Study on the objectives of micro finance institutions finance essay

A sustainable economic growth and development has its foundation on economic agent's access to financial services (credit, savings, pension funds etc). Studies have shown that there has been a failure of both the government and financial institutions to provide access to loan able funds to the grass root level of the economy (GCAP, 2010; Sundaresan, 2008), for this reason it has become increasingly fashionable for national economies to set up Micro-finance Institutions to meet the need of these groups of people. Microfinance is becoming widely accepted especially in the developing countries and it is now playing a major role in reduction of poverty and the economic development in the world. This essay seeks to analyse both theoretical and empirical evidence with the view to ascertaining whether MFIs have lived up to their objectives as key drivers of economic growth and development. In addition, the essay will look at the impact of MFIs in Nigeria in relation to poverty eradication within the following perspectives:

Provision of Financial Services

Access to Finance and

Regulatory and Legal Framework for access to finance

Nigeria Financial Services Sector is made up of the commercial banks, the Microfinance Banks, Discount houses, Cooperative societies, Insurance sector and Pension funds, Savings and Loans, Leasing companies etc. The essay will focus on those financial institutions that are licensed to take deposits and create loans.

Microfinance is defined in terms of the services they offer; the provision of a wide range of services including deposit taking, advancement of loans, payment services, money transfers, and insurance services to the low income members of the economy (ADB, date). Microfinance can simply be seen as the provision of quality financial services to the poor. The theory of Microfinance dates back to 1975 to Mohammed Yunus, an Economics University lecturer in Bangladesh. In his classic research project he designed a ‘ credit and delivery system’ to provide banking services to the rural poor (Hulme et al, 2009). The research gave birth to what is known today as the Grameen bank; that has grown both in assets and operations (Grameen, 2009).

The provision of financial services within the Nigeria context has been an abysmal failure. Recent survey by the FinScope found some staggering fact about the level of banking participation in the economy FinScope (2008). According to the study 74% of the adult population have not been banked, 15% of women at the time of the survey have no bank account and 86% of rural adults are not unbanked (FinScope, 2008). A comparison of the level of access to financial services particularly the deposit money bank done amongst four countries in African including; Nigeria, Kenya, South Africa and Tanzania found that Nigeria has the second largest number of non-banking population see Fig. 1 (Isern et al, 2009). The level of financial services illiteracy amongst the adult population is equally very low according to the survey (FinScope, 2008). See Fig 3. The close proximity of Microfinance banks to the rural population offers them a great advantage to reach the nonbanked populace unfortunately; empirical studies showed that only 3 percent of adults use Microfinance as their main bank (Bun et al, 2007).

The Small and Medium Enterprises have been identified as the engine room of growth and development in most economies (Malik and Teal, 2008). However, this very important sector of every developed and developing economy has been very dormant in Nigeria. A World Bank study in 2008 (World Bank, 2008) have identified access to finance amongst others as one of the top constraints of the development of SMEs in Nigeria. In a study that compared the Sectoral contribution to GDP, it was observed that Nigeria SME sector was much smaller than that of other developing countries; according to the study, the SME accounted for about 50% of the nation's GDP very little when compared with the 80% of the other developing economies. To improve on this the country need a well funded and operationally strong Microfinance institutions, it is arguable though whether the MFIs operating in the country have lived up to their expectations. For instance, a study done by Malik and Teal (2008) showed that only 5% of firms have received loans from Microfinance Institutions even when 80% applications were received from the SMEs. See Fig. 4.

The study showed the extent to which access to and cost of financing are a problem for Nigerian SMEs. Access to loan able funds was seen as a function of size; according to the survey, about 59% of small firms faced varying degrees of difficulties in accessing finance compared to 35% of medium firms and 11% of large SME firms. A world comparison of access to and cost of credit done on India, China, South Africa, Indonesia and Brazil saw Nigeria closely following Brazil as countries with the highest impediments to access to credit see Fig 5 (ICA 2008). The study of Isern et al (2009) showed that households, rural populace and SMEs are not very interested in accessing investment funds from MFIs. Part of the reasons adduced for this lacklustre attitude include high interest rates (cost of funds), collateral requirements, maturities mismatch etc. However, the study done by ICF in 2008 showed that cost of funds is cheaper in Nigeria relative to the other 5 countries surveyed.

