LEVERS FOR SCALING UP MICROFINANCE – THE CASE OF THE UK

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ABSTRACT

Microfinance Institutions (MFIs) play an important role in economic development by financing viable businesses that otherwise would go unfunded. However, scaling up the microfinance sector and its impact in a sustainable manner has proven challenging in industrialised countries. MFIs in these countries serve relatively small markets, often target vulnerable and excluded clients, and have limited scope to price in risk due to more price sensitive customers and interest rate caps. This paper critically discusses the pathways for scaling up microfinance in Developed economies using the UK as a case study. It is argued that there are three different logics for scaling up: commercial (growth through financial sustainability), public policy (growth through strong links to public policy objectives and debates) and technological (scaling up through changing customer expectations and transforming business models). The paper argues that determining how a national microfinance industry can scale up requires considering the market in which the providers operate.

Keywords: Microfinance; sustainability; growth

JEL Classification: G21

1. INTRODUCTION

The modern international microfinance sector, which emerged in the 1960s and 70s, has displayed impressive growth rates. The sector has grown from small NGOs to a multibillion global business sector. According to the 2015 State of the Microcredit Summit Campaign Report, the global microfinance industry grew from serving 13m customers in 1997 to 211m in 2013 (Reed et al, 2015). The overriding conclusion drawn from the experience of international Microfinance Institutions (MFIs) is that financial sustainability – the ability to cover operating and capital costs through income generated by the loan portfolio – is the indisputable mechanism to scale up:

> *"The debate is about whether or not MFIs can… provide services to poor households…while at the same time being financially sustainable… they should be able to reach to poor clients without making net losses and/or without being dependent on subsidies over the medium to long-term…if MFIs provide services to the poor, while making losses…their business model will not be sustainable for the long-term" (Hermes and Hudon, 2018, 1485-86)*

In other words, MFIs must be able to cover their costs whilst serving the poor. The international microfinance industry has inadvertently set expectations, often implicit or explicit in policy, for MFIs in industrialised countries to scale up without relying on public subsidies (see e.g. CGAP, 2004). Yet, scaling up the microfinance sector in a financially sustainable manner has proven challenging in industrialised countries. MFIs in these markets serve relatively small markets, often target vulnerable and excluded customers, and have limited scope to price for risk due to more price sensitive customers and interest rate caps (Dayson et al, 2008).

This paper critically discusses the pathways for scaling up microfinance in Developed economies using the UK industry as a case study. It argues that there are three distinct logics for scaling up: commercial (growth through financial sustainability), public policy (growth through strong links to public policy objectives and debates) and technological (scaling up through changing customer expectations and transforming business models). Further, the paper argues that determining how a national microfinance industry can scale up requires considering the market in which the providers operate. This determines if the MFIs can operate in a cost-effective, sustainable or profitable manner. The determinants of scale can explain why Developing world microfinance is larger but also why Developed country MFIs may not be able to pursue the growth strategies followed by their Developing country counterparts.

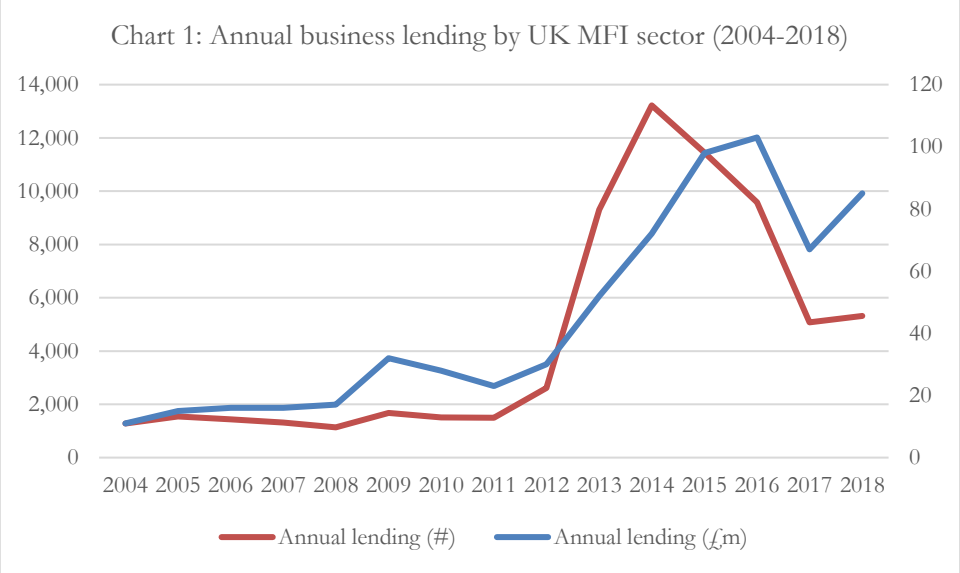
The remainder of this paper is organised as follows. Section 2 provides a brief overview of the UK microfinance sector. Section 3 examines the different levers for scaling up microfinance and three market

conditions affecting the levers available to MFIs: financial market, economic structure and supply side restrictions. Section 3 provides a short discussion and conclusion.

