

Assessing the important elements of microfinance



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Microfinance is the provision of financial services to the poor. This involves small amounts – hence “micro” – of savings, credit, insurance and money transfer services. There is significant net demand for financial services in many areas of the developing world, especially in rural areas. The formal banking system has so far been unable to fill the gap, even for the core services of safe savings and short-term credit for both productive activities and consumption. As a result a niche microfinance industry has emerged, and innovation and experimentation has led to success that has promoted the renewed interest and involvement of the commercial banking sector. A wide variety of methods have been used to reach these low-income communities with appropriate and affordable services, reflecting the diversity of contexts and environments in which these services are provided. While there are no specific methods that are appropriate in every context, there are certain principles that are recognized as good practice in delivering microfinance services. These principles are common to the range of institutions involved in the delivery of microfinance and reflect the fundamental principles of appropriateness and sustainability. (Principles of Microfinance – updated Sep 06, World Education Australia)

This report tells us the basic definition and functioning of microfinance.

Microfinance is basically meant for that set of population that is deprived of financial services and access to credit due to lack of finances. This lack of finances makes poor people poor and the only tool to intervene in the vicious circle of poverty is microfinance.

After going over the report published by the UNDP called the Essentials on Microfinance a lot of primary concepts about microfinance got clear to me.

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The report highlights the major lessons learnt through past experiences. To begin with it states that role of microfinance services, firstly the use of loan should not be restricted Microfinance organizations should allow for the fact that micro entrepreneurs have a variety of uses for funds, not only for the activity for which a loan is formally given but also for household operations and other family enterprises. It would be too risky for the poor, particularly the poorest of the poor, to invest all their income in a single activity. If the single activity or enterprise failed, the consequences of this would be much greater than if they had several sources of income. Providers of quality financial services recognize this and place relatively few restrictions on loan use. Most microfinance organizations do not monitor client loans to ensure that the loan is being used for its stated purpose because they recognize that it is part of the survival strategy of poor clients to make an ongoing stream of economic choices and decisions. The clients themselves know how best to manage their funds.

Then the second thing that the report mentioned was that the microfinance institutions should provide financial services and not subsidies. For microenterprises cannot afford to subsidize loans. If the organization is to provide loans on an on-going basis, it must charge interest rates that allow it to cover its costs. These costs tend to be high because providing unsecured, small loans costs significantly more than loans in traditional banking. The costs to the institution include operating costs, the cost of obtaining the funds for loans, and the cost of inflation. MFIs cannot rely on governments and donors as long-term sources of funding. They must be able to generate their own income from revenues, including interest and other fees. Since the

poor seek continued and reliable access to financial services and are able and willing to pay for it, it is advantageous to both the institution and the clients to charge interest rates that cover the cost of the services. (For a fuller discussion on setting interest rates, see Resources: Financial Sustainability, p. 11.)

Thirdly it stated that microfinance contributor's to empowerment of women. Women entrepreneurs have attracted special interest from MFIs because they almost always make up the poorest segments of society, they have fewer economic opportunities, and they are generally responsible for child-rearing, including education, health and nutrition. Given their particularly vulnerable position, many MFIs seek to empower women by increasing their economic position in society. Experience shows that providing financial services directly to women aids in this process. Women clients are also seen as beneficial to the institution because they are seen as creditworthy. Women have generally demonstrated high repayment and savings rates. MFIs interested in serving women should understand the specific needs of women clients and attract women as customers. Women often have fewer economic opportunities than men.

Women also face cultural barriers that often restrict them to the home (for example, the institution of the veil, or purdah), making it difficult for them to access finance services. Women have more traditional roles in the economy and may be less able to operate a business outside of their homes. Women also tend to have disproportionately large household obligations. Loan sizes may need to be smaller, given that women's businesses tend to be smaller than men's. They tend to focus on trade, services and light manufacturing.

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Women's businesses are often based in the home and frequently use family labour. Loans to women should allow women to balance their household and business activities, for example, by not requiring that too much time be spent in meetings and holding meetings in convenient locations. The gender of loan officers may also affect the level of female participation in financial services, depending on the social context.