The supply of Microfinance services has a very long history in Nigeria, although this was frequently done in informal ways. A study done by Food and Agricultural Organisation in 2004 estimated that 25% of Nigerian’s accessed some informal sources of financing (FAO, 2004). USAID in 2005 carried out a survey that estimated that a majority of funding for Manufacturing Small and Medium Enterprises came from ‘ personal savings’, informal lending schemes known as ‘ esusu’ and gifts from family members (USAID, 2005). The FinScope survey in 2008 equally revealed that 24% of SMEs used informal sources of funding for their businesses.

Various forms of Non-Governmental Organisations NGOs which are not for profit oriented micro-credit schemes have been in place since the 1980s. For instance Ford Foundation began supporting households and SMEs in 1993 and as 2004 have provided ‘ capacity building’ grants to 123 organisations worth $180, 000 US dollars at the 2000 exchange rate, and the Foundation have refinanced loans to 241 organisations to the tune of $1. 7 million (Isern et al, 2009). The study noted that majority of the NGOs used Grameen ‘ solidarity groups’ model to provide loans to small groups of people.

The 2005 Microfinance framework made provision for traditional community banks that were operating in the country to be re-licensed as microfinance institutions with a minimum capital base of NGN 20 million (CBN, 2005). The community banks operating in the country before the re-licensing were privately held companies licensed to take deposits from the public as well as provide credit services. CBN reports showed that these banks became very successful in deposit mobilization but failed in their functions as lenders to the rural households and SMEs within the communities that they operated (CBN/OFID Reports, date).

As at July 2008, about 125 Microfinance licenses were processed by the Central Bank of Nigeria and most of these licenses were for internationally experienced Microfinance organisations such as ACCION International which is a partnership between Citibank-Nigeria, Ecobank, Zenith bank, IFC and SME manager. Other international organisations like K-REP (Kenya), BRAC (Bangladesh), and the International Finance Corporation (IFC) have provided both funding and technical expertise to MFIs. The traditional commercial banks were not left out of the Microfinance arrangements as most of them opened subsidiaries that undertook the functions of MFIs (CBN reports, 2008). The growth of MFIs in Nigeria was encouraging. See Fig 6. The international capital flows as well as the technical expertise helped to build the much needed confidence that was lacking when the banks operated as community banks. However, the growth and concentration of MFIs may become too risky; as majority of them are serving the same market. CBN data showed that 100 of MFIs were operating in Lagos State alone and 16 in Abuja the Federal Capital. Reports from the CBN showed that as at the end of October 2008, a total of 724 MFIs were fully licensed and in operations, with 607 of them being community banks that were re-licensed as MFIs, about 86 MFIs have been given approval in principle during the period under review (CBN, 2008) Again another important source of risk is from the very low capital base that is required for the MFIs and poor regulatory and supervision framework. The CBN in their current reforms are taking some major steps to mitigate these risks; with the proposal of merging and consolidations within the sector. If the various reforms pull through, the country may see more financial strong MFIs that are able to perform their functions as key drivers of national growth and prosperity.

Despite the rapid growth of the MFIs in both size magnitude and operations; lending to rural households and SMEs has continued to stagnate. The growth in MFIs have failed to translate into easy access to investment funds, SMEs and households have continued to bedevilled by high cost of funds and collateral requirements. Adverse selection within the financial services sector has continued to persist as a result of information asymmetry. Information asymmetry in the sense that the MFIs have no way of fully guiding and protecting their loanable funds to the public, as a result of this; higher risk premia are demanded to provide financial services which excludes high quality borrowers.

The table showed the low reliance of SMEs in the country on capital from financial institutions; clearly borrowed funds from the banks including the MFIs have remained very low, largely as a result of the factors mentioned before. The result is even worst when compared with that of other developing economies like Brazil, South Africa, China, India, Indonesia and Kenya.

Source: ICF Survey (2008) the result showed is for short term financing as in the case of long term financing firms depend entirely on personal funding.

Table 8 clearly shows that only 4% of SMEs have access to lines of credit/loans while 8% have access to various forms of overdrafts. MFIs account for a very low percentage of financial services funding in Nigeria, largely because of loan ceiling that is active within that sector. Microfinance institutions operating in Nigeria are mandated to keep 60% of their loan portfolio below the NGN 500, 000 (US$4310) loan threshold.

