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PROGRESS IN MICROFINANCE SHOULD BE A SOURCE OF INSPIRATION FOR DIGITAL FINANCE

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Fintech, mobile banking… Digital finance needs to capitalize on the experiences of microfinance to bring smallholder producers and entrepreneurs in emerging and developing countries real added value.

Fintech, digital credit, pay-as-you-go… These new services are today essential and hold great promise. The **incredibly fast development of digital finance services is based on a promise of flexibility and easy lending, but especially on an extremely high mobile phone penetration rate**: 134 million active mobile banking accounts were identified around the world in 2017, including over 84 million in Sub-Saharan Africa. However, **these new financial services need to be developed in a way that ensures the right balance between financial objectives and the interests of clients.** The experience of microfinance shows that this is the only way for services to be truly useful to clients, while preventing risks of overindebtedness or exclusion.

Financial innovation and opportunities

In the field, digital finance is already transforming the microfinance sector. Loan officers of many MFIs at the very least enter loan application data into a touchpad during client visits. Certain innovations even lead to a complete dematerialization of relations between loan officers and clients, with loans being granted from the client's phone. **By**

adopting these new financial technologies, MFIs aim to become more efficient, better meet needs, reduce the costs of access to financial services and reach more clients.

Digitalization allows clients to interact with a broader financial ecosystem. It develops a wider range of uses, more suited to the capacities, needs, location and preferences of people, including for clients at the bottom of the pyramid. It can also facilitate access to energy, water and even education, thanks to innovative leasing-related systems (also called pay-as-you-go, or PAYG). **Another promise of digital finance is to reduce the costs of financial services**, as the supposed improvement in efficiency should make it possible to offer much lower rates and reduce fees.

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Technical innovations carry risks

Fintechs open up new opportunities and promise new access to financial services, but they also potentially generate new forms of discrimination in their selection and allocation methods. Questions are being raised and fintech actors will need to address them: in Africa, women still have less access to mobile phones than men. How to ensure that they are not once again excluded from these innovations of the financial system? How to limit the abuses of a system that collects quantity of data and which can mine digital personal data to decide on the allocation of a loan? How to ensure that banking information and loan conditions are understood by clients who are illiterate or not used to text messaging?

Digital finance can renew microfinance if it does not radically change it. The geographical, cultural and social proximity between the loan officer and the borrower was theorized by Servet, Gentil and Labie in the 2000s and is central to the approach of MFIs: *"By regularly going to the micro-entrepreneur's workplace and home, the loan officer becomes aware of the realities on the ground and can thereby gradually understand him better. This is very important both for the diagnostic made before the allocation of the loan and the follow-up to it"*. What will happen if the direct relationships with loan officers are replaced by text messages?

As for the debt risks usually assessed by loan officers when they meet the borrower, they may be stretched beyond their limits. **How to prevent algorithm-based systems from automatically granting loans – mainly, if not exclusively, for consumption – on the basis of a profile analysis rather than the actual repayment capacity,** with the risk that number of clients find themselves in a spiral of multiple and renewable debts. **In Kenya, the risk has become a reality: users are driven to take out consumer loans for increasingly higher amounts.** Their profiles are established using their personal data and integrated into the iterative allocation algorithms. The credit scoring is refined with the subsequent allocations. Observation confirms this assumption: the percentage of the portfolio-at-risk is particularly high, reaching levels which are unthinkable for institutions subject to regulation. People who do not repay are blacklisted from the system and lose all access to credit. For example, bad payers are blacklisted by credit reference bureaus responsible for analyzing and cross-referencing profiles. According to a MicroSave survey, there are 8 million Kenyan users and 3.5 million of them are negatively listed by the Kenyan Credit Reference Bureau. Moreover, despite the potential and promises of a more effective approach, rates remain particularly high.

CGAP (Consultative Group to Assist the Poor), a consortium of donors and foundations on inclusive finance, advocates for a slowdown in the growth of digital credit in East Africa, to give financial and development actors time to take up and address these various issues.

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It is interesting to look back at the history of microfinance as we witness the growth in digital finance. **Microfinance was widely praised when Muhammad Yunus, one of its founders, was awarded the Nobel Peace Prize in 2006 but shortly thereafter showed signs of drifting:** overindebtedness crises in India, uncontrolled growth in Nicaragua, Morocco, Bosnia and Herzegovina and Pakistan, and soaring interest rates in Mexico. Certain unscrupulous MFIs had focused on growth and profits to the detriment of their social mission, needs and well-being of their clients.

However, certain actors in the sector, such as CERISE, the Imp-Act consortium and microfinance rating agencies were already working to promote the development of a range of responsible, transparent, fair and secure financial services, likely to have a positive impact on poor clients. In 2005, the Social Performance Task Force (SPTF) was set up on the basis of several of these initiatives to identify the needs of customer-focused management, also called social performance management. The 3,000 members of SPTF today (MFIs, networks, investors, donors, consultants) have established a common definition of social performance and are building the related standards. **Since 2012, the Universal Standards for Social Performance Management have been adopted as a set of management practices to help financial service providers (MFIs, banks) assess and achieve their social objectives.** Strategic and operational decisions are customer-focused, making financial performance a means and not an end in itself. The emergence of standards have made the microfinance sector more responsible. MFIs now use social performance indicators to report on their social outcomes, discuss them and make decisions with their stakeholders.

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There are a growing number of digital credit services, but also already striking examples of overindebtedness, extremely high interest rates, files of bad payers in credit reference bureaus and a mainly urban focus for PAYG models for access to energy in East Africa, despite a stated rural mission. **Digital finance must organize its practices to bring real added value to its clients.** A responsible approach will also allow it to secure its economic model and its reputation. Since 2015 the Smart Campaign for Client protection works on principles adapted for Fintech, and in 2018, IFC (Internationl Finance Corporation) has proposed to investors the Principles for Responsible investment in Digital Finance.

Unlike MFIs, fintechs do not specifically claim to have a social mission. But, as organizations that wish to promote financial inclusion and reach an increasing number of clients, it is in their interest to avoid the missteps of microfinance**. A crisis caused by fintechs will inevitably have major impacts on the reputation and credibility of the entire inclusive finance sector.** This is why the SPTF has been disseminating its client-centered social performance management approach with investors and new fintech actors through webinars. In order to maintain a close customer relationship despite fewer client touchpoints, digital credit providers can build on existing approaches to client satisfaction and market studies to ensure their services meet client needs. Social performance management involves improving internal systems and processes in order to strengthen the external impact. **Digital finance needs to be based on these practices in order to assume its responsibilities and participate in greater financial inclusion.** Not coincidentally, a client protection code is currently being established for Fintechs in the off-grid solar sector.

Close cooperation between traditional microfinance actors and new digital finance actors should make it possible to leverage 30 years of responsible finance and avoid holding back the real creation of value for clients.

The opinions expressed on this blog are those of the authors and do not necessarily reflect the official position of their institutions or of AFD.

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