Then the report talks about how essential it is to develop sustainable institutions and the most important thing in it is to support institutions, not projects. This means, Donors can promote the development of MFIs by identifying and supporting promising local initiatives to develop as institutions. Donors should:

(a) identify promising local organizations; Donors should look for promising MFIs whose objectives and operations they can support rather than having to try to change them. Donors should not mandate the organization's target groups or geographic areas of operation. (For tools to appraise potential institutions, see Microfinance

Tools: Appraising Microfinance Institutions, p. 10.)

(b) identify a technical implementer;

One of the greatest areas of donor support should be to help to identify strong savings methods, reporting standards, accountability structures, and other institution-specific managerial and governance requirements.

(d) have a credible work plan and strategy for reaching sustainability.

The objective of the technical assistance is to build the local institutional capacity with a view to fostering the independent, long term growth of the institution. After the initial assessment of the organization's needs, the technical implementer should have a work plan with a clear strategy for developing the institution's client outreach, portfolio management, and financial sustainability. (For a fuller discussion on technical implementer who should have the primary responsibility for building the capacity of a promising local organization or local initiative. The technical implementer may be an existing local MFI that has a proven track record in microfinance or a credible international institution. Where there are no promising local initiatives to receive technical support, the technical implementer can develop a start-up organization.

(c) provide technical assistance for institutional capacity-building;

The identified technical implementer should provide technical assistance to the local organizations to develop their institutional and human capacity. Technical assistance can include a focus on: business planning, financial management systems, loan and savings methods, reporting standards, accountability structures, and other institution-specific managerial and governance requirements.

(d) have a credible work plan and strategy for reaching sustainability.

The objective of the technical assistance is to build the local institutional capacity with a view to fostering the independent, long term growth of the institution. After the initial assessment of the organization's needs, the technical implementer should have a work plan with a clear strategy for

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developing the institution's client outreach, portfolio management, and financial sustainability.

Then it states Successful microfinance institutions must reach large numbers of clients and become financially self-sufficient.

Outreach refers to the central purpose of microfinance: to provide large numbers of very poor people with access to quality financial services.

Attention to outreach is critical because there are millions of households and enterprises that lack access to financial services. If these millions are to be reached, MFIs must have the capacity that allows for significant expansion.

The most successful examples of large-scale outreach have been accomplished through specialized financial institutions.

Financial self-sufficiency is the point at which an organization can fully cover its operational costs as well as the cost of its funds (including the cost of borrowing from banks and the cost of inflation) from its interest and fees.

Once an organization is financially self-sufficient, it can fund its growth with capital from commercial banks, making it independent of donor or government subsidies. Being financially self sufficient is the only way for financial institutions to grow.

Then it states sustainability and serving the poor are not conflicting objectives.

Because the objective of many MFIs is poverty alleviation, they often wish to focus on the poorest segments of the population. A study of MFIs around the world by CGAP demonstrated that among the high-performing programmes,

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there is no clear trade-off between reaching the very poor and financial viability. (Source: Maximizing the Outreach of Microenterprise Finance: the Emerging Lessons of Successful Programs, CGAP, FOCUS Note, No. 2, October 1995.) Findings suggest that although it is possible to serve the extremely poor in a financially sustainable way, it is likely to take longer for the institution to become sustainable.

Then it talks about Savings Mobilization which means that Savings services are important in microfinance.

Extensive evidence from around the world shows that the poor do save and that they need secure places where they can build usefully large sums of money. Indeed, there is greater demand for secure savings services than credit on the part of the very poor. Most very poor people can - and do - save. They must save for emergencies, weddings, funerals, cyclical expenses such as the start of the school year, and financial opportunities such as establishing an enterprise. When there is no institution available, the poor use informal methods to save. They save in livestock, grain and jewelry and they save cash with savings clubs, rotating savings and credit associations (RoSCAS), money guards, supplier credit, pawnbrokers and safe places in the home. These informal savings services are limited, the transaction costs high and often risky. Poor people also regularly lose their savings to dishonest "friends," frivolous spending, illness of livestock, destruction of grain, theft and the like. As a result, there is a vast unmet demand for savings services. Effective savings services can enhance the financial management of the poor and increase their assets. For the MFIs, savings can be beneficial because

they are potentially the largest and most immediately available source of capital.

Lastly it talks about Policy Environment in which it states that Governments should facilitate, not over regulate, microfinance operations.

