MicroSave Briefing Note # 8

Dropouts and Graduates: What Do They Mean For MFIs? [1]

Graham A.N. Wright

Introduction

The microfinance industry remains a strange, archaic enigma. It is probably the only remaining industry in the world that is typically product- rather than market-driven. Companies in other industries offer their clients the products that they want, rather than the products that the company wants to produce. Companies that fail to make the transition from product-driven to market-driven (i.e., fail to respond to the desires of their customers) are almost invariably driven out of business by client-responsive competitors.

There is no reason to doubt that the microfinance industry will also follow this trend. Microfinance institutions (MFIs) that do not respond to the needs of their clients will eventually fail. The product-driven approach has long since been superseded by the market-driven approach and the recognition that there is more value in retaining customers than attracting new ones who cost more.

Typically, retained customers are the ones with extensive credit history and who are accessing larger loans; whereas new customers require induction training and can often weaken the solidarity of groups. MFIs typically break even on a customer only after the fourth or fifth loan.

> *In Microfinance, the value of retaining clients is particularly clear.*

Careful analysis of the reasons for dropouts almost invariably points to inappropriately designed products that fail to meet the needs of the customers. Much of this problem is driven by the attempts to "replicate" models and products from foreign environments without reference to the economic or socio-cultural conditions into which they are being imported. This has been exacerbated by the lack of competition in many of the markets in which the original models were developed. This lack of competition and the huge demand for credit meant that MFIs could offer almost any product, however client-unfriendly, and they could find customers. Now, with the growth of competition in many markets, clients have choice and are voting with their feet.

Ironically, many of the clients are driven out not only by the inappropriate design of loan products but also by the unwillingness of MFIs to recognise that (particularly in rural areas) there are seasons when savings services, not loans, are required. Thus clients are forced either to borrow and try (against the odds) to service the loan, or to leave the MFI. All the while, their need for savings is unmet and ignored.

Dropouts

> *In East Africa, the rate of client dropout ranges between 25 and 60 percent per annum. Clearly this represents a substantial barrier to achieving self-sufficiency. When an organisation loses over a quarter of the clients every year, it is "running hard to stand still". In the words of Hulme, "Client exit is a significant problem for MFIs. It increases their cost structure, discourages other clients and reduces prospects for sustainability" (Hulme, 1999).*

The dropout or desertion rate has profound implications for the viability of an MFI. Groups from which members dropout are destabilised and must recruit new (less experienced) members, who qualify for smaller loans thus reducing the overall interest income for the institution. The new members have to take a disproportionate risk and guarantee the larger sums taken by their fellow group members, adding further stress to the group guarantee.

Each dropout is a lost client who underwent lengthy, expensive training. The replacement members must either receive this training on an individual basis, or join the system without the training that many MFIs regard as critical. In the face of frequent or multiple dropouts, some of the groups may disintegrate entirely.

High dropout rates often indicate dissatisfaction with the financial services offered by the institution. Members choosing to leave generally do so either because the organisation is not providing good enough services to warrant the (social and financial) costs involved, and/or because they have identified a better alternative. Dropouts often leave because they cannot (or do not want to) manage loan repayments. These clients stop

[1] For more on what drives members to leave MFIs see Hulme, David, "Client Drop-outs (Exits) from East African MFIs", ***MicroSave,*** 1999 and **Wright**, Graham A.N., "Optimising Systems for Clients and the Institution" in "Microfinance Systems – Designing Quality Financial Services for the Poor", *Zed Books,* London and New York, 2000.

attending meetings and, freed from the group guarantee and from the incentive of continued access to financial services, are likely to leave behind an unpaid loan.

> **Rose the Banana Trader**
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> *Rose grows vegetables and coffee with her husband on a small piece of land 20 kilometres outside of Jinja. Since she joined an MFI she has also been buying bananas locally and taking them to Jinja Town to retail. This has given her extra income. However, because the MFI she has joined insists that members keep on taking out loans, she has to try and sell bananas all the year round to get cash for repayments. This is very hard in the months after Christmas as quality bananas are harder to find and people do not have much money to spend. She thinks she may 'take a rest' for a cycle or two, 'balance' her loan off against her savings and probably rejoin next year.*

Members expelled from a microfinance program (for, of course, not all dropouts are voluntary) are likely to be indicative of an even more complicated bundle of factors, including: client selection (or better said "de-selection") by fellow members and/or staff, the clients' ability to pay loans or even savings, and the clients' willingness to repay loans, which is, in part, a proxy indicator for customer satisfaction.

Graduates

One reason for dropping out is graduation. A few years ago, there was a belief that credit programs would give such a boost to the income of "beneficiaries" that they would "graduate from poverty." However, the dynamics of poverty are such that the route out of poverty is neither linear nor absolute.

There were two schools of thought on graduation. One held that after a limited number of benign (subsidised) loan cycles, the beneficiaries' businesses would no longer need credit. In retrospect, this was supreme naiveté, for there is scarcely a firm in the world that does not use overdraft facilities to manage its way through business cycles. And vast international financial markets have developed around businesses' need for capital for expansion.

The other school, more plausibly, believed that poor clients could graduate with enough wealth and self-confidence to become the clients of formal sector banks.

Indeed many MFIs establish self help groups, credit unions or village banks and link them to formal sector financial service institutions. This is a more desirable option for foreign NGOs and government projects that cannot establish a permanent banking institution.

But for NGOs seeking to establish permanent MFIs, these richer, more self-confident, potential graduates are their most valuable clients. These clients often take larger loans to expand the working capital of their businesses or to finance asset acquisition. The MFI will make most of its profits on these larger loans since the cost of administering a loan is almost the same irrespective of its size. These long-term customers should also be better credit risks—although this is subject to debate. And crucially, these larger-loan clients allow the MFI to finance its smaller loans to poorer clients. The last thing that an MFI, with its sights set on financial sustainability, wants to see is the graduation of these precious clients.

Conclusions for the Microfinance Industry

There is compelling evidence to support the contention that a significant majority of dropouts occur because MFIs do not meet the needs of their target market. MFIs seeking to develop permanent sustainable organisations should improve their services to reduce client dissatisfaction and thus desertion: this strategy is likely to prove cost-effective.

For all these reasons, MFIs should pay (and indeed are paying) close attention to the nature and quality of their financial services. The trade-off between the quality of the services and cost of providing them is a clear one, but getting the balance right is difficult. To date, many MFIs have put too much emphasis on trying to implement standardised, inflexible, low-cost, credit-driven systems when their clients are asking (and willing to pay) for a better quality and broader range of services.

> *It is to the fundamentals of market research and product development that MFIs must return if they are to retain clients and build sustainable institutions.*

The irony of this situation was that the genesis of microfinance in Bangladesh was originally driven by an extensive program of careful market and operations research designed to understand the needs of the clients. Professor Yunus' work in the village of Jobra in 1975 was quintessential market research.[2]

[2] For more on the product development process see Wright, Graham A.N., "Market Research and Client Responsive Product Development", ***MicroSave***, 2001 – available on ***MicroSave's*** website: www.*MicroSave*.net under the Study Programme section.