Credit and Capital Markets, Volume 51, Issue 2, pp. 183–203
Policy Issue

Microfinance – Once and Today

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Abstract

The paper sketches the history of the German savings and cooperative banks of the 19th century and that of modern microfinance in developing and transition countries of today and explores the parallels that exist between these two histories. One result is that the German savings and cooperative banks of the 19th century can rightly be regarded as precursors of modern microfinance. Another result, that also contains important practical and policy-relevant implications, is that the success of both the German popular banks of the 19th century and of a number of today's microfinance institutions is due to a strategic shift undertaken quite early in their respective development: They have both abandoned their initial two-way specialization of offering only one type of financial services – either only loans or only deposit facilities – and of only addressing really poor people and very small businesses and instead adopted the role of genuine financial intermediaries, that offer loans and take clients' deposits, and broadened the spectrum of clients they aspire to reach, such that they have become truly inclusive financial institutions.

Mikrofinanzierung früher und heute

Zusammenfassung

Der Beitrag skizziert die Entwicklung der deutschen Sparkassen und Genossenschaftsbanken im 19. Jahrhundert und die der vor etwa 50 Jahren entstandenen modernen Mikrofinanzinstitutionen und analysiert die Parallelen zwischen diesen beiden Gruppen „volksnaher" Finanzinstitutionen. Ein Ergebnis dieses Vergleichs ist, dass es durchaus gerechtfertigt ist, die frühen deutschen Sparkassen und Genossenschaftsbanken als Vorläufer der heutigen Mikrofinanzierung zu betrachten, wie es in der Literatur zu Microfi-

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This article is based on the recent "From Microfinance to Inclusive Banking: Why Local Banking Works" by Hans-Dieter Seibel, Paul Thomes and the present author. I am extremely grateful to my coauthors for the opportunity to use our joint work for this publication. However, I bear sole responsibility for the present text, which picks out certain aspects from our book which I find particularly interesting for a general readership. The use of references in this text is intentionally parsimonious; since many more references can be found in our book.

nance gelegentlich angedeutet wird. Ein weiterer auch wirtschafts- und entwicklungspolitisch wichtiger Befund ist, dass beide Gruppen von Banken ihre beträchtlichen Erfolge einer radikalen strategischen Umorientierung verdanken, die sie recht früh in ihrer jeweiligen Entwicklung vollzogen haben: Beide haben ihre ursprüngliche doppelte Spezialisierung auf nur eine Art von Finanzdienstleistung – entweder nur auf die Kreditvergabe oder nur auf die Sammlung von Spareinlagen – und nur auf wirklich arme Menschen und nur auf sehr kleine Betriebe als Kunden aufgegeben und sich zu wirklichen Finanzintermediären entwickelt, die ihre Leistungen einem breiteren Kreis lokaler Kunden anbieten und somit als entwicklungsorientierte „inclusive banks" gelten können.

Keywords: Sparkassen, Genossenschaftsbanken, deutsche Bankengeschichte, Microfinance, inclusive banking

JEL Classification: G21, G16, G17

Since a few years, the government of the People's Republic of China tries to curb the massive migration from rural to metropolitan areas. Evidently, this requires improving the living and working conditions in the remote and rural areas, which in turn presupposes a strengthening of the supply of financial services outside of the metropolitan areas. To achieve this objective, the Chinese government has recently decided to make government support to microfinance an essential part of its regional policy.

In this context, I was invited to Beijng about two years ago to talk to bankers and policy makers about international as well as German experiences in the field of microfinance. I was happy to accept the invitation because, generally speaking, I hold a very positive view on microfinance and I am convinced that learning from the experiences of other countries almost always makes sense. In Beijing, I was informed that the Chinese government had just started to introduce and support a type of microfinance institutions that was considered new to the country. These novel institutions would be specialized in a dual sense: First, they should only grant small loans and not take deposits. Second, they would only offer their loans to really poor people and really small businesses and not to the general population in their respective region of operation. By creating this new type of highly specialized institutions China intends to replicate the example of countries like Bangladesh considered to be world leaders in microfinance.

What I had to say about microfinance in general was well received in Beijing. My message, based on early German and more recent international experience, was that microfinance and more generally inclusive local banking is not too difficult to implement and, if done properly, can have substantial positive effects, not least in remote parts of a country.

However, my hosts were much less happy with what I had to say about microfinance institutions that are specialized in a dual sense as explained above. On this account, my message was that dual specialization is not a recipe for success in microfinance. Indeed, all microfinance institutions which are con-

sidered successful have chosen a different strategy. Even though most of them had started to operate as dually specialized institutions, which either only give out small loans or only take deposits and only serve really poor clients, they soon altered their business models. They all changed their strategy to become true financial intermediaries, which grant loans and also mobilize clients' deposits, as well as "inclusive" local banks, that is, banks serving a more broadly defined local clientele.

