Financial Access Initiative
Working Paper
01/2024

Lessons for Global Microfinance from…the United States?

February 1, 2024

Joyce Klein and Timothy Ogden

financialaccess.org

Financial Access Initiative
NYU WAGNER

Lessons for Global Microfinance from…the United States?

Joyce Klein* and Timothy Ogden**

February 1, 2024

Abstract

Questions about the future of global microfinance, and specifically the future of policy and subsidy for microfinance, abounded even before the pandemic. Competing policy priorities and limited budgets mean key questions must be answered: how should funders and policymakers approach subsidy to sustain or increase the reach of microfinance?; how do policymakers find a balance between consumer protection and minimizing the costs of regulation for providers who attempt to serve low-income (and often unprofitable) customers? Can technology be a solution to long-standing challenges, increasing reach and lowering costs? Insight into these questions can be gained from an unlikely place: the United States. For decades, global microfinance advocates have suggested the US has much to learn from the innovations and successes of the global microfinance movement. However, the financial system in the US is best understood not as the result of an absence of microfinance, but an example of how a financial system evolves, and the enduring challenges, even when it includes microfinance. Microfinance has been historically present in the United States, since at least Benjamin Franklin, and extending through the present. A clear-eyed and informed view of that history provides several important lessons, including the necessity for on-going subsidy, the never-ending challenge of consumer protection, the rising costs that can come with robust market competition and the inability of technology to fix systemic challenges. Policymakers and funders the world over can benefit from learning from each other, particularly if the conversations start from a different point: the challenges are shared and fruitful ideas and valuable lessons can come from all parties.

Keywords: Microfinance Regulation, Consumer Protection, Subsidy, Microcredit, FinTech

JEL classification: G21, L31, L33, O16, O35

*Klein: Economic Opportunities Program, the Aspen Institute, USA, email: joyce.klein@aspeninstitute.org.

**Ogden: Financial Access Initiative, Wagner Graduate School of Public Service, New York University, USA, email: timothy.ogden@nyu.org.

For over a century, Americans have debated the meaning of justice within capitalism for those on the economic margins, searching for a way to make small loans safer without restricting access for the riskiest borrowers. But a satisfying solution to the small-sum lending problem has remained ever out of reach.

Anne Fleming, *City of Debtors*

I. Introduction

'The future of microfinance' has been a common topic among policymakers, practitioners and funders almost since the dawn of the modern microfinance movement. A reckoning had already been in process when the 'great reset' of the COVID pandemic came along. The combination of an evolving understanding of the need for financial services among low-income populations, the uses of existing microfinance products, and the commonly neutral outcomes of microcredit provision yielded questions without easy answers[1] in the face of an industry that had grown to have at least a foothold and often much more than that, globally.

Given the questioning of the sustainability of microfinance without subsidy, and the difficulty of justifying such subsidies without clear causal effects on reducing poverty, there were fears that the pandemic would cause the shutdown of many microfinance institutions and a dramatic retrenchment in the number of low-income customers who had access to (at least partially) regulated financial services.[2] The damage to the global industry was not as severe as some (such as one of the co-authors) had feared, though there were failures, forced mergers and other setbacks. Still, as policymakers, funders, and financial services leaders contemplate the post-pandemic era, key questions remain unanswered and are more pressing than ever:

- How should funders and policymakers approach subsidy to sustain or increase the reach of microfinance to populations still not included in the formal financial system?
- How do policymakers find a balance between appropriate consumer protection and the increased cost associated with regulation (which potentially pushes providers out of the market, or up-market), whether for consumer or enterprise credit?

[1] see Roodman, *Due Diligence* for a review of evidence and unanswered questions

[2] See FAI's faiVLive on pandemic and microfinance, April 2020

- What impact will technology have on inclusion and the cost of serving excluded populations? How will technology innovation shape the strategy and behavior of consumers and providers of financial services?
- What role does microfinance play in a crowded financial services marketplace with a combination of "traditional" banking, mobile money, digital financial services, fintech, semi-regulated/semi-formal services (e.g. lightly regulated Saving and Credit Cooperative Organizations (SACCOs) and Rotating Savings and Credit Associations (ROSCAs)), and informal services?

While clearly there are no easy answers, and answers will vary from country to country, insight into all these questions can be found in an unlikely place for the global microfinance movement: the United States. In fact, for every modern question, controversy or policy decision related to the future of microfinance there is an analog from the US's history or present.

II. A (Very) Brief History of Microfinance in the United States

The United States, like other high-income countries, is generally considered at best to be a laggard, but usually simply irrelevant, in the modern microfinance movement. In fact, there has been plenty of writing about what the financial services industry in the US should learn from the modern global microfinance.[3] But as the word 'modern' suggests, there is in fact a long and neglected history of microcredit in the United States.

Thanks to David Roodman's review of 'pre-modern' microcredit, more are now familiar with Jonathan Swift as the first documented creator of a joint-liability lending, which he did in the early 1700s in Ireland.[4] But even many in the US do not know that Benjamin Franklin created and funded small enterprise microcredit programs in Philadelphia and Boston in the late 1790s. Each program was specifically designed in a fashion that would presage thoroughly modern conceptions of social investment. Lending was restricted to young apprentices in trades that

[3] See, for instance, *Replicating Microfinance in the United States*, Carr and Tong, eds. 2002, and 'U.S Microfinance at a Crossroads', Liberman, Mudd and Goodeve, 2012

[4] Roodman, *Due Diligence*, pp 36-37

would guarantee they had a source of future income, specifically to enable these apprentices to buy their own tools and open their own businesses. Each loan had to be guaranteed via joint liability by at least two co-signers. The interest rate was capped to be affordable to borrowers. Proceeds from loan repayment were to be reinvested in lending for 100 years, at which point a large portion of the return would be redirected to investment in other social projects (for instance, piping clean water into the center of Philadelphia).

