

CIPE Development Blog

Can microfinance ignite a good governance epidemic?

Posted By [Oscar Abello](#) on April 13, 2011 @ 1:05 pm

In *The Tipping Point*, Malcolm Gladwell called them ‘connectors’. The growth of social media has popularized the established marketing term for them: influencers. They’re the highly connected hubs in any network that play a key role in spreading information, ideas, practices, and even [diseases](#)^[2]. Banks, for example, are economic hubs. If only they took that role more seriously.

This week the Afghan government announced it is dissolving Kabul Bank, the country’s largest and the government’s sole financial services provider, because Kabul Bank executives and board members were using savings deposits as a personal slush fund rather than extending loans and credit on a commercial basis. Kabul Bank officials disbursed \$850 million in fraudulent loans to major shareholders and political allies, representing 94 percent of all Kabul Bank lending, [The Wall Street Journal reported](#)^[3].

If you think that sounds terrible consider China’s [estimated \\$1.2 trillion loaned to local state-owned enterprises](#)^[4] for mostly political rather than commercial purposes. Seeking ways to save, lend and seek investors more efficiently, China’s burgeoning middle class is creating a massive shadow financial sector, [according to a recent Financial Times report](#)^[5].

In the United States, the subprime mortgage crisis continues with no end in sight, as banks recently began to unravel the mortgage bundles underlying the asset-backed securities at the heart of the crisis. In order to satisfy court procedures for repossession, banks have been submitting forged materials from factory-style document farms, [as reported recently on 60 Minutes](#)^[6].

With such economic hubs at their core, whether in Afghanistan or China or elsewhere, it’s no wonder that corruption – by anyone’s definition – seems so intractable. But the story of banks as economic hubs doesn’t always have to be a tragedy. In the aftermath of the East Asian Financial Crisis in 1997, one financial sub-sector realized the importance of taking their hub status seriously: development finance institutions.

Created after World War II, development finance institutions in East Asia started out as channels for administering reconstruction loans and overseeing project management. Though they’ve since evolved in different ways to fund nascent and growing economic sectors ahead of other investors, development finance institutions remain heavily involved in improving client management and governance.

After the [1997 East Asian Financial Crisis](#)^[7], development finance institutions in East Asia knew that they needed to restore investor confidence and get economies back on the market-oriented growth path that has reduced more poverty than in any other region in the world. Led

by the [Association of Development Finance Institutions in Asia and the Pacific](#) ^[8] (ADFIAP), their collective response was to strengthen corporate governance in the region, [starting with themselves](#) ^[9].

With a collectively-built corporate governance rating system, region-specific training materials and the ADFIAP-housed Institute for Development Financing to support and conduct regular risk management and governance seminars for staff and board members (more info on www.governance-asia.com ^[10]), development finance institutions got themselves on track to strengthen corporate governance in the region by serving as the standard to which they held their client networks accountable.

After the Andhra Pradesh crisis, their largest to date, can microfinance providers follow in those footsteps? Though not inclusive of all microfinance providers, there are about \$26.9 billion in deposits and \$65 billion in loans on the balance sheets of the 1,933 microfinance institutions reporting to the [Microfinance Information Exchange](#) ^[11] as of writing this post – and those numbers have been growing about 20 percent a year. Microfinance providers are thus emerging as new economic hubs.

By serving as examples of effective corporate governance, microfinance providers could succeed where so many financial institutions have repeatedly failed, and in so doing could ‘infect’ their client and community networks with the ‘disease’ of strong corporate governance. With [almost three billion unbanked people](#) ^[12] still to reach, those are huge potential networks to infect.

Such an epidemic would be good for reducing poverty, as it would serve to attract investment into new and growing businesses. It would be good for financial sectors around the world trying to end the succession of financial scandals and crises. It also would be good for new or struggling democratic states, once more transparent financial sectors within countries take over development financing from international institutions.

If they [got their corporate governance act together](#), microfinance providers could ignite a good governance epidemic. But that’s a big if.

For a deeper look at corporate governance and microfinance, check out “[Corporate Governance, Scale, and Financial Inclusion](#) ^[13],” by Oscar Abello for CIPE’s Economic Reform Feature Service.