That this reorientation makes sense is an unambiguous lesson learned from the history of the savings banks and cooperative banks in Germany in the 19th century[1] as well as from the recent history of modern microfinance, which came into existence about fifty years ago.[2] These two accounts and their striking parallels are the topic of this article. It starts by discussing the emergence of local banking in Germany and shows that the early German savings and cooperative banks were indeed forerunners of modern microfinance, and then turns to an account of modern microfinance. In my conclusion section, I will briefly discuss whether and in what sense the early German savings and cooperative banks can be regarded as a model for today's microfinance institutions. As the current debate in China shows, looking at financial history offers interesting and also policy-relevant lessons.

I. Microfinance in Germany in the 19th Century

1. The Economic and Political Background

The economic, social and political situation in Germany in the early years of the 19th century and again towards the middle of the 19th century was largely similar to that in most developing countries at the time between 1970 and 1980 when modern microfinance was first implemented by Muhammad Yunus and some other microfinance pioneers in different parts of the world. Of course, there already existed some banks, but they were neither willing nor able to offer financial services to "normal" people, let alone poor people and small and very small businesses. In the case of Germany in the 19th century, banks' clients were the ruling nobility, some established enterprises and selected wealthy private citizens. Finance for the general population did simply not exist, and funding for poor people and small businesses in agriculture, trade or handicraft could only be obtained from money lenders and, of course, friends and family.

The political and structural economic changes brought about by the early beginnings of industrialization, and again 50 years later during its rapid expan-

[1] The relevant parts in our book are due to *P. Thomes* and contain extensive references.

[2] The relevant parts in our book are due to *H.-H. Seibel* and the present author.

sion, entailed deep uncertainty and sheer misery for many poor people. Last but not least, there was political change and as a complement a lot of uncertainty. Far-sighted reformers and innovators recognized that it was indispensable to prevent or counteract impoverishment, increasing uncertainty and political radicalization of large parts of the population in order to render these promising changes successful. This foresight prepared the grounds for something new to emerge. Among the innovations at the beginning as well as in the middle of the 19th century were new types of financial institutions that served the "lower classes", which had so far not had access to formal financial institutions and their services.

2. The Early German Savings Banks

The first German savings banks were created around the turn from the 18th to the 19th century. At that time change seemed necessary and imminent. Europe was uprooted not only by the new political ideas emerging in the French revolution of 1789 and the economic, political and institutional innovations introduced under Napoleon but also by the excesses of the post-revolutionary turmoil in France and the wars that originated from that country. It was also the time of the Prussian Reform Movement, a series of constitutional, administrative, social and economic reforms, also known as the Stein-Hardenberg reforms. Hence, it seemed that the old agrarian and feudalistic social structure and even the old political regime might soon disappear.

The first savings bank was founded in 1786 in the small residential town of Oldenburg. Only a few years later, cities such as Hamburg, Berlin and Frankfurt copied this first example. As far as their legal and institutional form is concerned, they were what is now called "non-governmental organizations" (NGOs), that is, they were set up by politically far-sighted and benevolent citizens as foundations or associations with the intentions of helping poor people such as house maids, day laborers and – in the case of Hamburg – sailors and other poor people living at the margins of society. These people should be offered opportunities and given some incentives to save money, be it for a later wedding or to tie them over hard times of sickness or unemployment. In addition, the target clients were supposed to develop a sense of thriftiness. Enabling and encouraging savings was the first role of these novel financial institutions, and savings mobilization has until today remained one of their core businesses. Hence the name savings bank. There was no intention of making a profit from doing business with poor people. Instead, social support and public education were on top of the agenda of this emerging type of financial institutions.

The legal-institutional form of private non-profit organizations was rather soon replaced by that of a community-based or municipal savings bank. The

first bank of this new type was created in the city of Göttingen in 1814. In the course of the 19th century, this model has been replicated in almost all German cities, small and large. For more than 100 years, municipal savings banks were simply a part of the general municipal administration, just like the administration of public parks and local hospitals. They only became somewhat independent or autonomous after the great financial and economic crisis of 1929 to 1932, when they were turned into public-law institutions whose operations are supported and overseen by the respective city or county in which they operate.

It is instructive to look in some detail at how the business model of the German savings banks changed over time. Already in the first half of the 19th century, the scope of operations was substantially widened and thereby altered in a fundamental way. Initially savings banks had been set up with the mandate to merely support poor people and educate them to set aside a penny for a rainy day; thus they had been specialized in the dual sense as explained above. However, very soon their mandate and, as a consequence, their operations and clientele were broadened. They were assigned the additional roles of building a stock of capital that could be used locally and of granting loans to the entire local community, including local business.

This development went hand in hand with a professionalization of the staff. More than anything else, these two interrelated developments were the main factors that made the savings banks as a group grow and thrive. By the end of the century, they had become the largest German banking group in terms of assets, clients and branches. Until today, serving their respective region and its economy and the entire population is the overarching purpose of savings banks. Being profitable as a business establishment is of course necessary as a precondition for being able to fulfill their main mandate. Thus profitability is in a certain sense also an objective, but, at least in principle, one that ranks second behind the mandate to support people and region.

3. The Early German Cooperative Financial Institutions

The first cooperative financial institutions emerged half a century later than the first savings banks. This was once more a time of hardship and political turmoil. In 1847, the last great famine had occurred in Germany, and this may have contributed to the political movement and unrest of 1848 that aspired to create a democracy, which unfortunately failed however.