While Franklin's plan did not include the precepts of modern lending—such as risk models or loan loss reserves—his calculations for the growth and future impact of the funds were not far off. The Philadelphia and Boston loan funds survived for more than 100 years, and both generated not only a source of credit for many borrowers outside the target market of commercial lenders over that time, but also ended up funding public improvements that continue to have impact to this day in both cities. But they also experienced 'mission creep.' For instance, Philadelphians complained that Boston's relatively higher returns were the result of abandoning low-income borrowers and shifting focus to real estate lending for middle-class Bostonians.[5]

That's not the last time there was innovation *and* recrimination in small-dollar lending in the United States.

After the Civil War, the Federal government recognized there was an immediate need for formerly enslaved people to have access to both credit and savings vehicles. But the government did not want to be on the hook for actually running a bank, nor was there sudden enlightenment that would lead to enforcing equal protection and access of African-Americans to existing banks. So, like happened in many countries in the developing world would later, the 'solution' was a partial one that created most of the negative consequences and none of the positive outcomes hoped for: a quasi-governmental chartered bank (the Freedman's Bank) which used official signifiers freely while not being actually guaranteed or closely monitored by government authorities. The bank, nominally focused on serving this specific marginalized population, had no formerly enslaved people in its leadership or board of directors. Much of the deposits were

[5] Rosenthal, *Democratizing Finance*, pp 5-6

redirected to artificially cheap loans for the friends and cronies of bank managers. In less than 20 years, the Freedman's Bank had to be wound up, with many formerly enslaved people losing their life savings.[6]

Meanwhile, as the turn of the 20th Century approached and the US was experiencing rapid urbanization—much like many of the countries where microfinance has flourished in recent decades—there was a great deal of foment in financial services for the excluded on two fronts:

- The growing number of urban residents with low- and uncertain incomes produced rapid growth in small-dollar consumer lending services. There was both a great deal of concern and regulation designed to prevent exploitation of low-income borrowers by predatory lenders and concern over this population being shut-out entirely from access to credit because of over-regulation.
- There was also major investment (and growth) in credit unions and credit cooperatives particularly focused on small towns and rural areas where banks were not interested in lending. Here there were concerns about scale and soundness (credit unions that were too local were exposed to correlated shocks like weather events) as well as 'mission-drift' whenever scale was achieved.

In the case of the former, by the early 1900's there was so much small dollar consumer lending that the newly formed Russell Sage Foundation commissioned a study to illuminate the situation titled *10,000 Small Loans*. Notably, the lenders behind this proliferation of small dollar credit employed women in roles that modern microcredit might call 'loan officers', though the logic was quite different. In the case of early 20th century New York City, the women were more effective at collecting repayment because of the social embarrassment that would accrue to male borrowers if a woman came to their apartment building or tenement and made a public scene of the borrowers' failure to make good on his debts.

The Russell Sage Foundation report and subsequent advocacy began a long-term battle to determine how to effectively protect consumers, detailed in Anne Fleming's book *City of*

[6] Osthaus (1976); Rosenthal pp 9-11

Debtors. These efforts included interest caps, targeted subsidies, outright bans, and almost any other form of regulation currently in place or proposed in the microfinance industry. Two particular episodes and the innovations by lenders to cope with the regulations deserve particular mention.

First, one way that these lenders coped with the dual challenges of adverse selection and moral hazard[7] was to require borrowers to have a wage job, and to sign a contract assigning their wages to the lender in the event of a default. In an effort to protect these workers from losing their paychecks, regulations were passed requiring lenders to present the assignment to employers at the start of the contract if they were to enforce garnishment or assignment later. The regulation backfired. Employers did not want to take on the burden of adjudicating (or being dragged into court) over whether the contract had been properly filed and so implemented policies that a worker who assigned his or her wages would be immediately fired. Thus, the lenders now had an even more powerful weapon to enforce repayment. They now could credibly tell borrowers they would lose their job if they didn't repay and the lender showed the contract to the employer.

Second, during an era where regulations were passed severely limiting the small sum cash lending business model, lenders quickly came up with ways to avoid the letter of the regulations. For instance, rather than lending cash at rates proscribed by regulation, they would 'sell' a piece of jewelry at an inflated price with a contract that required a small deposit and a balloon payment after a period of months (an implicit interest rate over 100%); they would then direct the nominal 'borrower' to a pawn shop nearby where they could pawn the jewelry for cash. Courts found that this practice did not violate the regulations because the original contract was not a term cash loan, and pawn was not covered under the law. Installment loans for the purchase of consumer goods (e.g. buying a refrigerator or freezer 'over time') were another common innovation designed in no small part to (successfully) evade interest rate caps on cash loans.

[7] See Morduch and Ogden (2024), part of this issue, on how arguments built on the theory of the economics of information, especially around moral hazard, played a large role in setting early microfinance 'best practice' (though they ignored the US experience as discussed here).

In all, Fleming documents 38 different laws to regulate small dollar consumer lending in New York City (at the city, state or federal level) from 1789 to 2010. More than a third of them are specifically 'amendments' to fix loopholes or address innovations by lenders to evade the prior regulations in the small dollar credit market.

The credit union movement in the United States, in the meantime, followed a development path eerily similar to that of modern microfinance. While originating largely in Germany, the idea of the credit union didn't gain traction in the United States until wealthy philanthropist Edward Filene learned about credit cooperatives while visiting villages in India (yes, even GrameenAmerica is a repetition of the history of South Asia exporting finance innovations to the US). Promoted with great fanfare as a mechanism for communities to 'help themselves' and rhetoric that is directly analogous to today's 'hand up not a hand out' (e.g. 'Every banking door…is barred to [someone] who wants to borrow $25 without security. That's the greatest thing about this movement, it reaches a class the banks cannot reach.'[8]), Filene evangelized for local credit cooperatives.