Governments have an important role in ensuring an enabling environment for microfinance. This includes maintaining a reasonable level of political stability, a stable macroeconomic environment, low inflation rates and no ceilings on interest rates. These conditions enable both microcredit and micro saving operations. The government should understand microfinance to be able to supervise MFIs effectively. Most countries have not yet established an approach to regulating MFIs and MFIs operate on the fringes of the regulatory environment.

Poverty and microfinance

In Pakistan, microfinance is often viewed by policy makers and the general public as a tool to alleviate poverty. It is thus also believed, or expected, that the target market for microfinance practitioners (MFPs) is the people living below the poverty line. However, over recent years as the microfinance paradigm has matured globally, there is an increasing recognition and acceptance of microfinance as an instrument for increasing access to financial services rather than direct poverty reduction. It is by providing access to services such as credit, savings, and insurance and secure payment transfer facilities that microfinance helps low income households better manage risks, smooth consumption, expand livelihood opportunities and thus improve their quality of life.

There is also an understanding that microfinance is not meant for the 'poorest of the poor' but rather for population segments that live close to the poverty line (above and below). Pakistan Microfinance Network (PMN) has undertaken a quick study to gain greater understanding of the poverty and microfinance nexus in Pakistan. This paper presents the data collected by four PMN members (i. e. FMFB, Kashf Foundation, NRSP - UPAP and SAFWCO) to give a snapshot of microfinance clients lie in terms of the national poverty line.

(Evidence from four MFPs using the Poverty Scorecard POVERTY PROFILE OF MICROFINANCE CLIENTS IN PAKISTAN, By ABAN HAQ & MAHEEN SALEEM FAROOQI)

The poverty alleviation approach followed in Pakistan consists of sustaining a moderate rate of economic growth with an emphasis on equity in distribution and human resource development. Different strategies have been adopted for the purpose, which include special programs and short-term measures targeted towards improving the earning capacity of the masses in general and provision of social safety nets for the really poor in Pakistan.

With a view to enhance the access of the low-income communities to socioeconomic services of the Government, an independent professionally managed unit, the Pakistan Poverty Alleviation Fund (PPAF) was set up in 2000. This is in the form of a private, not-for-profit, limited company, with an aim to reach the poor communities through the NGOs and Community Based Organizations (CBOs). It also focuses on institutional and capacity building

measures so as to enhance the outreach of the existing NGOs and social organizations, which would come under the purview of the PPAF as its partners on the basis of transparent criteria. In addition to Government of Pakistan, World Bank is the major contributor to the PPAF project.

Initially, PPAF has signed agreements with five Partner Organizations (POs) to disburse Rs. 5 billion over the next five years. These five POs are: Taraqee Trust, Quetta (Balochistan), Agha Khan Rural Support Program

(AKRSP), Gilgit (Northern Areas), National Rural Support Organization (NRSP), Islamabad (Federal Area), Family Planning Association of Pakistan (FPAP), Lahore (Punjab) and Kashf Foundation, Lahore (Punjab). Later on, several other partners entered into agreements with PPAF and the Soon Valley Development Program is one of such enthusiastic organization. The target population of the PPAF project is poor and disadvantaged rural and urban communities. The benefits of the project will accrue directly to poor through: (a) income generation opportunities; (b) improved community physical infrastructure in the underserved areas; and (c) greater economic integration of women. Importantly the project will be complementing government efforts in improving the living condition of the poor sections.

(SHIRAZI and KHAN: Role of PPAF's Micro Credit in Poverty Alleviation)

Microfinance has been gaining popularity for the last few decades, especially after the experience of the Grameen Bank in Bangladesh. The microfinance industry stands at a crossroads between increased commercialization and increased philanthropic aid (Emily, 2005). Micro financing has been successful in some of the regions but not everywhere. Microfinance providers

in Asia and Latin America have been the world leaders, and the demonstration effect of their achievements has helped to build substantial microfinance industries in countries such as Indonesia, Bangladesh and Bolivia (see Kieran, 2004).