In the early years of cooperative banking, there were two, or rather three, separate networks of financial cooperatives: first the rural cooperatives, which were later named Raiffeisenbanken to honor their founding father Friedrich Wilhelm Raiffeisen, second the more urban oriented cooperatives founded by Hermann Schulze-Delitzsch, most of which have been called Volksbanken (people's banks)

until today, and third a network of rural cooperatives created by Wilhelm Haas, which for some time played a strong role in central Germany and later merged with the Raiffeisen network.

Of course, they all have shared the legal form of a cooperative, which combines features of a corporation with those of a club or association. Formally, the clients, who are called members, are the owners of a cooperative. However, the ownership rights of those members are relatively weak. The so-called "democratic principle" postulates that each member has only one vote in the regular members' meetings. This one-person one-vote rule makes it impossible to accumulate votes. Therefore, it is extremely difficult for the owners to control the cooperative bank's management. However, there are also important positive effects of this legal feature. Moreover, the fact that every cooperative must be a member of an association which has a powerful auditing department with far-reaching competences largely compensates for the deficiencies of owner control.[3]

Like all cooperatives, financial cooperatives have by law and statutes the dual mandate to support the business undertakings of their members and to be successful as institutions. Thus, much like the savings banks, they can and indeed should make a profit in order to survive and prosper as institutions, but they are expected not to maximize their profit since this would be inconsistent with their task of supporting their members.

Often cooperative banks and their spokespersons create the impression that the early financial cooperatives were self-help organizations of the poor. In a historical perspective, this is not correct. Much like the early savings banks they have been created to serve and help poor people and formally these people even owned the banks. However, in most cases it were not the poor people themselves who set up the cooperatives but rather more educated and even wealthy but socially-minded citizens who did not belong to the intended group of beneficiaries of the institutions they created. This does not only apply to Raiffeisen and Schulze-Delitzsch, the founding fathers, who were a high-ranking public administrator and a politician, respectively, but also to innumerable local dignitaries like village doctors, teachers or preachers or more wealthy and better educated farmers including some staff members of private banks. They took the initiative to found a savings and loan cooperative in their village or town and often kept on serving this institution in the capacities of board members, auditors or trainers for a long time.

[3] The most important positive effects are that it makes it very difficult for individuals to accumulate votes and determine the policy of a financial cooperative in a way that would increase its riskiness and might endanger the very existence of the institution, and increase the profitability in ways that would imply various forms of discrimination of socially weaker members and would thus be incompatible with the original mandate of a cooperative to counteract discrimination. For an extended discussion of the pros and cons of the unconventional legal structure of a financial cooperative, see *Kotz*/*Schmidt* (2016).

In their early years, the German cooperatives were specialized in a dual sense: They served only really poor farmers or craftsmen and petty traders, and only granted small loans – as has now been planned in China. The funding was provided by charitable institutions or well-intentioned local dignitaries. Very soon it turned out that these funds were not sufficient to meet the credit demand of the members. Therefore, the cooperatives soon started to also mobilize savings from their members once they learned that the members do have at least some savings, and used them to lend the money out to other members who needed a loan and were regarded as credit-worthy. Moreover, they also opened up to a more general local clientele. Thus, in an even shorter span of time they undertook a similar strategic reorientation as the somewhat older savings banks had done a few years earlier.

Again largely in the same way as the savings banks, the German cooperative banks experienced stunning growth and success in the second half of the 19th century. At the end of the century, almost 10,000 cooperative banks were operating throughout the country, and their number almost doubled again until the beginning of the First World War. By that time, the number of members had grown to 5 million and their assets to 5 billion Mark, which was almost as much as the assets of the savings banks and more than those of the so-called big banks like Deutsche Bank and Dresdner Bank founded as joint-stock companies around 1870.

4. Common Features and Success Factors

There is no doubt that the German savings and cooperative banks of the 19th century were indeed precursors of modern microfinance. After all, they provided access to formal financial services for the overwhelming majority of the German population, which formerly not had this access. Furthermore, they did this at low costs for the institutions and affordable prices for their clients. Moreover, by creating networks of financially viable and stable financial institutions covering the entire country they contributed significantly to building a sound and "inclusive" financial infrastructure in Germany.[4] The development of the two groups of locally focused banks in Germany paved the way to what is known today as the German Three-Pillar banking system and still exists today.[5]

In a broader perspective, one has to acknowledge that through their own success the savings and cooperative banks have cushioned large parts of the population from harsh consequences of the fundamental and rapid structural trans-

[4] See Chapter II and especially pages 163–182 of our book.

[5] See *Schmidt/Bülbül/Schüwer* (2013) for details.

formation of Germany from an agrarian and feudalistic to a modern industrial society in the course of the 19th century. Thereby, they enabled a transformation with relatively limited frictions.

One important factor behind the success of both groups of "popular" banks was their lasting focus on local markets and their mandates to support their respective regions and their members/clients. Another one was their flexibility in terms of institutional structures, strategies and business models. As already emphasized above, both banking groups have rather quickly learned that providing only one kind of service and only addressing a narrowly defined group of clients does not constitute a viable and socially relevant business model.