While there was great enthusiasm for this new form of banking for the poor, growth was halting until a group of philanthropists funded the creation of an umbrella organization to enable credit union enthusiasts to share best practices and provide templates and models for others to follow to introduce credit unions and to promote enabling laws and regulations. Of course, there were also disputes between the leaders of the credit unions and funders over whether the poorest areas should be the primary targets of credit union organizing or the movement should focus on areas that were not quite so difficult but more likely to provide positive examples of progress.

Progress was rapid, the disputes notwithstanding. By the 1930s there were more than 1000 regulated credit unions focused on lending to the excluded. But by the 1940s there were serious questions about the direction the movement was going. In 1942 the president of one of the leading credit union associations was noting that many member credit unions, 'don't want to

[8] Massachusetts Governor David I. Walsh, quoted in Rosenthal (2018, p 13).

be bothered with $50 or $100 dollar loans.'[9] By the 1950s the whole movement was being accused of what we would today call 'mission drift', as more and more credit unions expanded into middle class lending. Indeed, eventually a breakaway group was formed called the National Federation of Community Development Credit Unions (today rebranded as Inclusiv) to distinguish those credit unions that kept to their original mission from those that were no longer motivated by the original 'community development' purpose of the movement. Of note, the story of credit unions in the United States is broadly similar to the history in Europe, though there are meaningful differences. See Caprio, Jr. (2016) and Wadwhani (2016) for a deeper and broader overview of the history of credit cooperatives and credit unions in the US and Europe.

This overview of some of the overlooked history of 'microfinance' in the United States hopefully establishes the *bona fides* of the US experience in speaking to and providing insight for debates and discussions on the future of microfinance globally. Of course, there is far more history—not to mention a great deal of modern practice and innovation—that is relevant to global microfinance. But, trusting that we've sufficiently accomplished the goal, the next section turns to four key lessons to be drawn from the US experience, both historic and modern, on topics central to today's debates: the role of subsidy, consumer/borrower protection, technology's promises and pitfalls, and competition and costs.

III. Four key lessons

Lesson 1: Subsidy is permanent; relative margins will always push responsible lenders upmarket

In another article in this collection, Morduch and Ogden discuss subsidy in microfinance extensively. Here we will limit ourselves to discussion of the mismatch between the hopes that microfinance can somehow cut costs and increase scale sufficiently to become fully self-sustaining and real world experience. As Cull et al (2019) have documented, subsidy has

[9] Credit Union National Association President William Reid, quoted in Rosenthal (2018, p 18).

been and continues to be a major part of the microfinance industry globally. This is no less true in the United States.

The erroneous belief that subsidy of financial services for low-income populations can or should be temporary is a misplaced focus on absolute rather than relative costs of providing financial services. Put simply, the central fact of mission-driven financial services is that low-income, marginalized or otherwise excluded customers will always be relatively more costly to serve, and therefore, at similar interest rates, relatively less profitable as customers.

Microfinance globally has had amazing success driving down operational costs. However, much of this success, while reducing the need for subsidy, essentially limits the ability of microfinance providers to scale, regardless of whether they attempt to move down- or up-market.

As an example, consider the quintessential ways that microcredit providers cut operational costs: pushing those costs onto borrowers. The group lending/weekly meeting model (leaving group liability aside which is rarely part of current operating models) is a major part of reducing costs, allowing microcredit lenders to screen borrowers and service loans at low cost—at least at much lower cost than operating branches, treating each customer individually, customizing services, loan amounts and terms, etc. It’s left to borrowers to arrange their schedules and in some cases their social connections around the weekly group meetings. Furthermore, the standardized contract, in terms of both amount lent and payment structure reduces costs further both in administration but also in terms of human capital costs—loan officers require far less experience, skills and training if every loan and loan payment is the same amount. Again, borrowers take on the cost of customizing their financial lives to the loan disbursement dates, loan amounts and payment schedules.

It's important to note that these types of innovations don’t really reduce subsidy, they just force the customer to subsidize the operating costs of the lender by complying with these rigid structures. And forcing customers to subsidize the provider by adjusting to the very limited product is exactly what then limits scale. The poorest borrowers may be unable to bear these costs limiting the downward reach of microfinance, and better-off, more profitable customers will be unwilling to comply with the rigid rules, and will seek financing where the costs they have to bear are lower.

There are also other potential target customers that these operating model innovations are wholly unsuited for, for instance businesses with plausible, but uncertain, growth prospects. These businesses require more complex assessments and underwriting, customized loan sizes and rapid response. Many of these costs that drive for-profit lenders away from making small loans to marginalized communities are not dealt with at all by the standard microcredit operating model. The borrowers themselves resist the standardized products and operating models that would reduce operating costs sufficiently to bring responsible (unsubsidized) for-profit lenders to the market.

In the US small business lending market this has been seen in the struggles of a variety of efforts by large, commercial lenders to partner with mission-driven, non-profit lenders targeting low-income or marginalized borrowers. These borrowers often apply to the 'name-brand' banks, who are not interested in lending to them due to a combination of small loan sizes and higher risk. A number of large banks have tried to create referral programs that hand-off these applicants to non-profit lenders who exist to provide such relatively small, higher risk loans. Our work with both the large commercial and non-profit lenders involved in these referral programs has shown that they have yielded a very low volume of closed loans. This partly stems from the fact that the referral process starts with the business owner receiving a decline from the bank, and then being told to apply to another organization – often an organization that they have never heard of, and without a clear sense of whether they will be successful with the new lender. Furthermore, the non-profit lenders understandably want referred borrowers to go through an underwriting process to ensure they fit the lender's mission and can service the loan without distress. Prospective borrowers are generally unwilling to go through another lengthy, time-consuming (and therefore expensive from the borrowers' perspective) process. They either give up on financing or seek it from lenders who offer much more rapid approval and funding typically at much higher (and non-transparent) prices.