The most recent entrants to the microfinance industry are commercial banks. This modality includes many variants: transformed microfinance NGOs, government owned development banks, reformed state banks and diversification into microfinance by existing commercial banks. The Khushhali Bank in Pakistan is an extraordinary example of a newly established retail commercial bank specialized in micro-finance. The transformation of NGOs into commercial banks is still a relatively new phenomenon. However they seem to be performing well in terms of profits and in expanding the scale of their operations significantly (Fernando, 2004).

In contrast, the state banks have generally under-performed. In the popular period of directed credit in the 1970s, subsidized loans were granted to politically-favored wealthy landowners rather than the poor farmers. Despite this, repayment rates were low and many programs operated at a loss. However, the case of commercial banks is different. The extensive branch networks, which enables them to achieve significant outreach. There are several examples of commercial banks diversifying into microfinance, either directly or through partnerships with financial NGOs. Even big multinational banks such as ABN Amro, Citibank and Deutsche Bank are now involved in microfinance (Montgomery and Weiss, 2005).

The above examples of incorporation of microfinance into the formal financial system are paradoxical, given that the initial motive of microfinance was to serve the poor borrowers who could not have access to formal finance program. In some cases, such as in Nepal or India, sector specific lending requirements may be the impetus behind diversification of large commercial banks into microfinance. But ICICI Bank in India, for example, has expanded its involvement in microfinance beyond the minimum requirement. In cases where such requirements do not exist, the motive seems to be profits and diversification of business lines. In Latin

America in particular, there is a growing market for relatively small loans and in several countries the larger MFIs have been generating considerably higher returns than have commercial banks. In contrast, smaller MFIs (principally NGOs) in the region are showing negative returns (Ramirez, 2004).

Targeting women through microfinance

The past three decades have witnessed a steadily increasing awareness of the need to empower women through measures to increase social, economic and political equity, and broader access to fundamental human rights, improvements in nutrition, basic health and education. Along with awareness of the subordinate status of women has come the concept of gender as an overarching socio-cultural variable, seen in relation to other factors, such as race, class, age and ethnicity. Gender is not synonymous with women, nor is it a zero-sum game implying loss for men; rather, it refers to both women and men, and to their status, relative to each other. Gender equality refers

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to that stage of human social development at which “ the rights, responsibilities and opportunities of individuals will not be determined by the fact of being born male or female,” in other words, a stage when both men and women realize their full potential. Women’s Empowerment: Measuring the Global Gender Gap, Augusto Lopez-Claros, World Economic Forum Saadia Zahidi, World Economic Forum

International aid donors, governments, scholars, and other development experts have paid much attention to microfinance as a strategy capable of reaching women and involving them in the development process. The microfinance industry has made great strides toward identifying barriers to women’s access to financial services and developing ways to overcome those barriers. A 2001 survey by the Special Unit on Microfinance of the United Nations Capital Development Fund (SUM/UNCDF) of 29 microfinance institutions revealed that approximately 60 percent of these institutions’ clients were women. Six of the 29 focused entirely on women. Among the remaining 23 mixed-sex programs, 52 percent of clients were women. The study also showed, however, that those programs offering only individual loans or relatively high minimum loan amounts tended to have lower percentages of women clients. These findings affirm the importance of designing appropriate products for women. According to USAID’s annual Microenterprise Results Report for 2000, approximately 70 percent of USAID-supported MFIs’ clients were women. Considerable variation among the regions was seen, however, with percentages of women clients ranging from 27 percent in the Near East to 87 percent in Asia. In Eastern Europe, where USAID has traditionally supported individual-lending programs, the

percentage of women clients dropped as low as 48 percent in 19993 before rising to 54 percent in 2000, when USAID began to support more group-lending programs offering smaller loans. Although the UNCDF study found that larger programs tended to have lower percentages of women clients, data collected by the Microcredit Summit Campaign found no statistically significant correlation between the number of very poor clients served by each institution and the percentage of those clients who were women.

The basic theory is that microfinance empowers women by putting capital in their hands and allowing them to earn an independent income and contribute financially to their households and communities. This economic empowerment is expected to generate increased self-esteem, respect, and other forms of empowerment for women beneficiaries. Involvement in successful income-generating activities should translate into greater control and empowerment. Closer examination shows us, however, that this equation may not always hold true and that complacency in these assumptions can lead MFIs to overlook both opportunities to empower women more profoundly and failures in empowerment.

