa transfer platform in Kenya, for example, opens the scope for MFIs'

[4] See, Cull et al (2009), "Microfinance Meets the Market", Journal of Economic Perspectives 23(1) (Winter).
[5] This phenomenon is often referred as mission drift. See, Armendáriz – Szafarz (2011), "On Mission Drift in Microfinance Institutions", in *The Handbook of Microfinance*, World Scientific Publishing (London).
[6] Idem
[7] Government intervention can at times be extreme. A recent case in point is the extensive intrusion of the Bangladeshi government in the microfinance operation of the Grameen Bank – a cooperative.

adoption of technological innovations. These can lower costs, and, therefore, prices. [8]

Cross-subsidization and technology adoption, working in tandem, is an innovation in its own right. Government support and subsidies are therefore required. Current subsidies towards financing traditional MFIs' practices must target research and Development (R&D) and technical assistance in order to foster convergence.

Convergence will make wider financial products within reach of poor clients at lower prices. And, like the 19th Century institutions have demonstrated, convergence is possible, albeit with government support and subsidies – just like any other R&D activity involving a social benefit which is not fully internalized by the private sector.

[8] Some MFIs are already lowering administrative costs by allowing loan repayments via clients' mobile phones.