

WHAT MAKES MICROFINANCE WORK

Last year's award of the Nobel Peace Prize to Muhammad Yunus reflects the emergence of 'microfinance' as an important instrument for combating poverty. In the past ten years, the number of microfinance institutions has increased from around 600 to over 3,000, and the number of people who received credit from these institutions has risen from 13.5 million to more than 113.3 million.

Writing in the February 2007 issue of the *Economic Journal*, Professors **Niels Hermes** and **Robert Lensink** review some of the latest research evidence on what makes microfinance effective. Among the findings:

- The stronger the social connections between members of a group lending arrangement, the higher is its repayment performance.
- Repayment performance is also associated with the extent to which group members have developed personal trust. This supports the view that social connections and personal trust are important in assisting monitoring and enforcement efforts.
- If social connections are too strong – that is, when group members are relatives – this actually decreases repayment performance.
- Individual-based microfinance institutions perform better in terms of profitability than group-based institutions. But the fraction of poor borrowers and female borrowers in their loan portfolios is lower than for group-based institutions.
- Especially when individual-based microfinance institutions grow larger, they focus increasingly on wealthier clients – 'mission drift'. This is less common with group-based microfinance institutions.

Microfinance programmes have been introduced in many developing economies. Well-known examples are the Grameen Bank in Bangladesh and Banco Sol in Bolivia. The Grameen Bank system of group lending (established in 1976 by Muhammad Yunus), in particular, has been copied in other developing countries, and the United Nations declared 2005 to be the international Year of Microcredit.

In spite of the almost euphoric attitude among policy-makers and aid organisations about the potential effects of microfinance, there has been surprisingly little empirical evidence on whether and how microfinance actually works. This paper summarises the findings of new empirical contributions on several key questions about microfinance.

These contributions deal with two hotly debated issues. One is the question of why and how group lending programmes work; the other deals with the financial performance and outreach of microfinance programmes. It is extremely important to have more insights into how and why microfinance works and how it performs so as to evaluate whether microfinance is an efficient instrument to combat poverty on a large scale.

With respect to group lending, new empirical evidence provides a number of important insights with respect to the drivers of repayment performance of groups. These insights are of crucial importance for policy-makers, since high repayment performance determines whether microfinance will be financially viable in the long term, which adds to the impact it can have on reducing poverty.

The main conclusions of the empirical studies on the repayment performance of groups

focus on the role of interactions between group members and the effect on repayment. These interactions are related to the nature of social connections and trust between group members. Research shows that the stronger the social connections between group members, the higher is the repayment performance of groups.

Research also shows that repayment performance is associated with the extent to which group members have developed personal trust. These results support the view that social connections and personal trust in group lending are important in assisting monitoring and enforcement efforts within groups.

Finally, research indicates that if social connections are too strong – that is, when group members are relatives – this actually decreases repayment performance. The reason is that group members are less inclined to pressure family members to repay their loan.

With respect to the financial performance and outreach of microfinance programmes, new empirical evidence strongly underlines the importance of institutional design in considering trade-offs in microfinance. Individual-based microfinance institutions perform better in terms of profitability than group-based institutions.

But the fraction of poor borrowers and female borrowers in their loan portfolios is lower than for group-based institutions. In addition, individual-based microfinance institutions, especially if they grow larger, focus increasingly on wealthier clients (mission drift), whereas this is less so for the group-based microfinance institutions.

ENDS

Notes for editors: ‘The Empirics of Microfinance: What Do We Know?’ by Niels Hermes and Robert Lensink is published in the February 2007 issue of the *Economic Journal*.

The authors are at the University of Groningen.

For further information: contact Romesh Vaitilingam on 07768-661095 (email: romesh@compuserve.com); or Niels Hermes via email: C.L.M.Hermes@rug.nl