Micro Finance Industry Review

Micro Finance Description

What is micro finance?

Micro finance can be defined as the provision of comprehensive financial services to micro-entrepreneurs

The vast majority of the populations of emerging economies work in the informal economy. These micro-entrepreneurs, traders, artisans or farmers are excluded from modern economic goods and services and must rely on themselves to survive. Their income often depends exclusively on the success of a small business in which they invest their frequently impressive skills, creativity and energy. Unfortunately, their ventures rarely extend far beyond the subsistence level, mostly because of lack of capital.

Like everyone else, people in emerging economies need and use financial services all the time. They save and borrow to take advantage of business opportunities, invest in home repairs and improvements, and meet seasonal expenses like school fees and holiday celebrations. The financial services available to the poor, however, often have serious limitations in terms of cost, risk, and convenience. Moneylenders, for example, often charge usurious interest rates on loans. Buying goods on credit is far more expensive than paying in cash. Local rotating savings and credit circles take deposits and give loans only at rigid time intervals and in strict amounts, and often result in the loss of members' money.

Basic financial services, like credit, savings and insurance, give people an opportunity to borrow, save, invest and protect their families against risk. But with little income or collateral, poor people are seldom able to borrow money from banks and other formal financial institutions. Even when they do have income or collateral, the amounts they require are often too small to appeal to banks. Instead, poor people tend to rely on informal financial relationships, like village moneylenders, that usually come at a very high cost to borrowers. Loan sharks charge 50% per annum and up.

Micro finance institutions (MFI), such as financial cooperatives, financial non-governmental organizations and rural banks among others, can provide poor people with small amounts of credit at reasonable interest rates. A loan as little as € 50 can give someone a chance to set up their own small business, and possibly create more jobs. It can also help secure a family’s food supply, buy medicine and pay for children’s education.

Although credit is an important part of micro finance, it is just one of the diverse financial services that improve lives. Saving services, basic insurance options and affordable remittance systems also help to manage assets and generate income.

Today

Over the past 20 years, specialized financial intermediaries have successfully targeted this market and developed products and methodologies perfectly adapted to its needs and characteristics. They have proved that micro finance is a risk-manageable and profitable business: micro-entrepreneurs borrow at market rate and boast a repayment track record that beats most commercial banks (97% on average). Experience has also shown that, while micro finance is a business per se, it is also a powerful development tool: even very modest loans generate huge business productivity gains and contribute both to create jobs and to raise family living standards (adequate nutrition, better health and housing, more education).

Micro finance is becoming an integral part of mainstream finance, and a new asset class. It is no wonder that micro finance is now quickly gaining momentum: about 10,000 institutions are engaged in it today

throughout the world. They are still a varied lot, in terms of size, legal structure and vision. However, three widespread and promising trends accompany the success of this new industry, reinforcing it structurally.

1. micro finance institutions are now **engaging into commercial funding** as a way to reinforce their long-term sustainability. Commercialization has indeed proven to be one of the essential conditions to stability, growth and independence for all leading micro finance institutions.

2. The micro finance industry increasingly requires **financial expertise and specialized know-how**. A growing number of talented business professionals have successfully achieved economies of scale, product diversification and profitable growth in this now increasingly competitive market.

3. micro finance is maturing into a **transparent and regulated industry**. There is a significant closer attention paid by regulators, well-known business auditors and rating agencies to leading micro finance institutions, given their growing importance in national capital markets. Their involvement provides a solid legal, financial and political framework to sustain the growth of the industry.

This evolution does not mean that micro finance is shifting away from its focus on poverty alleviation. However, commercialization, expertise and regulation are the means to improving the scale and quality of impact on the socio-economic situation of the micro-entrepreneurs and their families. Sustainability is the key to do this long-term effort, and this in turn is based on the economic longevity of the micro finance Institutions themselves.

History of Micro Finance

Beginning in the 1950s, development projects began to introduce subsidized credit programs targeted at specific communities. These subsidized schemes were rarely successful. Rural development banks suffered massive erosion of their capital base due to subsidized lending rates and poor repayment discipline and the funds did not always reach the poor, often ending up concentrated in the hands of better-off farmers.

In the 1970s, experimental programs in Bangladesh, Brazil, and a few other countries extended tiny loans to groups of poor women to investment in micro-businesses. This type of microenterprise credit was based on solidarity group lending in which every member of a group guaranteed the repayment of all members.