Combining the mobilization of savings and the provision of loans – and adding simple payment transfer functions to this – is in the interest of both the banks' clients and the local banks. Clients typically do not only want one opportunity that allows them either to save or to borrow money, but rather both services, and they desire to get them from one institution they are familiar with. On the other hand, combining different services helps small local banks to expand the scale of operations, makes them more efficient and enhances their stability. Last but not least, offering both deposit and credit facilitates the assessment of borrowers and reduces credit risk.

Addressing a broader segment of the local population was an equally important strategic move. It helped to increase the scale of operations and to stabilize the banks' revenue base. Higher institutional stability in turn also contributes to reducing credit risk since there are always some borrowers who would consider not to repay a loan as agreed if they had reasons to expect that the lending institution might soon collapse.

Without these changes, the two groups of banks would most likely have remained fringe players and not become genuine financial intermediaries and the kind of truly inclusive financial institutions which they already were at the end of the 19th century.

Of course, there are also some other reasons that can explain their success. I want to only briefly mention the most important ones. The savings banks and the cooperative banks were, and still are today, closely anchored in their respective local communities, economies and societies. They were, and still are today, organized and structured as institutions in a way that permits maintaining a balance between the objectives of being stable institutions and supporting the clients they are supposed to serve. They were early on, and still are today, embedded in dense networks of financial and non-financial institutions. The German term for these networks is "Verbünde", a term and phenomenon for which no equivalent exists in the English language and in English speaking countries, respectively. It is also worth mentioning that from quite early on – and especially in Prussia – the local banks benefitted from a favorable and stable legal, regula-

tory and supervisory framework[6] that seems to have prevented, or at least limited the danger of fraud and other negative events, and still left enough room for the banks and their networks to experiment, learn and adjust to changing needs and circumstances. Finally, it was certainly beneficial for them that policy offered security and refrained from appropriating the money of the ordinary people and their financial institutions, or from abusing these institutions for political purposes, as it happened again and again in many other countries where it seriously damaged the prospects of popular banks.[7]

II. Modern Microfinance

1. Background and Origins

What I am here calling "modern microfinance" came into existence in the 1970s, also a time of change and unrest. The Vietnam War was just coming to an end, decolonization in Africa had just started, and globalization was gaining momentum. Given these events, many people in developing as well as in industrial countries doubted whether the combination of Western-style democracy and an economic system based on markets, private property and private initiative would really be the best economic and political system for all people, cultures and countries. It was once more a time to fight marginalization, impoverishment and political dissent or, in other words, to win the minds and hearts of people.

Since the 1950s, that is already before microfinance began, Western countries have supported developing countries by means of development finance activities. These activities consisted in large-scale transfers of foreign funding to government-owned development banks in recipient countries. The banks were supposed to make these funds available to large industrial or infrastructural projects enabling them to buy machinery and other investment goods in the Western donor countries. Thus, in essence, it consisted in the transfer of real capital, as opposed to financial capital. The underlying idea behind this former development aid strategy was that it would also boost the general development in the host countries and thus "trickle down" to the general population. However, in most countries the intended trickle-down effect did not materialize. Instead, it only strengthened the trend towards the establishment of a dualistic economy, which made the richer people richer and the poorer ones even poorer.

[6] The first savings bank regulation was issued in Prussia in 1838, and the first law on cooperatives in 1868. In 1889, and thus after the founding of the then new German Reich in 1871, this Prussian law was transformed into a general German law.

[7] In our book, the political abuse of cooperatives in India is presented as an extended case study.

In the economic and ideological context of the 1970s, these negative effects of the then dominant type of development finance was politically not acceptable anymore. As a consequence, Robert McNamara, then president of the World Bank, declared the "end of trickle down" in a famous and influential speech in Nairobi in September 1973 and ushered in a complete turn-around of development finance policy: No longer should large projects and the limited number of people associated with these projects be the main beneficiaries of development aid. Instead henceforth the large number of "simple people" should receive funding in the form of small and very small loans. Only those financial institutions that were close to them and able to reach them should serve as conduits for funding. But as before, the source of these funds should still be Western donor countries. This was the kick-off for modern microfinance.

Those banks that existed and operated in developing countries by that time were neither suited to serve as channels for small and microbusiness financing nor were they interested in taking over a role in this new policy, particularly since in most countries central banks or finance ministries had imposed rather rigid interest rate caps. As a consequence, literally thousands of new very small organizations were identified or even created – again with substantial amounts of aid money – throughout the developing world which were not in any formal sense banks. Many of them were associated with church organizations or international welfare institutions. In line with the spirit of the time, the foreign development volunteers working in these non-bank institutions were full of good intentions and highly motivated to benefit the poor. However, they rarely knew much about how to lend money in such a way that it would eventually be repaid, and which kind of support poor people including the so-called micro-entrepreneurs really want and need.