The ability of a woman to transform her life through access to financial services depends on many factors-some of them linked to her individual situation and abilities, and others dependent upon her environment and the status of women as a group. Control of capital is only one dimension of the complex and ever-changing process by which the cycles of poverty and powerlessness replicate themselves. Women also face disadvantages in accessing information, social networks, and other resources they need to

succeed in business and in life. Only by evaluating the needs of women will an MFI be able to maximize its empowerment potential (Susy Cheston)

Another reason for the lack of attention to women's empowerment in mainstream microfinance is that MFIs fear that building empowering elements into their programs will threaten their financial sustainability ratios and limit their access to funds from major bilateral and multilateral donor agencies. Many donors agencies' funding criteria focus primarily on outreach and institutional sustainability criteria and do not "reward" programs that are able to demonstrate greater and more sustainable impact on their clients. The incentive structures lead many MFIs to consider including program elements intentionally empowering for women as "extras" or "luxuries" rather than as an integral part of their program design and goals.

But many MFIs with a strong focus on empowerment maintain very high levels of operational and financial sustainability, suggesting that a great deal can be done to enhance women's empowerment even within the constraints of financial sustainability.

Working Women's Forum (WWF) in India, for example, is fully financially sustainable and offers a range of nonfinancial services, including organizing women in the informal sector to achieve better wages and working conditions. WWF also empowers poor women through its institutional structure by training them to act as health promoters and credit officers in their neighborhoods.

Several Women's World Banking affiliates also manage to maintain a balance between strong financial performance standards and empowerment. For

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example, ADOPEM, in the Dominican Republic, has more than 28, 000 borrowers and a financial sustainability ratio of 127 percent and is in the process of becoming a regulated financial institution. Yet ADOPEM, whose mission is to incorporate women and their families into the economic and financial system through the provision of credit and training, and to strengthen the position of women entrepreneurs with micro-, small-, and medium-sized businesses, provides more than just loans to its clients. ADOPEM not only provides business training for its clients but offers training in a range of areas including democratic processes and civil society participation designed to encourage women's empowerment and leadership. In addition, ADOPEM supports the Association of Women in Small and Microenterprise (ANAMUMPE), which provides access to information on training events and legislative issues and has given women an opportunity to participate in working groups organized by the government on issues affecting micro enterprise.

Other elements important to microfinance

In the effort to achieve self-sufficiency, many MFIs have become commercial institutions. If successful at this change, MFIs will no longer be reliant on government grants or below market-rate loans. But like all commercial lending institutions, commercial MFIs must manage risk. This study examines portfolio risk in MFIs. Microlending is inherently risky and a purpose here is to identify existing practices and contributing factors to a low rate of payment default. In particular, the disaggregated nature of the data used for this study allows for a test of lending methodologies as a factor in risk of the

portfolio, while controlling for other micro and macro economic variables.

(PETER R. CRABB, Sept 2004)

Much of the previous empirical work on microfinance institutions includes only case studies and small sample reviews of their financial conditions. This study used a large cross-section of institutions, from many parts of the world, segregated by the types of loans made, and measured over a significant period of time. The results identified key risk factors in loan portfolios - institutional size, rates of return, and macroeconomic factors. The lending methodology used by the MFI is thought to be a major factor for both positive and normative reasons, but appears to negligibly affect the risk in the loan portfolio. Greater lending to women consistently raises the risk of the portfolio, but this activity is in many ways why the institution exists. In total, this evidence suggests that if MFIs are to continue with their stated missions of meeting the needs of the most impoverished they should continue to explore both individual and group lending, scale up their operations, charge a rate of return that provides financial stability without undue risk, and diversify to mitigate the effects of changes in the economy. In the future, empirical studies such as these will benefit from more theoretical models on the development and operations of MFIs. Additionally, further empirical research should look at more disaggregated data to more closely examine risk factors. For example, this study does not directly control for the extent of savings by the borrowers. While group-lending generally includes a savings component, more tests using the actual level of savings on the part of the borrowers for each MFI may show any contribution to lower risk that exists. Controlling for savings on the part of the borrower may also

help with the normative benefits of teaching financial stewardship. Finally, further research should be conducted on how MFIs can coordinate their activities, including their financial operations, to controlling the significant economic factors affecting their success.