There is another type of innovation that avoids the limitations described above: information technology-based innovations that directly reduce costs of operation without pushing those costs entirely onto customers. These include such things as automated application portals, use of credit scoring and data tools, and even the tools available to loan officers to increase their efficiency such as text chat and video calls. These kinds of innovations are much in vogue, but also crash up against harsh realities. Such innovations cut the cost of operations for all customer segments, so while the absolute margins of serving low-income customers improve, the margins *relative* to less excluded and less poor customers don't change materially and the pressure to move upmarket to increase profitability (or reduce subsidy) remains. And it's also the case that many underserved business owners lack sufficient credit scores and detailed financial records (whether paper or electronic), requiring lenders to continue to use some lower-tech practices to be able to reach them.

Hopes of eliminating subsidy also rest on the idea that once excluded customers are brought into the formal, regulated, responsible financial system the costs to serve them will fall below levels requiring subsidy. Putting aside the fact that there is little empirical evidence this is true, and plenty of suggestive evidence that it's false (the theory of microcredit borrowers 'graduating' to mainstream financial services not only hasn't happened, but may actually increase the need for subsidy rather than decrease it[10]), the bite of relative costs is felt again. When subsidy is applied to bring excluded customers into the system, the easiest to reach segment of the excluded will almost certainly be the first to be included. The next segment of the excluded will necessarily be more expensive to reach and the gap between them and the newly included will be even larger than it was before the subsidy was initiated. So rather than reducing the need for subsidy, even if the costs of serving the excluded come down as they are included, on-going, and larger, subsidy will be needed to continue progress toward inclusion.

[10] If subsidy is required to bring borrowers into the responsible system but those customers leave subsidized institutions once they become profitable, the subsidized lenders will be even more dependent on subsidy since they will not be able to internally cross-subsidize.

These dynamics are abundantly clear in the United States. While Cull et al document the persistence of subsidy in modern microcredit despite 40-plus years of rhetoric, innovation, shared learning and more, the persistence of subsidy in the United States despite more than 100 years of effort makes it clear that subsidy should be considered a permanent necessity if the goal is to keep the focus on low-income and marginalized populations. In the United States the continuing subsidy takes many forms:

- Subsidized access to capital which includes Federal, State and Local government funds granted to financial services providers for on-lending, as well as lending to financial services providers at subsidized rates by government and philanthropic actors.
- Direct operating grants from government and philanthropic sources to providers who target excluded populations.
- Regulatory subsidy in the form of regulations penalizing commercial financial services providers for not serving low-income customers. The most well-known form of regulatory subsidy in the United States is the Community Reinvestment Act (CRA). The CRA requires bank regulators to score for-profit banks on their efforts to serve low- and moderate-income neighborhoods. CRA scores are a factor in regulatory approval of expansions and acquisitions. Commercial banks can improve their CRA scores by providing grants or subsidized capital to non-profit lenders serving these neighborhoods, or purchasing loans from these lenders (often at a premium).

Even with these near-permanent subsidies, there remain meaningful gaps in inclusion, especially in access to small business credit. The reasons for these persistent gaps are a key lesson for the global microfinance industry: while subsidy can permanently reduce costs of serving some parts of the excluded population, relative profitability does not shift enough to prevent "mission-creep" toward more profitable segments.

Figure 1 conceptually illustrates the key points. In the Figure, customers are divided into quintiles based on cost to serve—the lowest cost to serve are generally the ones who are most included in the financial system at the start, and these customers are likely those with the highest wealth and/or income, and so generate financial activity at higher scales and volumes. Assume, as many conceptions of the financial services market do, that as customers are served over time, the cost of serving them declines (because of both provider experience and the presence of data that can be used to market to and assess the risk of served customers). In the simple model of Figure 1, at the market rate of interest the first three quintiles are profitable to serve, and therefore are served at time 0 (T0); these groups of customers become somewhat more profitable over time (with a lower bound). Subsidy is necessary for commercial providers to serve the 4th quintile. A subsidy is introduced beginning at T1. Over time as this quintile is incorporated into the system, the costs to serve them decline eventually to a point at T3 where they can be served profitably without a subsidy. This is the imagined situation in much of the thinking about subsidy in credit provision; to serve the 4th Quintile, subsidy is only necessary between T1 and T3 and thereafter it is no longer necessary.