2. From Good Intentions to Good Institutions

In spite of all good intentions, this new one-sidedly poverty-oriented development finance policy of the 1970s and 1980s employing non-banks as conduits for the distribution of donor funds to the real addressees of aid, could not claim to be successful. The reason was simple: it was highly inefficient and simply much too costly. Many of the presumed distributors of microloans had annual costs for administration and loan losses that came close to the outstanding volume of their loans. Even the most abundant donor funds were not sufficient to fill the funding gaps of the new institutions. Eventually, most of the newly created or newly appointed credit-distributor institutions disappeared as fast as they had appeared only a few years earlier.[8]

Development and finance experts had of course soon recognized this weakness of the new donor policy. Microfinance in this style could not meet the ex-

pectations placed in it if it was so costly. Neither could it reach a significant number of those people who would seek to get a microloan for their investment projects worthy of support, nor could any appreciable impact be expected because of the small volume of funds that could be lent out through these channels. To be fair, one has to acknowledge that many of the new microfinance institutions achieved what government-related development institutions had rarely achieved in the years before: they got in touch with the intended beneficiaries, the potential borrowers from the lower classes. Some of them even succeeded in getting back a sizeable fraction of the loans they had extended. However, having an impact on social and economic conditions presupposes operations of at least some scale as well as "sustainable" microfinance institutions which can cover their costs, do not depend on a permanent stream of subsidies for their continuing existence and possibly even make a moderate profit. If they achieved this ambitious objective they would be classified as "sustainable" microfinance institutions, and this status would enable them to borrow money on commercial terms from national or international sources and finally to also take deposits from their clients. Tapping these funding sources would allow a microfinance institution to stay in business and offer its services to its intended clients for a long time and on a much larger scale and thereby also have a sizeable social and developmental impact.

The term "commercial approach" captures exactly this idea: As much as any other business enterprise a microfinance institution should be designed, managed and also supported in such a way that it can cover all of its operating costs and pass on the full costs of its operations to its clients without charging its borrowers more than they can afford to pay, and paying a sufficiently high interest rate on deposits to make formal savings attractive for depositors.[9] Of course, becoming sustainable also requires a prudent cost management in line with social expectations. Advocates of the commercial approach argued that all of this can be done without abandoning the social and developmental aspirations that had always been a hallmark of microfinance. And indeed, already in the mid-1990s, they could point to some examples of microfinance institutions that had adopted the commercial approach and operated successfully.

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[8] The exception to this rule and thus one of the few non-bank microfinance institutions created in the 1970s that survived and even became the world's best known microfinance institution is the Grameen Bank.

[9] Both the concept and the term "commercial approach" have been propagated, if not even invented, by ACCIÓN, a US-based microfinance support organization. One of ACCIÒN's landmark publications is *Otero/Rhyne* (1994). Other microfinance support organizations such as the Frankfurt-based IPC also strongly supported this approach but used the label "institution building approach". In substance, the differences are negligible, and the difference in labels was, at that time, merely a marketing device for competing consulting firms.

Good microfinance institutions have grown rapidly. The growth alone lowered the unit costs of small loans considerably. Moreover, they changed their business model in terms of the services they offered to their clients. In order to keep costs low – and accountability high – they stopped offering several types of services to poor clients at the same time, as many development institutions had formerly done, and concentrated on financial services. They also standardized products, reorganized operations and even started to employ IT for their operations.

In a conversation with the author in 1994, J. D. Von Pischke, perhaps the most influential microfinance expert of the 1990s, expressed his vision that an interest rate of 20 percent should be sufficient for full cost coverage of a lending institution and would also be acceptable for the clients that take out small and very small loans with a short maturity. After all, these people would have to borrow money on the informal market at rates well above 100 percent if no microfinance institutions existed that are able to serve them. In 1994, the 20 percent mark seemed utopian, but only a few years later the leading microfinance institutions made Von Pischke's vision reality.

Another change was even more important than lowering costs and charging the borrowers cost-covering interest rates. Microcredit institutions which cared about financial sustainability and social impact also started to collect deposits from the same clientele which they had formerly only considered as potential borrowers. This turned former credit distributors into financial intermediaries – once more exactly like the German savings and cooperative banks 150 and 100 years earlier.

In most countries taking deposits requires a banking license. In order to get such a license, many microfinance institutions found it advisable or even simply necessary to give up the formerly prevailing legal form of an NGO – a foundation or an association – and adopted the legal form of a corporation. This was often not easy, and it was even more difficult to find suitable owners as shareholders who would feel responsible for assuring that the institution would over the long term remain committed to the dual objective of having a social and developmental impact and of being stable and able to survive as an institution.

It may have been due to the spirit of the time to think that obtaining a bank license would only be possible with the legal form of a corporation under a private law regime and even that this legal form would be simply better than any other one, or it may reflect the expectations of those responsible for granting a license that permitted taking client deposits. However, a proof that the corporate form is necessary or even simply better has never been provided. It did not appear to be necessary at that time.

3. *The Hype and a Noble Peace Price for Microfinance*

Initially it was a relatively small group of institutions which demonstrated to the expert community that the commercial approach to microfinance can work and achieve even more of the aspired impact than the older more welfare and poverty oriented approach.[10] The older approach had one spokesman and one leading example: Muhammad Yunus and the Grameen Bank which he had founded and led for a long time. In spite of Yunus' reputation and his great influence among politicians and journalists, the commercial approach soon won many followers among microfinance practitioners and in the relevant academic community. They accepted that microfinance can work better and even be moderately profitable. However, apparently none of them expected the possible profits to be more than just merely moderate.

