

# Are We Overestimating Demand for Microloans?

How much microcredit is needed? Or, more precisely, how much money will it take to meet global or national demand for microloans to poor and low-income people?<sup>1</sup> Although numerous attempts have been made to answer this question, it is difficult to come up with a reliable answer. The limited evidence available suggests that current estimates may be too high.

This Brief addresses demand for microcredit only, not demand for microfinance or other microfinance services, such as savings or funds transfers, which may be greater than the demand for microcredit. For instance, the ratio of savers to borrowers is about 10-to-1 for Bank Rakyat Indonesia, 9-to-1 for Centenary Bank in Uganda, and 4-to-1 for PRODEM in Bolivia (MIX Market).

Most microcredit demand estimates address the amount of funding required: the expected number of active borrowers is multiplied by an assumed average outstanding loan amount. Reasonable estimates of average loan size can be derived from international databases maintained by the MIX Market and Microcredit Summit. But estimating numbers of expected borrowers can be a minefield.

Most borrower estimates begin from one of two starting places: the number of poor or low-income people or the number of microentrepreneurs. Whichever universe one starts with, the total number must be reduced when estimating demand; otherwise, one would be making the dubious assumption that every person in the identified population would have an outstanding microloan all of the time. This Brief discusses the kinds of reductions that should be factored into a demand estimate and looks at some all-too-sketchy empirical evidence about the size of those reductions. Most—but not all—of this evidence raises a concern that demand may often be overestimated by a considerable margin.

How do population-based estimates move from the total number of poor<sup>2</sup> people to an estimate of potential borrowers? To begin with, some poor people are too young or too old to be able to use and repay loans. Others do not have the income from which to repay a loan. To reflect these facts, some estimates divide population by average household size, on the assumption that there will be one loan per household, more or less (World Bank 2006 and Bruch 2006).<sup>3</sup> Other estimates reduce overall poor population by positing a percentage who are “economically active” or “economically able” or “the working poor,” and thus are assumed to be potential borrowers (Ehrbeck 2006).

Other estimates, especially country-specific ones, begin not with the poor population but with the number of “microentrepreneurs,” based on survey or census data (Navajas and Tejerina 2006 and Tejerina and Westley 2007).

At this stage of the analysis, the estimator has a broad set of potential borrowers. But three further reductions must take place:

- Many people simply don't want microloans.
- Some people who might want loans are not creditworthy—that is, currently available microcredit delivery systems can't lend to them without incurring unsustainable default levels.
- People who want and qualify for loans are not necessarily borrowing all the time.<sup>4</sup>

1. Almost all microfinance institutions serve some borrowers who are above the poverty line. In Bangladesh, estimates of “nontarget” or “nonpoor” borrowers range from 15 to 50 percent (Zaman 2004; World Bank 2006). The World Bank study estimates that about three-fifths of microfinance clients in South Asia are nonpoor, based on government-defined poverty thresholds, though many of these may be “vulnerable nonpoor” who are prone to transient bouts of poverty (Zaman 2004).

2. In this Brief, “poor” is used as shorthand for poor or poor-plus-other-low-income people.

3. Four persons per household is sometimes used as a divisor, though actual household size in developing countries varies from 4.8 in Latin America to 5.6 in Africa (Bongaarts 2001).

4. For more about these issues, see Reinke (2004).

**Some don't want loans.** Many poor people don't want microloans, even if they qualify for them. They may be reluctant to commit to a repayment schedule; they may prefer to finance their investments through savings, loans from family, or other informal means; or they simply may have no good use for borrowed funds.

In 2002, microlending officers from Bank Rakyat Indonesia (BRI) interviewed 1,438 households chosen at random from local censuses in 72 villages throughout six provinces. The loan officers applied their usual screening methods to determine whether each household would qualify for a BRI microloan. Of the poor households that would have qualified for a loan, less than a quarter had borrowed from any formal microlender in the past 3.5 years, despite the fact that almost all of the households surveyed were located reasonably close to such a provider (Johnston and Morduch 2007).

A survey of 17,000 microenterprises in Ecuador found that only one in six had requested a loan in the past 12 months. Of those who had not requested a loan, about half did not want credit at all because they either did not want to be indebted (37 percent) or did not need a loan (14 percent) (Magill and Meyer 2005).

Navajas and Tejerina (2006) reviewed surveys of household businesses in Ecuador, Guatemala, Nicaragua, Panama, and the Dominican Republic. Only 20 percent of them had applied for a loan. Of those who hadn't applied, 42 percent said they did not apply because they did not need a loan; this reason was given more than any other.<sup>5</sup>

Dean Karlan and his associates at the Institute for Poverty Action have conducted experiments in which loans are offered to people who are identified by a microfinance institution (MFI) as viable clients and who generally do not have access to other formal credit. They report take-up rates (that is, the percentage of

people who accept the offer of a loan) between 5 and 15 percent in Peru, Mexico, Ghana, Morocco, the Philippines, and India.<sup>6</sup>

**Some cannot qualify for a loan.** Whether a client is "creditworthy" depends on the lending system used. Millions of poor people would not qualify for a normal bank loan because they do not have acceptable collateral, but they may qualify for microloans that use a lending methodology based on cash flow and past repayment performance. But not all of them can qualify for microloans. There are important differences among MFI lending techniques, some of which can qualify more customers than others. But no MFI can lend to everyone and still achieve high enough repayment to avoid losing its assets. Clearly, people with a bad history of repaying prior loans have to be excluded. The biggest excluded group consists of people who do not have an income large enough or reliable enough to meet a loan's payments.<sup>7</sup> For instance, Rasmussen et al. (2005) estimate that 10 percent of households in Bangladesh are too poor to be able to use the microcredit products offered. For these people, other services like grants, special services, and savings vehicles may be more useful.