Figure 1

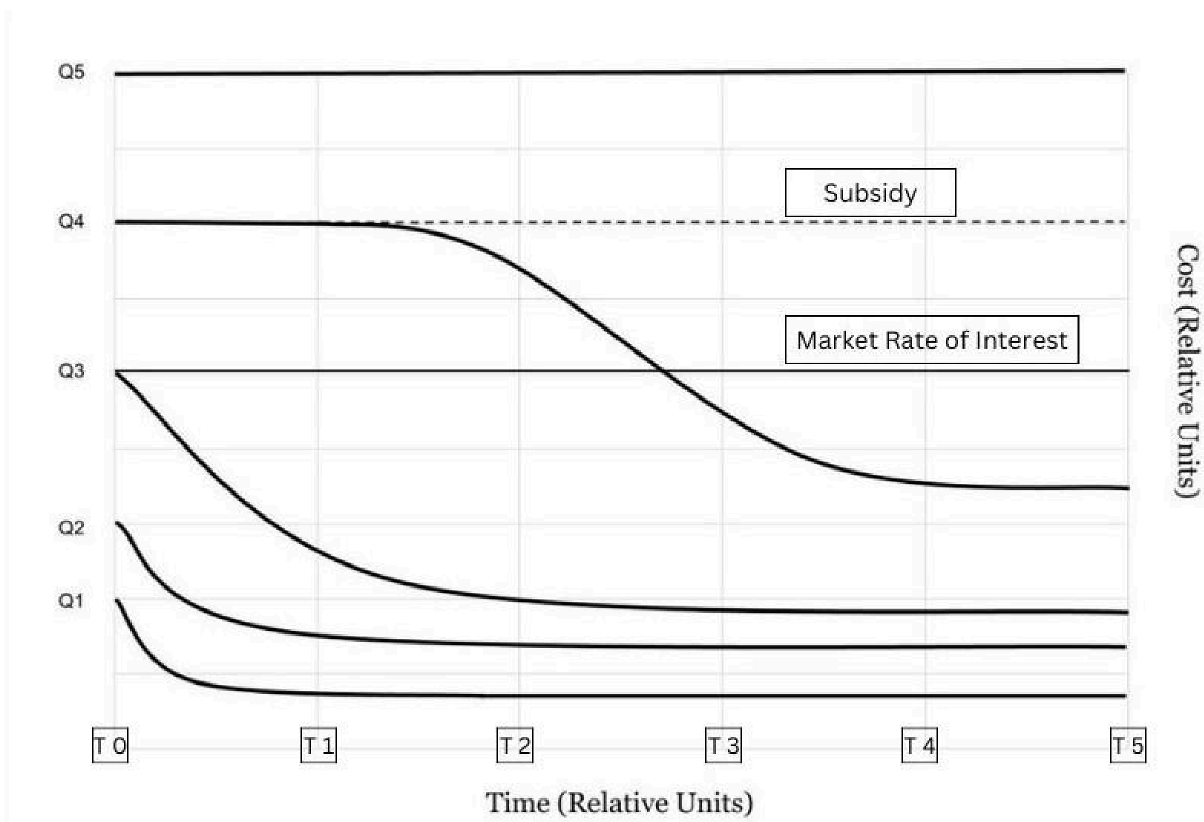

Figure 1: A Stylized Model of Subsidy, and Profitability of Different Customer Segments Over Time

The figure illustrates how this thinking is accurate though extremely limited. First, note that while the 4th quintile becomes profitable at market rate, it does not fully close the gap with the other quintiles. Thus, profit-focused providers will continually have an incentive to shift their investment and attention to more profitable segments—the mission drift that was called out as early as the 1940s in US 'microcredit' and the credit union movement. Mission drift is not inevitable—a diligent, mission-focused board of directors can, for instance, help ensure an institution maintains efforts to serve less-profitable segments—but it is a historical fantasy to pretend that it is not a powerful force that changes institutions' behaviors over time. Even within the US Community Development Financial Institution (CDFI)[11] sector, there was for many years a popular aphorism that 'CDFIs are profit-making but not profit-maximizing,' suggesting that any lender that chose to undertake or scale its lending of products requiring ongoing subsidy was operationally unsound. And it is still the case that many CDFI small business lenders limit or do not make loans less than $50,000 because they require subsidy. This is a challenge because of the clear evidence that most business owners who are women and/or minority are seeking smaller-dollar loans.

Second, the 5th quintile is still not profitable to serve at the subsidized rate. Additional subsidy is necessary for providers to pursue that group. But just as importantly, the profitability gap between the 4th and 5th quintile has grown from T0 to T3. Therefore despite the success of the subsidy introduced at T1, the necessary subsidy required at T3 to continue progress toward inclusion would more than double, not decrease, to justify the effort of providers to pursue this additional customer group.

The effort of pursuing and maintaining relationships with these segments is an underappreciated ongoing cost for financial services providers. While experience with these customer segments can reduce costs (and might build some loyalty), they often require

[11] A Community Development Financial Institution is an organization certified by the US Treasury Department for providing financial services 'in low income communities and to people who lack access to financing.' CDFIs can be regulated banks or non-bank financial institutions like loan funds. For more, see: https://www.cdfifund.gov/programs-training/certification/cdfi.

specialized staff, programs, training, and more. Over time many financial services providers have determined that the ongoing costs, and management complexity, of serving these customers is not justified even when doing so is (marginally) profitable. The rewards of focused attention and allocating resources to more profitable segments are larger.

Finally, note that while the simple model of subsidy above does bring the fourth quintile into the realm of profitability over time, a similar decline in costs for the fifth quintile would not make that segment profitable without subsidy at any point. Thus, providers may view even a subsidy sufficient to reach this group in the first place as undesirable. Providers have rightly learned that subsidy, government or philanthropic, is a dangerous foundation to build a business on. These subsidies come and go, often unpredictably. Given that this segment will not be profitable without a subsidy, providers may decide the costs of building up and then divesting of capability to serve such a market is not worth the profits available through an unreliable and temporary subsidy. The approach to complying with the US's Community Reinvestment Act that most for-profit lenders have adopted (note above) is an excellent example: commercial banks typically provide grants to and investments in CDFIs as doing so is cheaper than developing and maintaining the capacity to serve these excluded segments and geographies themselves.

The bottom line: Relative profitability matters to the on-going efforts of the providers and whether the least profitable customers will ever be served without significant subsidy. The US experience illustrates that subsidies therefore should be conceived of as permanent, not temporary.

Lesson 2: Competition can increase costs

Understanding of demand for microcredit in global markets has come a long way. Early narratives suggested that low-income communities were so starved for the credit offered by MFIs that demand was only limited by population. In recent years, careful work has established that demand for borrowing--under the terms and processes that allow reducing operating costs as noted above--is quite limited. In fact, some estimates suggest that roughly half of borrowers are not using loans for business purposes at all (borrowers never start a new income-generating activity).[12] Furthermore, the landscape is not nearly as credit-deprived as initial conceptions of microcredit claimed. Households and small businesses do a lot of borrowing and lending outside of microcredit.[13]

The global microfinance industry has adapted to differential demand patterns as it has moved out of the densely populated areas of South Asia, especially in rural Latin America where operational models tend to be quite distinct from the popular conception that remains from the early days of microcredit. Penetration of microcredit has always lagged in rural areas in comparison to urban ones, especially in countries with increased emphasis on commercialization (or reduced subsidy).

In urban areas around the developing world—Nairobi, Cape Town, Jakarta, Barranquilla--it is now common to see storefront 'microcredit' providers, whether these are organizations with any social outcome emphasis or what would commonly be called moneylenders. This is a great success of the microfinance movement. What was once invisible and entirely informal is now highly visible and a major portion of the market is formalized and at least nominally regulated.