The new view started to prevail around the turn of the century. As a consequence, the number of microfinance institutions increased significantly and the loan portfolios of the best among them grew even faster. In the new millennium microfinance became an essential part of the financial systems of many developing countries.[11]

Moreover, its stunning growth made microfinance prominent in policy circles, with the media and even the general public. The wave of enthusiasm reached its peak in 2005/2006. The United Nations declared the year 2005 as "the year of microfinance", and in 2006 the Noble Peace Price was awarded to Muhammad Yunus as the "inventor" of (modern) microfinance and to the Grameen Bank he had once founded and had managed and represented for more than three decades. Experts like Karl Dieckmann from Deutsche Bank Research predicted an even stronger growth of microfinance in the following years as eventually occurred implying the recommendation to private investors to hop on the band wagon and invest in successful microfinance institutions.[12]

4. *Disenchantment and Crisis*

It often happens that success harbors the seeds of failure. This was also the case with the kind of microfinance that follows the commercial approach. The word spread rapidly that microfinance is possible at a much larger scale and that

[10] The success cases of that era were in most cases associated with the microfinance support organizations ACCIÒN and IPC mentioned in the last footnote. However, an even more successful "sustainable" microfinance institution is the Unit-DESA system of the Indonesian Bank BRI, which is also covered as an extended case study in our book.

[11] An excellent account of this branch of modern microfinance can be found in the highly readable book "Due Diligence" by *David Roodman* (2012).

[12] See *Dieckmann* (2007).

it requires lower investments than it had been believed only a few years before and that, if done well, it can also be moderately successful in purely financial terms. This attracted new players to the playing field. Retrospectively, it seems that some of them may have overlooked the adjective "moderate" in front of the noun "profit" and only seen a high profit potential. Unfortunately, they acted in accordance with this perception and caused substantial damage to the formerly excellent reputation of microfinance.

Two highly problematic cases of ultra-commercial microfinance contributed greatly to the ensuing disenchantment: the initial public offerings (IPOs) of the Mexican microfinance institution Compartamos and its Indian peer SKS-Microfinance. Both institutions had once started to operate as socially motivated NGOs providing very small loans to poor people and were really successful in this field. Then, after a few years, they were transformed into corporations, expanded their respective loan portfolios dramatically, became financially very successful and finally undertook an IPO.[13]

In early 2006, the managers and owners took Compartamos public. A fraction of their shares were issued to private investors, and the shares were listed on the Mexican stock exchange. In financial terms, the IPO was a huge success. Based on the issue price, Compartamos, at that time still a microfinance institution of moderate size, had a total market value of 1.5 billion USD. The issue price was 12 times book value, and investors who had bought shares at the time of the conversion of Compartamos from an NGO to a corporation in 2000 had seen the value of their investment doubling from year to year for seven consecutive years.

The financial success of this IPO raised serious – and in my view legitimate – concerns of the followers of microfinance. However, it was not because of the mere fact that a microfinance institution was taken public, even with a fabulous profit for the early investors. What caused their concerns was the reason for the high issue price. In the case of Compartamos, the high issue price can be explained by the enormous profits in the years prior to the IPO which, in turn, were due to the high interest rate Compartamos charged its borrowers: The interest rate on loans was in the range of 100 percent on an annual basis even after adjustment for inflation. Apparently, the investors expected that this policy of "usurious" interest rates would be maintained after the IPO – and this is exactly what happened.

The case of SKS was similar in many respects. SKS was taken public in the summer of 2010 and its market valuation at the issue price was also approximately 1.5 billion USD. As in the Compartamos case, there were good reasons to question the ethical and developmental merits of SKS. However, it was not

[13] The best critical account of the Compartamos IPO is *Rosenberg* (2007), and that of the SKS IPO is *Chen* et al. (2010).

because of the level of the interest rates but the growth rate of the loan portfolio and the way in which SKS implemented its lending policy. In the years preceding the IPO, the loan portfolio had grown by 70 percent per year on average, and as it seems investors expected this growth rate to be maintained. No organization can cope with such a high growth rate in the long term, at least not if it aspires to conduct its lending business in a responsible manner. This was indeed the problem with SKS. Loans were granted by lending agents without any consideration of borrowers' ability to repay – and, in fact, many borrowers could not repay their loans. When delinquency rates started to shoot up, SKS implemented extremely harsh measures to enforce repayments. As Indian newspapers reported, some 50 borrowers committed suicide within a few weeks since they could not bear the repayment pressure any longer. These sad events were widely reported in the media, also in the developed countries, and led to a rapid and drastic reassessment of microfinance as a developmental tool.