Through the 1980s and 1990s, microcredit programs throughout the world improved upon the original methodologies and bucked conventional wisdom about financing the poor.

- First, it showed that poor people, especially women, had excellent repayment rates among the better programs, rates that were better than the formal financial sectors of most developing countries.
- Second, the poor were willing and able to pay interest rates that allowed MFIs to cover their costs.

These two features—high repayment and cost-recovery interest rates—permitted some MFIs to achieve long-term sustainability and reach large numbers of clients. In fact, the promise of micro finance as a strategy that combines massive outreach, far-reaching impact, and financial sustainability makes it unique among development interventions.

Today, the micro finance industry and the greater development community share the view that permanent poverty reduction requires addressing the multiple dimensions of poverty. For the international community, this means reaching specific Millennium Development Goals (MDGs) in education, women's empowerment, and health, among others. For micro finance, this means viewing micro finance as an essential element in any country's financial system.

Market Dimensions

Only a fraction of the world's poorest people have access to micro finance services. While the micro finance sector continues to grow, at least 400 million poor and low-income people are not being served by micro finance programmes.

The market for micro-finance can be segmented as follows:

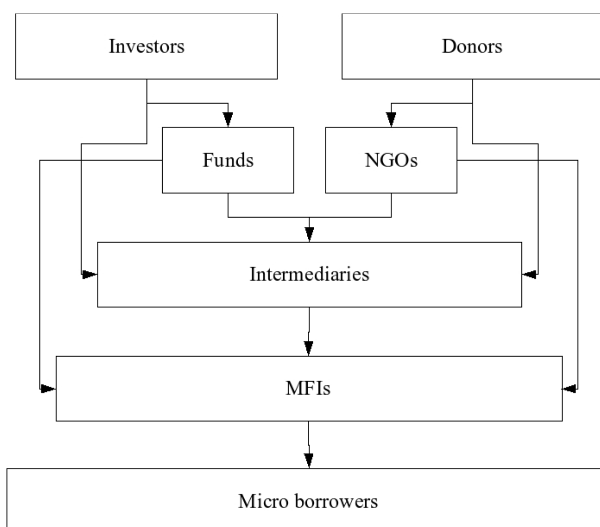
Firstly by developed and emerging economies. We are focussing on emerging economies, although lending to small borrowers in developed economies is growing.

Secondly by part of the world: Africa, Asia and South America.

Also by type of lender or micro finance institution (MFI): NGO, regulated micro-finance organisation, commercial bank. The other important intermediary are the brokers that source capital and funnel it to the lenders.

Also by size of loan: local median sizes range from € 50 to € 2,000.

The structure of the industry involves more levels of intermediary than normal lending because the actual lending requires more face time and the ability of investors to access small lenders is low.



The transaction costs can be substantial.

	Interest/Yield/Cost	***Aggregate***
Fund fee	2%	-2%
Fund performance	2 – 3%	-3%
Intermediary fee	1 – 2%	-4%
MFIs lend at 1 – 2% per month	12 – 27%	
Costs of MFI are 0.5 – 1 % pm	6 – 12%	
Net revenue to MFI	6 – 12%	+6%
Loan amounts	€ 500 – 5,000	
Monthly payment	€ 5 – 10 to € 50 - € 100	

Actual fund performance is about 2% pa.

Indicator	Central Africa	East Africa	Indian Ocean	Southern Africa	West Africa	Average
Cost/Borrower ($)	84	58	240	83	77	72
Cost / Borrower/GNI pp	17%	24%	83%	14%	19%	21%
Cost/Saver ($)	29	27*	50	56	21	29
Cost/Saver/ GNI pp	6%	13%*	17%	7%	5%	8.1%

Region Notes

Africa has the most catching up to do economically and receives much donor/NGO micro finance.

Asia dominates the market with the greatest number of borrowers and lenders and the most committed capital. Each country is different. The biggest markets are China and India. India has a culture of repaying debt to avoid social rejection, making it a receptive market. It also has high natural rates of interest. The currency is volatile.

South America suffers because as a whole it is reasonably rich, therefore NGOs and donor do not focus on this continent, however, income inequality is great so the poor find themselves without alternatives. Approximately 220 million people live in poverty of which 95 million live in extreme poverty.