2. THE UK MICROFINANCE SECTOR

UK MFIs, or Community Development Finance Institutions (CDFIs), lend and invest in deprived areas and underserved markets unable to access mainstream finance. They are non-deposit taking financial institutions regulated by the Financial Conduct Authority and are mostly affiliated to Responsible Finance as a trade body. The earliest MFIs were set up in the 1980s, but many were set up in the late 1990s with financial and technical support from Government and other organisations. They take various legal and institutional forms, including mutual organisations, charities, not-for-profit organisations and private limited companies. Most MFIs serve local markets in the area in which they are based.

In 2017, there were 27 MFIs providing just over 5,000 business loans and support to existing businesses and aspiring entrepreneurs unable to access finance from the mainstream banking sector. Chart 1 shows the number and value of loans issued annually by the sector between 2004 and 2018.



In 2018, the sector made around 5,300 loans of a value of £85m, largely to start-ups and self-employment. Lending by the sector grew significantly from 2004 to today, especially between 2012 and 2016. The periods of growth and decline in lending has largely been driven by the availability of public funding for loan capital.

3. LEVERS FOR GROWTH AND THE IMPORTANCE OF CONTEXT

There are three distinct logics for scaling up microfinance. Firstly, there is the commercial logic, whereby providers expand in a financially sustainable manner without using indirect or direct public subsidies (e.g. grants, capital at below market-rate costs etc.). In other words, MFIs can cover operating costs and capital at market price with income generated by the loan portfolio if they operate in efficient manner and price for risk and cost. In international microfinance, there has been a drive for MFIs to become financially sustainable.

Secondly, there is the public policy logic, according to which providers scale up by fulfilling public policy objectives and addressing public policy debates. MFIs in Europe and the US have scaled up through strong links to public policy objectives and debates (see e.g. New Economics Foundation, 2008). This has led to sustained public funding of and strong partnerships with mainstream financial institutions (Cozarenco, 2015). In these countries, there is often a case of market failure, as markets are seen not to operate efficiently precluding people with viable business propositions to access finance (often due to information asymmetries) or due to positive or negative externalities on a societal level (e.g. welfare costs etc.).

Thirdly, there is the technological logic, whereby providers can scale up rapidly by changing expectations and transforming operational models. The rise of Fintech – "the use of technology to deliver financial

solutions" (Arner et al, 2016, 1272) – brought about by the financial crisis, technological breakthroughs and changing consumer habits and preferences is changing how financial services are developed, delivered and used. Technological innovation in financial services is not new, but Fintech involves a paradigm shift in terms of the fast pace of change and introducing new actors disrupting the marketplace by transforming the delivery of financial services (Arner et al, 2016).

This paper argues that market conditions influence which business model MFIs, defined as "how a company creates, sells, and delivers value to its customers" (Davila et al, 2006), can use, which in turn influences the logics they can use to expand. This relationship is illustrated in the figure below.