The two controversial IPOs coincided with the publication of a series of academic studies that conformed to highest methodological standards and cast doubts on the effectiveness of microfinance as a tool to lift poor people out of extreme poverty, as it had been claimed by Yunus and many of his followers and whole-heartedly accepted by the general public.[14]

Other developments of the time around 2010 raised additional doubts about the merits of international support for microfinance. For space reasons, I will only briefly mention the most important ones. In the past years, the number of microcredit providers had increased enormously in most developing and transition countries. As a consequence, the competition among them had become fierce. This undermined the business model of modern microfinance because if there are many credit providers borrowers can easily switch from one to another one. A lower degree of dependence on one loan provider weakens the incentives of borrowers to repay their loans as contractually agreed. Moreover, they can draw a loan from one provider only to repay their debts with another one. As a result, the levels of indebtedness increase, borrowers suffer serious financial pressure and default rates for the lenders rise.[15]

In a widely read book, *Hugh Sinclair* (2012) vividly described some cases of mismanaged microfinance institutions and in a rather sweeping way questioned the moral integrity of the people running and supporting such institutions. In a series of publications another author, *Milford Bateman* (e. g. *Bateman* 2010) took issue with the concept of development underlying the common microfinance rhetoric, namely that creating a huge number of very small business undertak-

[14] A very competent and also readable summary and evaluation of this highly technical line of research is Chapter 6 of *Roodman* (2012).

[15] For details see *Roodman* (2012), pp. 252–259.

ings is the best policy for economic development. One may indeed have some doubts whether it really constitutes an effective economic impulse if microloans make the number of rickshaws in Dakka, the capital of Bangladesh, increase from 10,000 to 20,000.

As a result of all this, shortly after the outbreak of the general financial crisis in 2008, there also emerged an additional microfinance crisis. The formerly excellent reputation of microfinance as the silver bullet of development policy was demolished and the former enthusiastic support for microfinance turned into general skepticism.

5. The Recent Turn from Microfinance to Inclusive Finance

Several elements of the recent criticism of microfinance were justified. Pulling poor people out of abject poverty in a short time does indeed not seem to work. However, apart from Yunus and his most enthusiastic followers, most experts had never really made this claim. Instead of seeing the merit of microfinance in "poverty alleviation", they had for a long time argued that it is effective in providing access to formal finance to a much larger part of the general population thus making developing countries' financial systems more open and in a certain sense also more democratic. Not least for this reason, the now less appealing term microfinance started to be replaced by a new term "inclusive finance". But this is more than an exchange of labels. It also reflects the well-founded insight that socially relevant financial institutions should not only provide their services to poor people and very small businesses and their owners but rather to the entire local community including small and even some mid-sized enterprises. In other words, they should be "inclusive" financial institutions whose activity ultimately also benefits the entire population. After all, there is some truth in the old idea of "trickle-down", provided that funding does not only go to large firms or projects.

Of course even before the microfinance crisis set in people knew that a booming industry such as microfinance after the turn of the century would attract some black sheep or even crooks. It was also more or less clear to anybody who thought about it that the merit of creating and supporting thousands of extremely small "enterprises" has at best a limited developmental impact. And of course, there is a risk of over-indebtedness and increasing default rates if too much microcredit is offered by too many institutions so that people can easily take out several loans from different lenders. Excess supply of loans rather hurts than helps poor people.

What was really new, even for experienced practitioners, were two lessons, both mainly deriving from the microfinance crisis and the cases of Compartamos and SKS mentioned above.

The first lesson learned is that multiple borrowing and over-indebtedness of borrowers are more common and much harder to avoid than had been believed before the microfinance crisis. It is indeed much more difficult to finance really poor people and really small businesses today and thereby achieve positive effects than it was at a time when there were only very few microfinance institutions operating in a country or a region. The microfinance institutions of earlier years and their staff tended to treat each other more like colleagues and refrained from stealing customers from their peers. This difficulty of genuine poverty-oriented lending is exactly why socially responsible and considerate microfinance institutions have by now also started to serve small businesses – and not only very small ones – for which a thorough credit analysis can be performed and which may have "bankable" collateral and still find it difficult to get the loans they need. Moreover, these firms are also more likely to generate employment and income for others than the true micro-businesses that had been regarded as the "ideal" target group of micro-lenders.

The second lesson is that an IPO is dangerous if a majority of the shares, and thus the power to shape an institution and its policy, can be acquired by hedge funds, private equity companies or other investors who are only interested in making as much profit as possible and do not care about social and developmental effects. If those investors have the opportunity they will most likely use it and convert a microfinance or small business bank into a money-making machine.

By now, these lessons have been learned, and the situation has improved somewhat compared to, say, ten years ago. The idea of "inclusive finance" has been widely accepted, and even ways have been found to implement the IPO of a microfinance or small-business bank without having to fear a take-over by hedge funds and similar investors.[16] Taking an optimistic stance, one might even claim that the inclusive finance approach has succeeded in maintaining most of the strengths of former microfinance initiatives and overcoming some of its weaknesses. Most importantly, the general population in developing and transition countries now has better access to financial services than only a few years ago, and the financial systems of these countries have become more open and more efficient.

[16] A case for showing how this can be done successfully is the recent "technical listing" of ProCredit Holding on the Frankfurt stock exchange. A technical listing is not an IPO but has many features in common with an IPO. The main difference is that no new and no existing shares are issued to the general public. Only on-exchange trading of existing shares is made possible.

III. What Can we Learn from History?

Looking back at the history of savings and cooperative banks in Germany in the 19th century and that of modern microfinance we can draw some general lessons. The most important one is that local finance for a broad segment of the population "works", that it can be implemented and that it can have strong positive effects if one takes a longer time perspective than the recent impact studies that question the ability to pull poor people out of abject poverty.