That demand landscape is similar to what US microlenders experience, albeit with even more formal lending than informal lending, and a smaller self-employment/microenterprise sector. While increased competition has undoubtedly forced down the prices of many traditional moneylenders, there is a limit to how much competition lowers prices before it begins to increase costs for responsible lenders who measure success in any way beyond their own gains. In these crowded urban markets, responsible lenders have a new (rising) cost to contend with: customer acquisition.

[12] This is suggested in the Banerjee *et al.* (2019) work where they examine 'reluctant' entrepreneurs and 'gung-ho' entrepreneurs.

[13] *Portfolios of the Poor* remains the best documentation of the wide variety of credit tools that poor households use outside of the formal financial system.

This is the experience of responsible microcredit lenders in the United States, and increasingly, responsible microcredit lenders in urbanized areas everywhere. Demand is not unlimited and there is a substantial amount of competition for customers. The costs of reaching those customers, explaining to them the differences and advantages provided by their more responsible lending (especially compared to lenders who tout their “easy approval” and rapid disbursement), and maintaining a relationship with a borrower over time increase with competition. Our discussions with the leadership teams of some of the largest responsible microcredit lenders in the US suggests that the customer acquisition is their most challenging cost to control. Less responsible providers have significantly larger budgets for marketing and advertising (harkening back to the discussion above of the permanence of subsidy). Far from lowering customer acquisition costs, increasing digitization is continuing to drive up costs related to marketing simply because the digital landscape is more crowded. It’s also harder to compete in the digital arena when your value proposition can’t be summarized in ‘Quick Approval!’ or ‘Get Cash Today!’ advertising taglines.

Compared to purely for-profit lenders (and especially lenders who do not fully comply with consumer protection laws), responsible lenders have many additional costs to contend with during customer acquisition processes beyond just marketing costs. For instance, a lender who cares about a borrower’s ability to repay without endangering the household or small business must spend more on underwriting and assessing a potential customer and their situation. It also must spend more on explaining the process and the requirements to the customer and supporting him/her/them in the process of completing a loan application. The customer experiences complying with the underwriting process as an additional cost to the loan, compared to the purely for-profit lender who does not require these steps.

Many of the strategic missteps in US microfinance in the last 20 years have been related to a ‘if you build it, they will come’ mindset. In other words, many social campaigners believed that all that was necessary was for a responsible lender to offer loans at affordable rates and ‘reasonable’ terms and customers would knock down their doors. Alternatively, as mentioned above, a number of microlenders focused on simple referral programs with commercial banks who did not offer loans of less than $250,000: customers seeking loans below the threshold would be referred to the microlender at essentially zero cost of customer acquisition.

Despite many attempts, US microlenders have learned that neither of these strategies works in practice. Thus the responsible lender is caught in a bind: raise prices to cover costs, cut costs associated with underwriting and assessing customer ability to repay (although doing so often requires expensive investments in technology, and dramatically increases risk), attempt to raise funds for larger subsidies to keep prices down, or limit outreach to more difficult and underserved segments. These are daily strategic conversations amongst the leadership of US microfinance lenders and will be a key part of the future of microcredit everywhere.

Lesson 3: Technology won't save us

One obvious way to deal with the bind delineated in Lesson 2 is technology. Technology has the potential to lower costs in all aspects of microlending operations from customer acquisition to underwriting to collections (also extending to impact evaluation for lenders who care about outcomes beyond loan repayment or renewal).

Technology has long been a part of conversations in global microfinance circles. Magnoni (2022) offers a useful overview of the evolving possibilities and challenges of technology for microfinance institutions (MFIs) in Central America post-pandemic, though the messages are much more broadly applicable. What can the global microfinance movement learn from the US experience on the potential benefits and limits of technology to improve outcomes by lowering costs, or extending reach?

Overall the message is that while there are benefits, there are limits to those benefits due to the high and rising costs of technology management, and ongoing issues with relative exclusion and ensuring excluded segments of the population are not left behind.

US microlenders have had particular success using technology to reduce costs in:

- Core Operations: The benefits here are the same as most microlenders around the world have seen from the use of core lending and back office software.

- Access/Outreach: In recent years much of the growth of US microfinance has occurred among a relatively small group of lenders that now operate well beyond their physical geographic footprint. These CDFIs are able to take applications, process loans and disburse and collect funds online.
- Data-based Credit and Risk Models: Some of the largest responsible US microlenders have reached a scale at which they can create and refine custom credit models based on their lending to these markets.

But these US microlenders are now encountering serious limits to the benefits of technology. The key challenges that the US microlenders have encountered relate particularly to unseen costs in maintaining technology infrastructure over time.

- Maintaining multiple channels: While 'virtual'-only customers can be a big boost to the sustainability of microlenders, by increasing their volumes and margins, responsible microlenders are still attempting to reach many populations who are quite far from being able to use all of the technology now available. That means that the lenders have to maintain a dual-structure with in-person or paper-based alternatives to the technology channels. And that quite simply increases costs. The lenders have to make the technology investments but they also have to maintain operations outside of the technology so the full cost savings of technology are not available. In addition there is the management cost of supervising and maintaining multiple channels.
- Security: While we are unaware of any significant security breaches at a US microlender (e.g. customer data being stolen or ransomware attacks) yet, leaders in the US microlending space are aware that it is really only a matter of time. Worse, they also recognize that they are dramatically underfunded in terms of being able to afford the staff or consultant resources necessary to fully protect themselves and their customers from such threats. Of particular concern are two areas: a) that technically unsavvy customers are potentially 'soft' targets that can enable breaches, and b) that the microlenders could become targets specifically because of their connections to deep-pocketed donors who may be more likely to pay ransoms.