Central to the Microfinance regulatory framework is the CBN guidelines for licensing of microfinance banks (MFBs). The guidelines provide two licensing options; unit MFBs that are licensed to operate within the local government area in which they are registered with a minimum capital base of NGN20 (US 172, 000) million naira. The unit MFBs according to the guideline may expand their operations subject to the NGN20 million capital requirement per branch. State MFBs are licensed to operate in all parts of the state in which they are registered and are subject to a minimum capital requirement of NGN 1 billion (US $8. 6 Million). For the state registered MFBs to raise additional funds and open more branches; they are required to have covered at least two-thirds of the state and raise additional NGN 20 million to open a branch in another state. The prudential regulations of MFIs are designed to manage credit risks that are part of the Microfinance operations; the capital adequacy ratios of the MFIs are set with the notion that the institutions will be engaged in mostly unsecured credit financing, the capital adequacy ratio is set at a risk-rated 10: 1 ratio (CBN2005). In addition, there are strict guidelines setting up reserves and dividend pay-outs.

Microfinance prudential regulations are designed to reduce risk concentration by putting a cap on the amount of credit an individual and groups can access. The Microfinance prudential regulation is designed to reduce risk concentration by putting a ceiling on individual loans (1% of unimpaired shareholder funds and 5% for group borrower), a 100% provisioning is required for loans over 90 days in arrears or restructured (Isern 2009). Microfinance deposits up to NGN 100, 000 (US $862) are protected by the Nigeria Deposit Insurance Fund (CBN 2008). The Supervision of microfinance is based on both on and off-site supervision, box 2 shows a summary of the regulatory and supervision principles of microfinance institutions in Nigeria.

Interest Rate policy of Microfinance institutions in Nigeria ranges above 20-30% for loans, advances, overdraft facilities and other types of lending services (Isern, et al 2009). The interest rates charged by the MFIs are quite high when compared to that charged by the conventional money deposit banks see Table 13. The high rates of interest reflects the high risk premia of the targeted audience that the MFIs are designed to serve.

The high rate of interest rate has been identified as one of the key factors that limit rural households and businesses from access to credit through the MFIs (Philips 2002). This imposes distortion in the flow of credit as companies that cannot afford the high cost of borrowing look for informal sources which are marred by risks and uncertainties. The review of the operations of Microfinance Institutions in Nigeria has clearly revealed that there should be a trade-off between high cost of funds on one hand and provision of financial services on the other hand. From what they are designed to achieve, they are supposed to provide some sort of lose collateral lending and as such have a higher risk than the conventional commercial banks.

Microfinance Institutions in developing economies like Nigeria faces some challenges both in their operations and in the environment in which they operate. One of these challenges as noted by Cerven and Ghazanfer (2008) includes some cultural practices that discriminate against women such as ' specific cultural, familial and personal circumstances' other important considerations to women empowerment in Nigeria are religious issues like Purdah: (seclusion of women) which is rampant in Northerner Nigeria. Technical know-how and in-adequate regulation has been identified as one of the internal and external factors that militate against the growth of MFIs in Nigeria (Campion 2002). Microfinance been in a somewhat embryonic stage; developments and regulations are still evolving is expected that the sector could face some hiccups before stabilizing.

Microfinance Institutions have enormous growth opportunities in Nigeria as a result of most of the factors highlighted in this essay; the nature of their operations and the Acts establishing them makes them a better preferred choice for consumers of financial services. However, this comes with a high cost to both the MFIs and their customers. To the MFIs the potential for high loan defaults are present; this may if not managed properly lead to financial fragility in the sector. To their customs; the high cost of interest and cumbersome application process that they have to face is a big challenge; there is an irony in the interest rate charged by MFIs in Nigeria, a country that has a forecasted average growth rate in GDP of between 5-6% per annum, has a cost of fund of between 20- 30%, this presupposes that businesses should grow more than the country's GDP.

Despite all the challenges of the MFIs in Nigeria, they remain substantial to the growth and development of any economy; and in Nigeria in particular the MFIs have large un-tapped markets and are set for long-run profitability if the relevant infrastructures are put in place.

Fig 3 Percentage of adults who have never heard of the listed services and products