In the Indonesia study mentioned earlier, 40 percent of the poor households were deemed creditworthy. By far the predominant reason for a negative determination was insufficient or unreliable household income from which to repay the loan. Insufficient collateral was almost never an issue. These results do not mean that none of the rejected households could have qualified for a loan from another microfinance provider; BRI's lending standards are somewhat conservative. The rejection rates were considerably lower for households above the poverty line (Johnston and Morduch 2007).

Data cited later in this Brief suggest that MFIs in Bangladesh lend to a much higher percentage of

<sup>5</sup> Authors' calculation from table on p. 14 of Navajas and Tejerina (2006), based on simple averages of the countries.

<sup>6</sup> Personal communication from Karlan. These take-up rates usually reflect client response to an initial offer in an area where microcredit is new. Take-up rates may rise significantly higher after people in the area become more familiar with the MFI and hear good reports from their neighbors.

<sup>7</sup> Many people are under the impression that MFIs expect their loans to be repaid out of the extra income generated by the borrower's investment of the loan proceeds in her microbusiness. This is usually not the case. In most MFIs, the decision-makers (whether loan officers or a client's fellow group members) want to see an existing income source capable of paying the loan even if the investment of the loan proceeds is unsuccessful. As many as half or more of microborrowers use their loans for some non-business purpose. And those who invest the proceeds in their business are subject to the high risk of failure that is inherent in small business generally.

households (Rasmussen et al. 2005). But exclusion still takes place. A MFI may lend to almost any group that applies, but group members are often unwilling to accept a risky new member, and individuals may self-exclude—they won't risk committing themselves to a regular loan repayment because their income is irregular or insufficient. Whatever the variations among lending techniques and countries, significant numbers of people will not qualify for microloans.

**Borrowers don't necessarily borrow all the time.**

This point is relevant when estimating funding requirements. To serve a million people with loans whose average outstanding balance is \$150, one would need funding of \$150 million—if and only if all those borrowers immediately get new loans as soon as they repay the old ones. But if borrowers are active only two-thirds of the time on average, the funding requirement would be only \$100 million.

In 2003–2004, MFIs and government microcredit programs in Bangladesh reported 23.8 million members, but only two-thirds were active borrowers as of the respective reporting dates. In the “Big Four” MFIs—Grameen, BRAC, ASA, and Proshika—five out of every six members had an active loan. In the other nongovernmental organizations, two out of three members had an active loan (Rasmussen et al. 2005).<sup>8</sup> These numbers suggest that a significant reduction should be made to allow for gaps between loans.

**A large caveat: market penetration in Bangladesh.**

Most current demand estimates assume that half or more—sometimes much more—of the target population would be borrowing at any given time if microcredit were available in their areas. The data cited so far in this Brief consistently suggest that these estimates are probably far too high.

But reports of total market penetration in Bangladesh paint a different picture. Rasmussen et al. (2005) cite an analysis by Dewan A. H. Alamgir of actual and potential microcredit users in Bangladesh. The eligible population, based on current lending patterns, is the 10th through the 65th percentile in the national income distribution—about 13.7 million households.<sup>9</sup> After adjusting for the estimated one-third of borrowers who have loans at more than one MFI, Alamgir estimated outreach at 10.5 million individual borrowers, or about three quarters of the number of eligible households. In areas with very high coverage, Rasmussen et al. suggest that as many as 80 percent of eligible borrowers actually take out loans. The 2006 World Bank study estimated that microcredit reached 62 percent of poor families in Bangladesh.

The ultimate test of market estimates is actual numbers of active borrowers once a national microcredit market approaches saturation. Thus, the Bangladesh data deserve particular weight, assuming they are correct. However, it remains to be seen whether many other countries achieve this level of penetration. Fairly mature microcredit markets in countries like Bolivia and Indonesia fall far below the penetration levels reported in Bangladesh.

Data about microcredit usage in various countries are sketchy and not entirely consistent. On balance, our suspicion is that most microcredit demand estimates are probably overstated, sometimes by wide margins. Such estimates should be treated with considerable caution, both by those who prepare them and by those who read them.

<sup>8</sup> These figures do not take into account people who are members of multiple MFIs and who may be borrowing from one when they are not borrowing from another, or borrowing from two or more at the same time.

<sup>9</sup> Authors' calculations, based on a 2005 population of 142 million UNFPA (2005) and 5.7 people per household (Britannica online).

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### Suggested citation for this Brief:

Anand, Malika, and Richard Rosenberg. 2008. "Are We Overestimating Demand for Microloans." Brief. Washington, D.C.: CGAP, April.

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