- Staffing: As noted above, staffing is a major concern for US microlenders. Qualified IT staff are in short supply the world over, and mission-focused lenders are unable to pay competitive salaries for highly qualified IT staff (to mitigate security risks as well as simply to maintain and adapt the technology infrastructure). US microlenders face a tough balancing act in determining how much they can afford to invest directly in technology that potentially cuts costs, while also investing in the rising costs of the staff necessary to deploy and maintain technology systems.
- Relative costs: We return to the recurring theme of how relative rather than absolute shifts in costs affect lender strategies and operations. As noted above, lenders who are attempting to reach excluded populations have to maintain flexibility to deliver 'Tech and Touch' that are customized to the level of technology adoption and comfort of target markets. Not only do those multiple channels and modes of operation raise overall costs of operation, but the customers who need 'high touch' or even a blend of technology and in-person support become relatively more expensive than the subsegments of target populations that are more comfortable and able to use technology and therefore are less costly for the lender to serve. This leads to tough strategic decisions about cross-subsidy within the lender. Should a mission-focused lender pass on lower costs to the most technically capable borrowers who use less human resources? Or should they keep prices constant and use the lower costs of serving the more technically savvy to keep costs lower for more excluded populations? If the latter, how much do they risk losing these lower-cost customers to more commercial lenders?

The bottom line is that the US is currently at a point where it is unclear how much the Total Cost of Ownership[14] of technology undermines the savings available from technology. The lesson for the global microfinance industry is that while technology can lower some operational costs and enable new products (either because of more sophisticated credit models or the ability to offer different products to different markets), it also increases costs in other domains of operations (such as IT management and security) and requires hiring or training staff that can

[14] Total Cost of Ownership is a concept introduced by IT consulting and advisory firm Gartner that attempts to capture not only the direct cost of buying or licensing technology but all the costs related to such things as deployment, training, upgrades, support, hardware maintenance, security and other costs that go along with using IT. See Aspen Institute (2022).

move seamlessly between tech and touch. The hopes that technology will help microfinance escape cost pressures is misplaced.

Lesson 4: Whack-A-Mole; consumer/borrower protection is never done

Increasing the flow of credit to the least served and poorest customers requires an ongoing effort to balance access with borrower protections. As in other countries, the US has a long history of financial predation targeting the poor and/or those who haven't had access to traditional financial institutions. And that is before considering predation by traditional regulated financial institutions.[15] At best excluded populations have accessed capital at much higher cost than others; at worst they have been targeted by lenders and products that strip wealth and trap them in cycles of debt. In the US, on the consumer side, high cost 'alternative' financial services such as payday lending, secured credit cards, 'rent-to-own' and now including rapidly proliferating 'buy now, pay later' offerings continue to have a major presence in the market. Similarly, as commercial lending in amounts less than $250,000 has declined, the market has been filled by alternative providers offering high-cost products whose costs and terms are not transparent, that are not underwritten with a full consideration of ability to repay, and that in some cases use high-pressure collections practices.

Although the U.S. has strong consumer protection and truth-in-lending laws that pertain to consumer and mortgage lending, these guardrails do not apply to business lending. Predatory providers are fully aware of this fact--some of the lenders and brokers that offer the most problematic small business credit products are the same organizations involved in the sub-prime mortgage crisis in the US in the early 2000s. These organizations moved into small business lending after the U.S. enacted regulatory reforms focused on mortgage lending.

Predatory lenders, of course, specifically target the same excluded populations that responsible microlenders do (and many of the predatory lenders tout their reach into underserved markets as a marker of their value and to shield off regulation). Research by the Federal Reserve

---

[15] For instance, a relatively recent example is the widespread use of practices by consumer banks that maximized overdraft fees by, for instance, ordering debits from largest to smallest in order to charge an overdraft fee on more transactions. See 'Comparing Overdraft Fees and Policies Across Banks', Borne and Zirkle, Consumer Financial Protection Bureau,
https://www.consumerfinance.gov/about-us/blog/comparing-overdraft-fees-and-policies-across-banks/

found that minority-owned firms are more likely than white-owned firms to apply for potentially higher-cost and less-transparent credit products.[16]

Above we touched on some of the ways that predatory lenders have historically evaded regulation in the US whenever it arrives. When cash lending is the focus of regulators, these providers shift the product to 'asset' financing (see above example of lending nominally to buy jewelry which is then immediately pawned for cash). When regulators focus on interest rates, providers find ways to impose 'fees' rather than charge interest. When regulators focus on the total cost of lending, providers shift to products or terms that reduce their risk at the expense of the borrower—like merchant cash advance lending which inserts the lender into the payment flow before a business receives funds from a customer—while keeping charges as high as allowed.[17]

As capacity for financial services regulation and consumer protection rises in many developing countries, a key lesson from the US is that predatory lenders are highly adaptable. Not only can they be very effective at fighting regulation in the first place, they are very creative in finding loopholes around consumer protection laws and regulations.

Just as important is recognizing that non-predatory financial services providers are not necessarily going to be allies for regulators in the attempt to protect consumers. Their opposition stems from concerns about the cost of complying with the regulations (consistent with the discussion above of the need for subsidy). In the fall of 2023, a major regulatory initiative for borrower protection in the US is the long-delayed application of rules requiring lenders to collect and report data on the race, ethnicity, and gender of borrowers along with the amount of credit provided and the cost of that credit. In other words, the data necessary to examine whether minority or women borrowers are being excluded from credit markets or being systematically discriminated against in terms of amount and cost of credit. Among the many groups attempting to prevent the rule being enforced are the Independent Community Bankers Association (ICBA)

[16]Federal Reserve Bank of Atlanta, (2019), p. IV

[17] Of note, the consumer protection challenge of products like Merchant Cash Advance is not necessarily the position they hold in the flow of funds, but that this arrangement potentially creates a fundamental misalignment. The lender can manage their own risk by underwriting to revenue, and ignore the borrower's overall ability to service their debts.

and the American Bankers Association (ABA), both trade associations of financial services providers that would not be termed 'predatory' or 'alternative.'