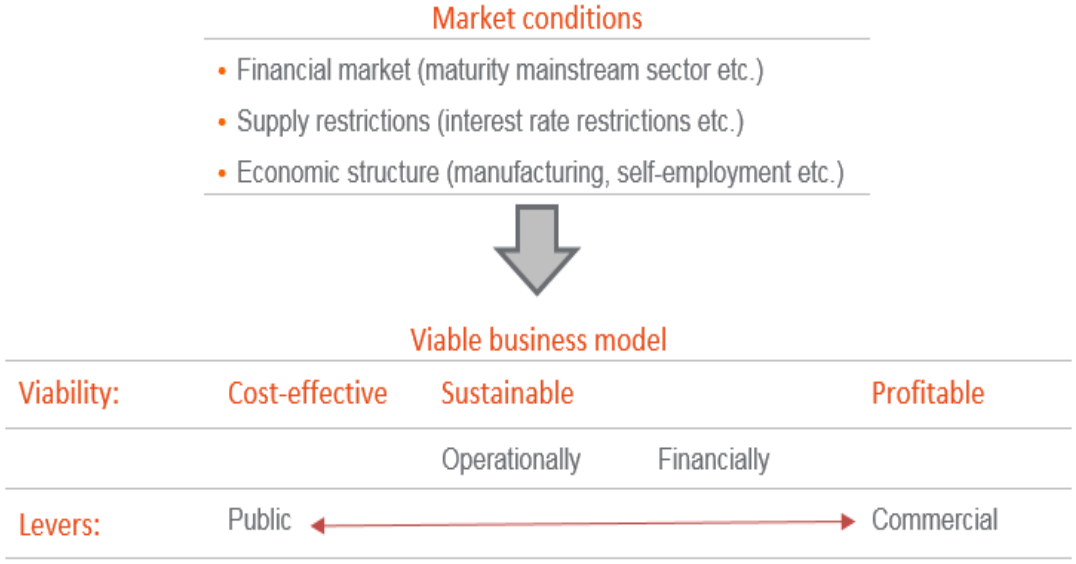


Figure 1: Business models and market conditions

The definition of a viable business model can range from being cost-effective (relative to other interventions) at the one end to being able to generate a profit at the other. In between these two, providers can reach operational or financial sustainability. Operational sustainability refers to the ability of MFIs to cover their operating costs with borrower interest and fee income, whilst financial sustainability means being able to cover capital costs as well as operating costs through such income.

Depending on where the MFI is on this scale, it can resort to commercial or public levers. There may be some overlap, especially in the sustainable business models. The fit of the technological levers is more complex. For example, by fundamentally altering the delivery model and customer expectations, it may in theory make a previous market profitable. This paper identifies three market conditions – financial market, supply restrictions and economic structure – that help determine if an MFI can operate in a cost-effective, sustainable or profitable manner.

3.1. Nature and structure of financial market

The nature of financial markets – in terms of development and maturity of the mainstream or formal financial sector – help determine of it is possible to be cost-effective, cover costs or generate a return. The microfinance sector emerged to address the lack of access to formal finance. Hence the size and maturity of the formal financial sector influences the size of the market. The maturity of mainstream financial institutions may also influence the customer profile in terms of risk and support required, as a greater proportion of lower risk potential borrowers are likely to have access to mainstream finance.

Few studies have looked at relationship between MFI performance and the maturity of the financial sector (Hermes and Hudron, 2018). The results are mixed for those that do. Some find that a more developed financial systems improve financial performance, possibly because it improves the access to financial services for MFIs and it pressurises MFIs to improve. Other studies find the relationship to be negative as MFIs have greater outreach and financial performance where the financial system is weak. In contexts where banks compete with MFIs, it may lead to higher debt levels and lower demand.

In the case of UK, there are two important observations to make. Firstly, the banking sector is a highly mature sector and well-developed sector even compared with Developed country counterparts. Large, national banking organisations started emerging in the latter part of the 19th century (Vik, 2017) and make up a large proportion of economic activity compared to many other countries (Davis, 2009). Table 2 shows the number of commercial bank branches per 100,000 adults, a proxy for the density of the mainstream financial services sector.

Table 2: Commercial bank branches (per 100,000 adults)

	2004	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
East Asia & Pacific*	7.8	6.6	5.7	6.0	4.9	4.0	4.1	4.3	6.1	6.4
Latin America & Caribbean*	10.7	11.7	11.9	12.8	13.1	12.9	13.4	13.0	12.9	12.6
Middle East & North Africa*	9.3	9.7	10.6	10.7	10.7	10.8	11.2	11.2	11.5	10.6
Sub-Saharan Africa*	1.5	1.5	1.6	2.1	2.5	2.8	3.4	3.5	3.7	3.8
South Asia	7.3	7.3	7.4	7.5	7.7	7.9	8.0	8.2	8.7	8.8
UK	**29.0**	**28.3**	**26.4**	**26.4**	**26.0**	**25.4**	**24.7**	**24.1**	**22.1**	**25.1**
North America	32.7	33.3	29.3	29.7	29.9	30.0	29.7	29.7	29.6	28.9
European Union	28.9	28.2	29.4	29.9	33.1	33.5	30.6	29.8	25.6	26.0

*IDA & IBRD countries only

The UK has a significantly higher density of commercial bank branches than Developing country regions, which also have significant microfinance activity. This is especially the case for Sub-Saharan Africa, South Asia and East Asia and Pacific. Bank branch density is also higher in North America and the European Union than in these regions.

