Aid donors have shown microfinance can work. They should now leave their successes behind

SUCCESS has many fathers. No wonder, then, that paternity suits are flying in microfinance—lending small amounts to help the poor pull themselves out of poverty. Thanks first to charities and, later, international financial institutions (IFIs) like the World Bank, microfinance has been shown to work (see article). Now philanthropists such as Bill Gates and Pierre Omidyar, the founder of eBay, are using their own charities to pour money into the field. So, increasingly, is the for-profit sector, including “socially responsible” investors and capitalists more interested in the bottom line than the poverty line.

Microfinance is a promising way to get credit to parts of the economy that are starved of capital. So it is a pity that all these lenders are competing to support the same, small group of microfinance institutions that cater to the most creditworthy borrowers. It would be better for the poor if the IFIs and donors left the best credit risks to profit-seeking lenders and concentrated instead on those still stuck outside the system.

Micromanagement

No doubt that sounds ungrateful. Microfinance is in vogue thanks partly to the IFIs, which provided grants, loans and training to untested microcredit institutions. The private sector shunned the risk—out of ignorance, a lack of expertise and fears that making money from the poor would look predatory. The pioneering work of donors means there are now some 10,000 microfinance institutions lending an average of less than $300 to 40m poor borrowers worldwide.

As a result, microfinance has become profitable. Top-tier microlenders no longer need subsidies or even commercial loans from IFIs or philanthropists. ProCredit, made up of 19 microfinance banks
in countries from Moldova to Ecuador, was established in 1998 by some IFIs. Now wildly successful, it boasts over 2.2m customer accounts and arrears by volume of a minuscule 1.2%. So many of its banks make money that it could even list its shares on the stockmarket.

The Inter-American Development Bank has acknowledged that the best microlenders can finance themselves either by gathering deposits to finance loans or by attracting commercial investors. It is busily selling equity stakes in its portfolio of microfinance investments. But other development groups are less willing to cut the apron strings. They continue to devote scarce aid dollars to the microlenders that need them least. Having nurtured these outfits when for-profit groups would not, they now want to bask in their successes. Some philanthropists, too, prefer to take the safe route and invest in stable, profitable top-tier microfinance groups.

This trophy lending is harmful. By subsidising microfinance groups that do not need it, aid bodies and philanthropists discourage private money, which cannot compete with their soft terms. In the long run, this harms microfinanciers, because it slows their integration into the financial-services industry and thus hampers their transformation into lenders able to stand alone.

Aid money is better spent where commercial cash fears to tread—such as on the next generation of microfinance institutions. Subsidies are often needed to lend to the rural poor, where small, scattered populations make it hard for commercial lenders to cover their costs. Donor funds could be used to invest in technology such as mobile payments, which promise to cut the cost of providing microcredit. Top microfinance institutions themselves may need help in expanding into insurance and other financial products for the poor, as well as in tapping the capital markets. IFIs, in particular, can press foreign governments to get rid of interest-rate caps and other misguided regulations that impede microlending.

Only a fraction of the world's 500m impoverished “micro-entrepreneurs” have access to the financial system. There is not enough donor or “socially responsible” money in the world to meet the demand. That's why microfinance needs private-sector capital. Aid agencies, philanthropists and well-meaning “social” investors can help attract it by investing only where commercial outfits will not. When the children come of age, the best parents step aside.