# What Does the Microfinance Debate Imply for Impact Investing?

**A flexible, outcome-focused approach is the best way to achieve societal goals.**

The Covid pandemic has made it clear that the world must do more to address poverty and inequality. It has highlighted the chasm between the haves and the have-nots, with the World Bank **estimating** Covid may have pushed up to 120 million people into extreme poverty.

Given that philanthropic and government funds are not enough, impact investing – which aims to deliver both financial returns and positive impact – is being seen as an important tool for addressing major societal issues. It's certainly growing fast, with the 2020 report by the Global Impact Investing Network estimating this space is already worth **US$715 billion**.

It is hard not to see this as a win-win situation for everyone involved. But while proponents of impact investing love pointing to a record of attractive financial returns for investors while seemingly doing good, that is perhaps not the full story. The reality is that less rigorous attention has been paid to the social performance of impact investing. As such, claims that it is "working" could be premature.

**Looking past the headlines**

Some investors are content with collecting stories from the beneficiaries or communities they serve, an approach that hardly qualifies as serious impact evaluation. Others pursue more comprehensive and objective impact data collection. Still, even here the focus is on "outputs" (e.g. number of farmers reached) rather than the actual difference in critical "outcomes" (e.g. evidence of an increased income for poor households). This has led to development experts, such as charity **Oxfam** raising concerns that impact investing risks losing credibility if meaningful impact is overlooked in the pursuit of financial returns.

This debate seems to echo similar controversies that have played out in the field of microfinance over the past decade. Microfinance, which offered access to small loans to unbanked populations, was also once seen as the '**miracle cure**' that promised to lift millions of people out of poverty. Yet **rigorous research** subsequently demonstrated that such transformative impact was absent in many microfinance schemes, leading to much soul searching regarding their true societal benefit.

Microfinance lending certainly has the potential to make a positive difference. However, as is true of many things, it is also a complex proposition. Influenced by many variables it can't be seen as a universal panacea for economic development. Instead, there is a need for microfinance institutions to apply critical thinking and impact management processes to truly understand which solution works best in a specific scenario.

**Analysing the real impact**

Our **recent research** (co-authored with Arzi Adbi) builds on this premise by applying an analytical approach to the impact of microfinance loans. Specifically, our study looked at how microloans that fund different types of activity might vary in their impact on household income. Our research analysed five years of data on 40,000 low-income borrowers of a microfinance company we refer to (for confidentiality) as Sri Lankan Microfinance or SLM. SLM is a leading microfinance institution in Sri Lanka, significantly funded by global impact investors.

We analysed three categories of microfinance loans given out by SLM: loans supporting traditional livelihoods, such as agriculture or fishing; loans to fund microenterprises, such as opening a small retail store; and, finally, funds to cover productive non-livelihood purposes, such as housing or education. The increase in household income did vary depending on the type of loan, but not always in ways that matched current thinking on how microfinance generates impact.

Supporters often claim microfinance loans are most impactful when supporting new microenterprises. However, our results reveal that borrowers who took out loans for more traditional activities, such as farming, actually experienced a (slightly) greater increase in income than those starting a new business. Those who borrowed money specifically to grow an existing microenterprise also did slightly better than those starting a new microenterprise from scratch. These patterns are consistent with an argument that borrowers are more likely to succeed in more familiar activities than with a completely new undertaking.

Overall, while borrowers who took out any form of a livelihood loan did see greater income increase than those who took out non-livelihood loans, the difference was less than 6 percent. This indicates that even non-livelihood loans (only granted by SLM to productive uses like housing or education) might also have a meaningful impact, even if the funds only indirectly related to making money. Extrapolating from this finding, one could expect that impact might often be greater if loans were given with no strings attached, allowing the borrowers to decide the best use for the money.

We also found that the income increase was generally greater if a loan covered the full amount a borrower required. This is probably because it removed the need to source additional and more expensive funding, such as from local moneylenders. Again, this points to the value of adopting a more flexible approach to microfinance that focuses more on matching specific customer needs. Borrowers also recorded better income gains when loans funded the same kind of activity across entire peer groups. This suggests there are important benefits gained from a shared pool of knowledge, skills and support.

**A need for flexibility**

For microfinance to be effective, lenders clearly need to understand the local market they are lending into and the borrower's existing skills and strengths. They will then be better placed to offer tailored solutions that match specific local needs and improve the desired outcomes. These findings can also be taken as a cautionary tale for other kinds of solutions for poverty alleviation.

Our findings reinforce the benefit of taking a flexible development approach. One that is sensitive to the real needs of the stakeholder being served, and that discards rigid external views of what kind of interventions are best. It is vital to study relevant outcome data to make sure that actions are meeting stakeholder needs and expectations. Rather than seeing market-based solutions as a catch-all panacea, we should recognise that in some cases, even non-market solutions – such as giving cash, akin to a universal basic income – might be a better solution.

We expect many of these lessons to carry over to impact investing. It would be inappropriate to continue using the term "impact investing" without ensuring credible evidence of impact in line with the claims of a given fund's marketing brochure or website. Like microfinance, impact investing is a tool that is well suited to some contexts but not all. It is therefore best employed as a complement to other valid development approaches. The focus in the end should not be on the tool itself but on how it helps **achieve societal goals**.

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