Secondly, financial exclusion, the inability to access mainstream finance, is a relatively marginal phenomenon in the UK. For example, since the 2004-05, more than 90% of the population have owned bank accounts (Vik et al, 2018). Table 3 shows the estimated unmet need for finance among SMEs relative to national GDP.

Table 3: SME finance gap as percent of GDP

All developing countries	19
East Asia & Pacific	18
Europe & Central Asia	20
Latin America & Caribbean	23
Middle East & North Africa	25
South Asia	13
Sub-Saharan Africa	22
UK	**0.8**

Notes: UK data from National Audit Office (2013); Rest of data from SME Finance Forum covering Developing countries only

In the UK, the National Audit Office (2013) estimated that the unmet need in 2017 would be £22bn but that it could potentially reach £39bn depending on wider economic developments. Although significant, this constitutes less than one percent or a percent and half of the UK GDP. This is significantly lower than in Developing countries where the unmet SME finance need was 19% on average and ranged from 13% in South Asia to 25% in Middle East and North Africa.

Microfinance in both Developing and Developed world countries originally emerged because credit markets by themselves do not ensure efficient and equitable distribution of business loans. Due to

information asymmetries, where the lender has less information than the borrowers about the business proposition, mainstream lenders often resort to secured lending or credit scoring, whilst local moneylenders charge high interest rates. The original innovation in lending methodology, group lending or peer monitoring, made it viable for MFIs to lend in a financially sustainable manner without charging rates perceived to be extortionate, as it significantly reduced default rates (Stiglitz, 1990). In the UK, there are persistent information asymmetries in the SME and start-up finance market (PWC, 2015), which MFIs have sought to circumvent through offering non-secured loans, relationship-based underwriting and offering business development support. Although this lending methodology and approach has enabled UK MFIs to reach their target market they have not enabled them to do so in a financially sustainable manner (PWC, 2015).

3.2. Economic structure

The growth and performance of MFIs is likely to be influenced by the national and regional economy in which it operates. On the one hand, a growing economy may improve repayment performance and increase demand for microfinance, because it may encourage microentrepreneurs to invest. On the other, it may dampen demand for MFI services, as businesses have better access to formal finance or can use profits to finance projects (Hermes and Hudon, 2018). More specifically, the economic structure in the sense of employment and firm composition, may influence the scale of the target market for MFIs. The microfinance sector mainly provides small loans for business purposes to self-employed and microenterprises. Many microfinance clients also operate in the informal sector. Some studies have found that higher labour market participation reduces demand for microfinance services (Ahlin et al, 2011).

Table 4 displays self-employment for the past ten years.

Table 4: Self-employment rates (%)

	2008	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
East Asia & Pacific	44.8	44.0	42.9	41.8	40.9	40.4	39.7	38.9	38.6	38.6
Latin America & Caribbean	36.5	36.7	36.1	36.2	36.4	36.3	35.9	36.3	36.6	36.7
Middle East & North Africa	35.7	35.2	33.9	34.2	33.3	33.4	33.2	32.7	31.5	31.5
Sub-Saharan Africa	75.7	75.7	75.4	74.9	74.6	74.0	74.0	73.9	74.0	74.0
South Asia	79.9	79.4	78.6	77.0	76.4	76.0	75.7	75.3	74.9	74.8
UK	**13.4**	**13.7**	**14.1**	**14.3**	**14.7**	**14.7**	**15.3**	**15.1**	**15.5**	**15.4**
North America	11.0	11.2	11.2	10.9	10.9	10.7	10.5	10.5	10.4	10.4
European Union	16.5	16.6	16.9	16.7	16.7	16.5	16.5	16.1	15.9	15.9

Notes: World Development Indicators

Self-employment rates are significantly lower in the UK, and other Developed country regions, than in several Developing country regions, where microfinance is also more widespread. Self-employment rates in the UK oscillate between 13.5 and 15.5%. In comparison, self-employment rates range from 31% in the Middle East and North Africa and 75% in South Asia.

Table 5 shows the size of the informal sector as measured by the proportion of people employed in the sector.