DATA		**Africa**	**Asia China**	**Asia India**	**South America**	**Total**
Population		1,000,000,000	1,900,000,000	1,400,000,000	600,000,000	4,900,000,000
Population ratio		20%	39%	29%	12%	
Client ratio of Microcredit summit		3%	50%	40%	7%	
Client ratio		**5%**	**45%**	**35%**	**10%**	
GNI/p atlas		700	1,100	600	3,500	
GNI/p ppp		2,000	4,600	2,600	7,130	
SMEs		20,000,000	25,000,000	40,000,000	15,000,000	100,000,000
Micro SMEs		4,250,000	38,250,000	29,750,000	8,500,000	85,000,000
NGO/MFI/CB		70/15/15	50/20/30	50/20/30	25/50/25	
Loan Size		€100	€800	€800	€1,600	
Loan % GNI/p		14%	73%	133%	46%	
Loans % of total		20%	20%	20%	40%	
Demand (households)		25,000,000	225,000,000	175,000,000	50,000,000	500,000,000
Demand capital						€4,000,000,000
Clients	CR	4,000,000	36,000,000	28,000,000	8,000,000	80,000,000
Loans out	CR	300,000,000	2,700,000,000	2,100,000,000	600,000,000	€6,000,000,000
Supply donor funding						1,000,000,000
Potential depoistors						19,000,000
SRI						2.40E+12
MFIs	CR	500	4,500	3,500	1,000	10,000
Female Borrowers		10%				90%
Female Users		70%				90%

Product

MFIs can deliver a range of financial services, including micro-loans. This report focusses on lending and the intermediation of channelling capital from investors, via brokers and MFIs, to micro-loan protfolios. This asset (a portfolio of micro-loans) is attractive to investors because

- micro finance investments are less correlated to market movements (some data even shows negative correlation.
- micro finance investments are ethical.
- micro finance investments contribute to poverty alleviation and social development.
- micro finance is a market opportunity offering high growth for medium to long term as financial infrastructure is built in fast growing emerging economies.

The Double Bottom Line: Financial and qualitative impacts are positive:

1. Financial return: the micro finance investment risk-return profile is attractive

Competitive return: micro finance debt offers a better return than monetary instruments (an estimated additional 150 to 200 basis points) with only a slightly higher level of risk: it is an excellent alternative to fiduciary deposits or certificates of deposits. micro finance equity represents also an attractive longer term opportunity.

Systematic risk: Low volatility - micro finance offers a lower volatility than traditional equities or bonds from emerging markets. It is materialised by instruments which are not yet quoted on stock exchanges and its value is not influenced by hard to predict interest rates and credit spread movements. Weak correlation - micro finance is weakly correlated with political, economic or even climatic events. The informal sector is by its very nature a thriving place of permanent business creation, less directly linked to the fate of the formal economy. It is similarly weakly correlated with global financial movements on the major market places.

Specific risk: High solvency - The leading micro finance institutions are solvent institutions with low risk profiles. Their main assets are loan portfolios of high quality, as demonstrated by their exemplary low default rate (3% on average), usually much better than many traditional commercial banks. Strong diversification - micro finance institutions have very well diversified portfolios. Their own credit risk is spread over thousands of micro-borrowers, operating in markets with good growth prospects.

Data from the Micro Banking Bulletin reports that 63 of the world's top MFIs had an average rate of return, after adjusting for inflation and after taking out subsidies programs might have received, of about 2.5% of total assets. This compares favorably with returns in the commercial banking sector and gives credence to the hope of many that micro finance can be sufficiently attractive to mainstream into the retail banking sector. (*CGAP*)

2. Social return: micro finance brings a new dimension to investment – it becomes globally responsible

Micro finance contributes to the growth and poverty alleviation of micro-entrepreneurs through specialized financial intermediaries delivering financial services of all kinds (credit, savings, insurance). It launches local virtuous development cycles of capital accumulation, investment and job creation. Better housing, nutrition, health as well as better children education are among the most immediate social spill-over of micro finance operations on the welfare of the micro-entrepreneurs' families.