However, the general lessons from the recent microfinance crisis need also be taken into account. What do they imply for the assessment of the so-called commercial approach? Based on the answer to this question given below, one may also ask what history tells us about what the best legal and institutional form is for a microfinance institution or a bank that aspires to serve very small, small and even some mid-sized firms and to reach a large segment of the so far underserved population.

As outlined above, local banking can operate efficiently and have sound economic, social and also political effects. One important condition of success is that relevant institutions are not specialized in a dual sense, which means first offering either only deposit facilities or only loans and second exclusively addressing really poor people. Instead, they should be set up as true financial intermediaries that offer loans, take local deposits and add elementary additional financial services such as payment services to this. Moreover, they should be inclusive financial institutions that cater to a broader class of clients in order to survive and have a positive impact. Both the history of savings and cooperative banks in Germany and the history of modern microfinance clearly support these general conclusions.

But what about the merits of the commercial approach? Even though a number of microfinance institutions have gone too far in their quest for profit and may have cited the commercial approach in justifying their strategies, micro- and small-business banks must cover their costs and even make a moderate profit like any other commercial undertaking. Otherwise they cannot survive and achieve whatever positive effects they may aspire. Thus, they must follow the commercial approach irrespective of their legal form and even if a social or developmental effect ranks high on their agenda. Because they have done this successfully for approximately 200 years, the German local and popular banks are at least in this sense a model for development-oriented financial institutions of today.

However, this is just one aspect of what we can learn from looking at the history of Germany's savings and cooperative banks and that of modern microfinance, including the microfinance crisis. It is remarkable that the popular, locally focused German banks have succeeded over decades in maintaining a certain

balance between the dual objective of playing an important social and developmental role and of being able to survive and prosper as institutions. There are several explanations for their ability to maintain this balance. However, it is highly plausible that one of the reasons is their respective legal and institutional form which implies that profit-making is not their primary objective.

Does this suggest that we can also learn from German history that the legal forms of a savings bank as a public and municipally-based institution and that of a cooperative bank as an institution in which clients and owners are identical are generally suitable for development-oriented and inclusive financial institutions in developing and transition countries? Are savings and cooperative banks also positive examples in this respect?

Until merely a few years ago, this idea would have appeared almost absurd to most experts and competent observers. Prior to the microfinance crisis it was almost a dogma that the commercial approach – which is, as I said, absolutely necessary – can only be implemented in financial institutions in the legal form of a corporation governed by private law and owned partially or even exclusively by private owners. After all, it is commonly known that particularly in public banks in developing countries inefficiency, corruption and cronyism are widespread problems. Further, people who are powerful anyway in a local community tend to seize control of cooperatives in order to serve only themselves and their cronies. Alternatively, to take the other extreme, there is indeed the risk that no one really cares about the common good – in this case a cooperative – and that therefore financial cooperatives are bound to fail. These assessments may be too sweeping and too skeptical, but they contain more than just a grain of truth. And even the scant historic evidence that fraud and corruption do not seem to have been wide-spread in the German savings and cooperative banks of the 19th century does not invalidate these concerns in respect of the developing and transition countries of today.

The microfinance crisis – combined with insights from the general financial crisis of the past years – has weakened the former, almost dogmatic views on what are appropriate and clearly inappropriate legal forms for development finance institutions. It demonstrated that also the private law and private ownership model has its drawbacks: There is always a risk that in a predominantly private institution the profit interest will gain the upper hand and drive out any social or developmental aspirations. Compartamos and SKS are the most prominent cases in which this seems to have happened, but unfortunately they are not the only ones.

An assessment as to whether the legal and institutional forms of a public, municipal bank or a cooperative bank are suitable for developing countries must always be performed on an individual, case-by-case basis and it must be based on a meaningful comparison with relevant alternatives as far as legal and insti-

tutional forms, ownership structures as well as corporate governance models are concerned. Moreover, it must take into account the most important or structural risks of the different legal and institutional forms. In the case of a public bank the structural risk is that of falling prey to inefficiency and corruption. In the case of a cooperative it is the risk of the seizure of power by a local "elite" or the suffering from neglect by owners/members. And in the case of a private corporation with strong private owners it is the risk of a conversion into a purely profit-driven and socially irresponsible organization.

Such an assessment must in any individual case consider the conditions of time and place including the legal and political conditions in a country as well as the individuals who would have the final say. And last but not least, it should also deliberate about the existing options and measures that can be used to counteract the relevant structural challenges. Fortunately, the history of local banking in Germany in the 19th century also holds valuable lessons with respect to the available means of protecting banks from becoming victims of their most salient institutional weaknesses. This was also a part of my message to my hosts in Beijing two years ago.

As demonstrated in this paper and more comprehensively in our book "From Microfinance to Inclusive Banking: Why Local Banking Works" with my coauthors *Hans-Dieter Seibel* and *Paul Thomes*, looking back at the history of microfinance from an earlier century as well as that of modern microfinance can be valuable for present and future models of microfinance business. It is instructive and can inspire and to some extent even guide current policy.

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