For regulators, finding the balance between recognition that serving excluded customers comes at a high cost, and even responsible lenders need to defray some of these costs (with, in the absence of full subsidy, higher than average market rates), and protecting consumers and small business from predatory practices, is a continuing task. There is no 'model regulation' or consumer protection regime that will solve these issues. Just as human capacity to secure technology implementations are a significant limiter to the benefits of technology, regulator capacity will continue to be a limiter to the ability to provide consumer protection that does not deter responsible lenders from serving excluded populations (even with subsidy).

Conclusion

It is likely that the evolution of the financial services marketplace in developing countries will accelerate in the coming years. Technology developments such as digital payments and artificial intelligence, demographic trends such as aging, youth bulges and urban migration, and climate change-induced shifts in micro- and macro-economies will both exert pressure on existing providers (formal and informal) as well as open new opportunities and possibilities.

While the US has been considered a laggard in the microfinance space (and sometimes with good reason), the coming decades will emphasize the "'great convergence'[18] in the challenges and opportunities for continuing progress in financial inclusion between developed and developing countries (and the US in particular).

There are large opportunities for policymakers, practitioners and funders to learn from each other as this great convergence evolves. Learning isn't just one-directional. The US offers a host of lessons on the perils and pitfalls of financial inclusion directly applicable to developing markets today. We've covered the four we believe to be most important and relevant today: the permanence of subsidy; the costs of competition; the limits of technology; and the challenges of consumer protection. But there are many more lessons to be learned at the micro- (or product

[18] Ogden, 'The Great Convergence', 2019, https://www.aspeninstitute.org/publications/the-great-convergence-toward-a-global-strategy-for-financial-inclusion/

development and business practices) and at the macro- (or market development and integration) level.

There are positive examples to draw from the United States, of course. Specifically, there has been progress in extending basic consumer protections to small business lending. There are also well-functioning and technically-savvy (in both the finance and IT sense) coalitions of non-profits, advocates, government officials and agencies and financial services providers continually working on improving the overall financial services ecosystem (e.g. the Responsible Business Lending Coalition and the Small Business Borrower Bill of Rights).

We hope this article can serve as a different starting point for conversations and engagement between stakeholders in the US and elsewhere than we have seen in the past. The developing world should not simply be looking to the current state of the US financial services system and regulation as a goal or endpoint; neither should stakeholders believe that if only the US could follow the lead of modern global microfinance current problems would be solved. The US has many lessons for the future of global microfinance, but the US does also have much to learn about alternatives to the current situation, and creative potential ways to address challenges.

Acknowledgements: We gratefully acknowledge Muhammad Meki and Simon Quinn for entertaining the idea of this article, Jonathan Brereton, Jonathan Morduch, and Louis Caditz-Peck for helpful comments, and Mayada El-Zoghbi and an anonymous reviewer for thoughtful reviews. Financial Support was provided by the Mastercard Center for Inclusive Growth and the Mastercard Impact Fund.

References

Aspen Institute, Business Ownership Initiative, Webinar, 3 August 2022, "Integrating Technology into CDFI Small Business Lending", https://www.aspeninstitute.org/events/integrating-technology-into-cdfi-small-business-lending-the-real-deal/

Banerjee, A., E. Breza, E. Duflo, and C. Kinnan (2019), 'Can Microfinance Unlock a Poverty Trap for Some Entrepreneurs?', NBER Working Paper 26346, https://www.nber.org/papers/w26346

Caprio, Jr., G. (2016), 'Financial History and Economic Development: Pitfalls and Promises', ch. 4 in Y. Cassis, R. Grossman, and C. Schenk (eds), The Oxford Handbook of Banking and Financial History, Oxford, Oxford University Press

Collins, D., J. Morduch, S. Rutherford, and O. Ruthven. (2009). *Portfolios of the Poor: How the World's Poor Live on $2 a Day*. Princeton University Press.

Cull, R., A. Demirguc-Kunt and J. Morduch (2018), 'The microfinance business model: enduring subsidy and modest profit', *World Bank Economic Review*, 32(2), 221–244.

EA Consultants and Financial Access Initiative (2023), 'MFI Digitization in Central America's Northern Triangle:The Impact of the Covid-19 Pandemic', https://www.financialaccess.org/publications-index/2023/1/31/mfi-digitization-in-central-americas-northern-triangle-the-impact-of-the-covid-19-pandemic

Federal Reserve Bank of Atlanta (2019), 'Small Business Credit Survey: Report on Minority Owned Firms.' https://www.fedsmallbusiness.org/survey/2019/report-on-minority-owned-firms

Financial Access Initiative, faiVLive, 10 April 2020, 'Global Pandemic Meets Microfinance', https://www.financialaccess.org/faiv/2020/04/10/faivlive-microfinance-and-covid-19

Fleming, A. (2018). *City of Debtors: A Century of Fringe Finance*. Harvard University Press.

Lieberman, I., J. Mudd, and P. Goodeve. (2012) 'U.S. Microfinance at the Crossroads: Scale and Sustainability: Can Lessons from International Experience Help Guide the U.S. Sector?'J http://www.omegafoundation.ca/documents/Report%20-%20US%20Microfinance%20at%20the%20Crossroads.pdf

Osthaus, Carl R.(1976) Freedmen, Philanthropy, and Fraud: A History of the Freedman's Savings Bank. University of Illinois Press.

Robinson, L. and M. Stearns (1930). *10,000 Small Loans*. Russell Sage Foundation.

Roodman, D. (2012). *Due Diligence: An Impertinent Inquiry into Microfinance*. Brookings Institution Press.

Rosenthal, C. (2018). *Democratizing Finance: Origins of the Community Development Financial Institutions Movement*. FriesenPress.

Wadhwani, R. D. (2016), "Small-Scale Credit Institutions: Historical Perspectives on Diversity in Financial Intermediation," ch. 9 in Y. Cassis, R. Grossman, and C. Schenk (eds), The Oxford Handbook of Banking and Financial History, Oxford, Oxford University Press