Comprehensive impact studies have demonstrated that:

(i) micro finance helps very poor households meet basic needs and protect against risks;

(ii) the use of financial services by low-income households is associated with improvements in household economic welfare and enterprise stability or growth;

(iii) by supporting women’s economic participation, micro finance helps to empower women, thus promoting gender-equity and improving household well-being;

(iv) for almost all significant impacts, the magnitude of impact is positively related to the length of time that clients have been in the programme.

Studies have shown that during an eight year period, among the poorest in Bangladesh with no credit service of any type, only 4 percent pulled themselves above the poverty line. But with individuals and families with credit from Grameen Bank, more than 48% rose above the poverty line.

Studies of the impact of microcredit in more than 24 countries found dramatic improvements in household income levels. These improvements took place primarily through growth in the borrower's business, which translated into increased household income. The studies found that access to microcredit allowed the borrower to increase the number of goods or services sold and reduce the costs of supplies and raw materials. As a result, sales increased and profits grew 25% to 40%.

Micro finance programs from different regions report increasing decision-making roles of women clients. The Women's Empowerment Program in Nepal found that 68 percent of its members were making decisions on buying and selling property, sending their daughters to school, negotiating their children's marriages, and planning their family. These decisions traditionally were made by husbands. World Education, which combines education with financial services, found that women were in a stronger position to ensure female children had equal access to food, schooling, and medical care. TSPI in the Philippines reported that program participation increased the percentage of women who were principal household-fund managers from 33 percent to 51 percent. In the control group, only 31 percent of women were principal fund managers. (*CGAP, Focus Notes. 24, Elizabeth Littlefield*)

(The world's seven richest men could wipe out global poverty. Their combined wealth is more than enough to provide the basic needs of the poorest quarter of the world's people.)

MFI Operations

MFIs have a similar approach to delivering capital to micro-borrowers as in normal retail and commercial lending operations. Screening involves the following basic criteria:

Character refers to how a person has handled past debt obligations: From the credit history and personal background, honesty and reliability of the borrower to pay credit debts is determined.

Capacity refers to how much debt a borrower can comfortably handle. Income streams are analyzed and any legal obligations looked into, which could interfere in repayment.

Capital refers to current available assets of the borrower, such as real estate , savings or investment that could be used to repay debt if income should be unavailable. CAMEL is a tool sometimes used for assessing credit-worthiness of a borrower. CAMEL refers to:

C: Capital **A**: Assets **M**: Management **E**: Equity **L**: Liquidity

More on issues and charcateristics of MFI services and operations is in the appendix. One area of particular focus is regulation and supervision. MFIs are generally not regulated owing to the informal nature of their work or charity status (eg NGOs). However, in order to mobilise more commercial bank capital and build the deposit base regulation is needed.

Regulation and Supervision

Banks are regulated to protect their depositors and to prevent risks to the financial system. Bank regulatory and supervisory authorities generally require frequent and detailed reports from commercial banks. These reporting requirements were originally designed for institutions with fewer, larger transactions.

Credit-only MFIs do not take deposits from the public and are too small to pose much risk for the financial system. Regulation by the financial authorities *is* needed for MFIs that do take deposits—for instance, savings-based financial cooperatives or credit-based MFIs that want to start taking deposits to finance their growth.

In many countries, various factions are pushing for new laws to create a special, new type of financial license that is tailor-made for deposit-taking MFIs. Such laws need to be approached with care. New licensing windows for MFIs have been most successful in countries where a critical mass of profitable credit-only MFIs existed *before* the opening of the window.

Drafters of new legislation typically fail to give enough attention to the practical feasibility of supervising compliance with the new regulations. In Indonesia, Ghana, and the Philippines, for example, dozens of new institutions took advantage of a newly created licensing window, but supervision proved grossly inadequate and a high proportion of them failed.

MFIs that do not take deposits do not need intensive regulation and supervision, but they do need a certain minimum regulatory structure in order to operate. In the transition economies of former socialist countries, legislation is sometimes necessary to clarify the right of NGOs and other non-bank institutions to engage in the business of lending.

In all countries, enforcement of unrealistically low interest-rate caps can make sustainable microlending impossible. MFIs need to charge interest rates that are considerably higher than normal bank rates because the administrative costs of making small loans are high in relation to the amount lent.

In many developing countries, legal reserves on deposits are extremely high, discouraging deposit mobilisation. Banks are less likely to utilise their own, scarcer funds for micro-enterprise programs in this environment.