Table 5: Share of informal employment in total employment (%)

Africa	76.0
Latin America & Caribbean	37.4
South East Asia & Pacific	57.4
South Asia	77.4
UK	**13.5**

North America	16.0

Notes: 2017 data from ILO

The informal sector is, not surprisingly, considerably smaller in the UK compared with Developing country regions. It is estimated that the informal sector accounts for less than 14% of total employment compared with three quarters in Latin America and Caribbean, and Africa, 57% in South East Asia and 37% in Latin America.

3.3. Supply restrictions

Restrictions on the supply of credit also potentially affects the viable growth path available to MFIs. Such restrictions may include general regulatory requirements for business operating in the market, restrictions of lending by non-deposit-taking institutions and interest rate caps. Supply restrictions may contribute to making it commercially unviable to operate in certain market segments by increasing operating costs and restricting interest rates that can be charged to cover costs and risks associated with lending. Stronger regulatory frameworks and institutions may improve general conditions for MFIs and customers by reducing corruption and allowing for more pro-business environment or they might increase regulatory burden. Most studies find that stronger regulation and institutions have negative or no effects on MFI performance, especially on outreach (Hermes and Hudon, 2018).

Unlike with economic structure and financial markets, which are significantly and universally different in Developed and Developing countries, the role of supply restrictions is more complicated. Firstly, it is difficult to make general comparisons as research has found that "the effects of regulation are context specific" (Parker and Kirkpatrick, 2012, p. 7). Secondly, there is less likely to be a clear distinction between Developed and Developing countries in terms of supply restrictions. For example, interest rate restrictions are widely applied across countries of different development stages, as at least 76 countries around the world impose some restrictions on lending rates (Ferrari et al, 2018).

Regulation and interest rate caps, in particular, affect the commercial viability of microcredit provision where it raises costs or reduces potential income above or below a threshold at which the provider can cover costs and risks through interest and fee income. Several European countries operate with business lending interest rates caps and it is recognised that it is difficult if not impossible to serve entrepreneurs without access to mainstream finance in a commercially viable manner within the interest rate cap (e.g. Cozarenco, 2015). In the UK, there are no interest rate caps on business lending. However, the UK regulator has imposed interest rate ceilings on some parts of the consumer lending market. There is some indication that these caps have restricted supply, which was indeed their intention. In 2015, the UK financial sector regulator introduced a cap on the cost of credit for the payday lending industry. This contributed to a drop in the number of firms in sector from 400 in 2014 to 144 in 2016 (Smith, 2017) and the number of loans fell to 1.8m in 2015 from 10.2m loans in 2012 (Collinson and Jones, 2016).

4. DISCUSSION AND CONCLUSION

The microfinance industry in the Developing world has inadvertently set expectations that MFIs in Developed countries should be financially sustainable without having to resort to public funding or subsidies (e.g. CGAP, 2004; Hermes and Hudon, 2018). Like international MFIs, they should move on to use commercial levers as they reach financial sustainability or profitability with the end-result of generating positive customer outcomes without having to rely on public subsidy or charitable investments. However, as highlighted by this paper in the case of the UK, the market conditions determine if MFIs can operate in a cost-effective, sustainable or profitable manner. This paper has identified three forms of market conditions.

Firstly, MFIs operating in Developing countries have and, to some extent, continue to be able to target large undeveloped markets, especially rural areas and microenterprises, not served by commercial, mainstream financial institutions. In Industrialised countries, financial markets are better-developed with smaller segments being left unserved, which MFIs can serve. In the case of the UK, the unmet need for business loans is less than 1% of GDP compared with nearly 20% on average in the Developing world.

Secondly and related to the first point, there may also be a link between microfinance growth capacity and the economic structure. As shown in this paper, UK has significantly lower levels of self-employment and

smaller informal sector relative to the Developing world. This is a key market for MFIs, as larger formal firms have better access to finance, including capital markets.

Thirdly, supply restrictions, notably interest rate caps and restrictions on non-bank lending, which are common across Europe, directly or indirectly limits the ability of providers to cover delivery costs through interest income by increasing costs and reducing income. This is less applicable to the UK as it does not operate with interest rate caps for business loans.

It is important to note that this paper has not empirically or systematically tested these drivers through analysing historical data on scale and growth on global dataset, including Developing and Developed world MFIs. However, recent systematic reviews of the empirical literature on growth and performance suggest that context is important (see Hermes and Hudon, 2018).

The implications of the findings in this paper are that MFIs operating in countries where potential markets are small, costly to serve and high risk and provision is restricted by supply restrictions (especially interest rates), it might be unrealistic to expect providers to use commercial levers and not rely on subsidies in some form.

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