Borrowers

The borrower profile is most simply characterised as a borrower around or below the poverty line. The poverty line for each country is estimated at the amount required for daily food and basic essentials. Borrowers are predominantly female and a greater proportion are rural than in normal retail lending.

Micro-enterprises

Micro-enterprises are small businesses employing up to ten people, in urban or rural areas, generally family owned and operated. Their total assets rarely surpass USD 10,000. They are active in the trade, production or services sectors of the so-called "informal economy" which can be seen as the most important place of value creation and the nurturing ground of entrepreneurship in emerging countries.

Industry specialists estimate that there are about 500 million micro-entepreneurs in the world. Each one necessitates an average micro-credit of USD 800 per year to finance its activities. This small loan allows the micro-enterprise to pre-finance staff and materials as well as to cope with specific and systematic shocks; this shifts the enterprise's focus from survival and emergency to stability and sustainability.

Estimates indicate that today only 5% of the micro-credit demand is fulfilled. Thus, although leading micro-banks enjoy significant growth rates, the gap between supply and demand is still very large.

Investors and Intermediaries

Investor Profile

Most private investors consider micro finance too risky, limiting cash flow potential from there. Much investment is in fact donation aid channelled via NGOs.

Micro Finance Institutions (MFI)

A micro finance institution (MFI) is an organization that provides financial services to the poor. This very broad definition includes a wide range of providers that vary in their legal structure, mission, methodology, and sustainability. However, all share the common characteristic of providing financial services to a clientele poorer and more vulnerable than traditional bank clients. An MFI can be broadly defined as any organization—credit union, down-scaled commercial bank, financial NGO, or credit cooperative—that provides financial services for the poor.

MFI characteristics

Formal providers are sometimes defined as those that are subject not only to general laws but also to specific banking regulation and supervision (development banks, savings and postal banks, commercial banks, and non-bank financial intermediaries). Formal providers may also be any registered legal organizations offering any kind of financial services. Semiformal providers are registered entities subject to general and commercial laws but are not usually under bank regulation and supervision (financial NGOs, credit unions and cooperatives). Informal providers are non-registered groups such as rotating savings and credit associations (ROSCAs) and self-help groups.

Ownership structures of MFIs can be of almost any type imaginable. They can be government-owned, like the rural credit cooperatives in China; member-owned, like the credit unions in West Africa; socially minded shareholders, like many transformed NGOs in Latin America; and profit-maximizing shareholders, like the micro finance banks in Eastern Europe.

Focus of some providers is exclusively on financial services to the poor. Others are focused on financial services in general, offering a wide range of financial services for different markets. Organizations providing financial services to the poor may also provide non-financial services. These services can include business-development services, like training and technical assistance, or social services, like health and empowerment training.

Services that poor people need and demand the same types of financial services as everyone else. The most well-known service is non-collateralized "micro-loans," delivered through a range of group-based and individual methodologies. The menu of services offered also includes others adapted to the specific needs of the poor, such as savings, insurance, and remittances. The types of services offered are limited by what is allowed by the legal structure of the provider—non-regulated institutions are not generally allowed to provide savings or insurance.

Types of MFI

- associations
- bank guarantees
- community banking
- cooperatives
- credit unions
- grameen

The Grameen model emerged from the poor-focussed grassroots institution, Grameen Bank, started by Prof. Mohammed Yunus in Bangladesh. It essentially adopts the following methodology:

A bank unit is set up with a Field Manager and a number of bank workers, covering an area of about 15 to 22 villages. The manager and workers start by visiting villages to familiarise themeselves with the local milieu in which they will be operating and identify prospective clientele, as well as explain the purpose, functions, and mode of operation of the bank to the local population. Groups of five prospective borrowers are formed; in the first stage, only two of them are eligible for, and receive, a loan. The group is observed for a month to see if the members are conforming to rules of the bank. Only if the first two borrowers repay the principal plus interest over a period of fifty weeks do other members of the group become eligible themselves for a loan. Because of these restrictions, there is substantial group pressure to keep individual records clear. In this sense , collective responsibility of the group serves as collateral on the loan.

- group
- individual
- intermediaries
- NGOs
- peer pressure
- rosca

Rotating Savings and Credit Associations (ROSCAs) are essentially a group of individuals who come together and make regular cyclical contributions to a common fund, which is then given as a lump sum to one member in each cycle. For example, a group of 12 persons may contribute Rs. 100 (US$33) per month for 12 months. The Rs. 1,200 collected each month is given to one member. Thus, a member will 'lend' money to other members through his regular monthly contributions. After having received the lump sum amount when it is his turn (i.e. 'borrow' from the group), he then pays back the amount in regular/further monthly contributions. Deciding who receives the lump sum is done by consensus, by lottery, by bidding or other agreed methods.

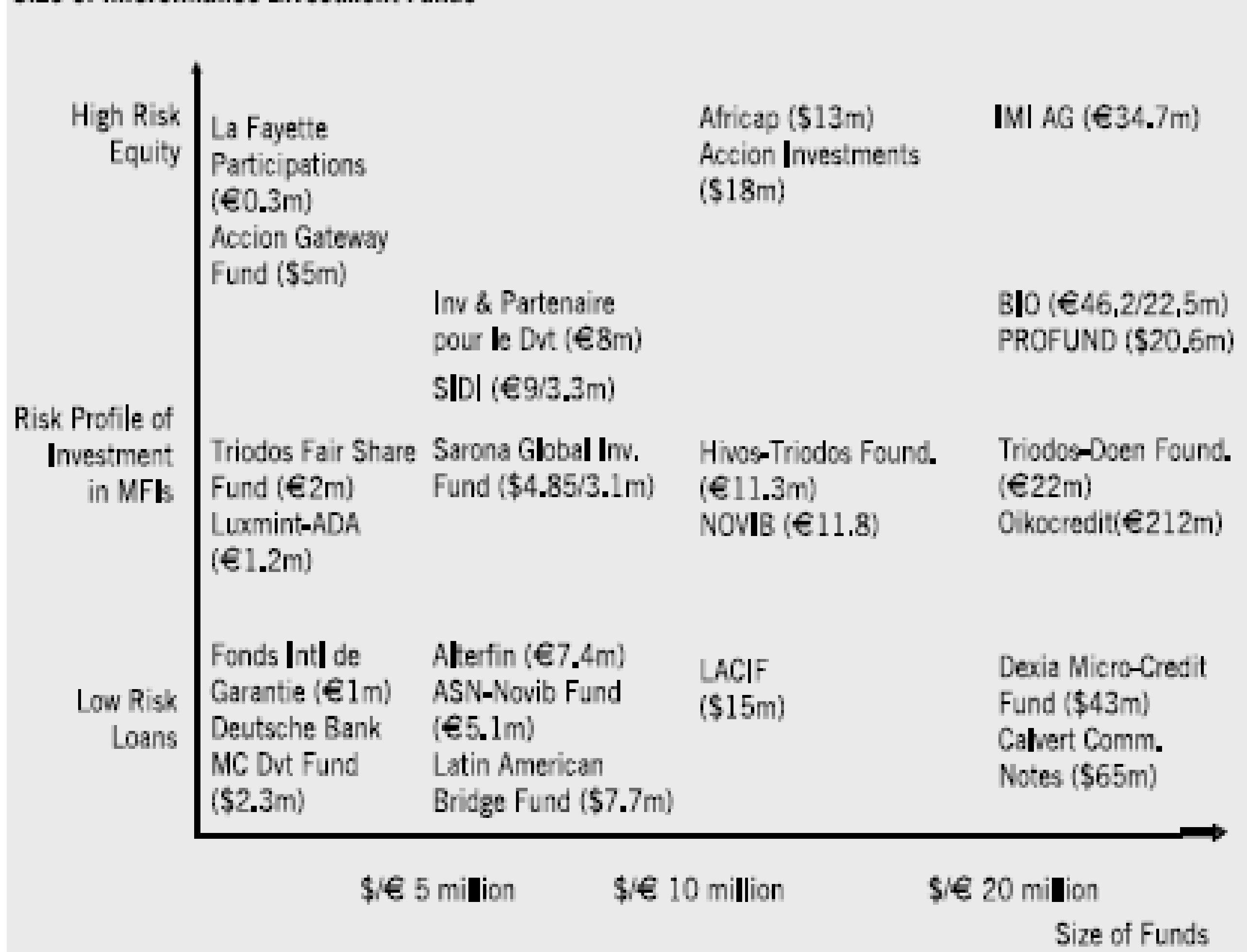
- small business
- village banking

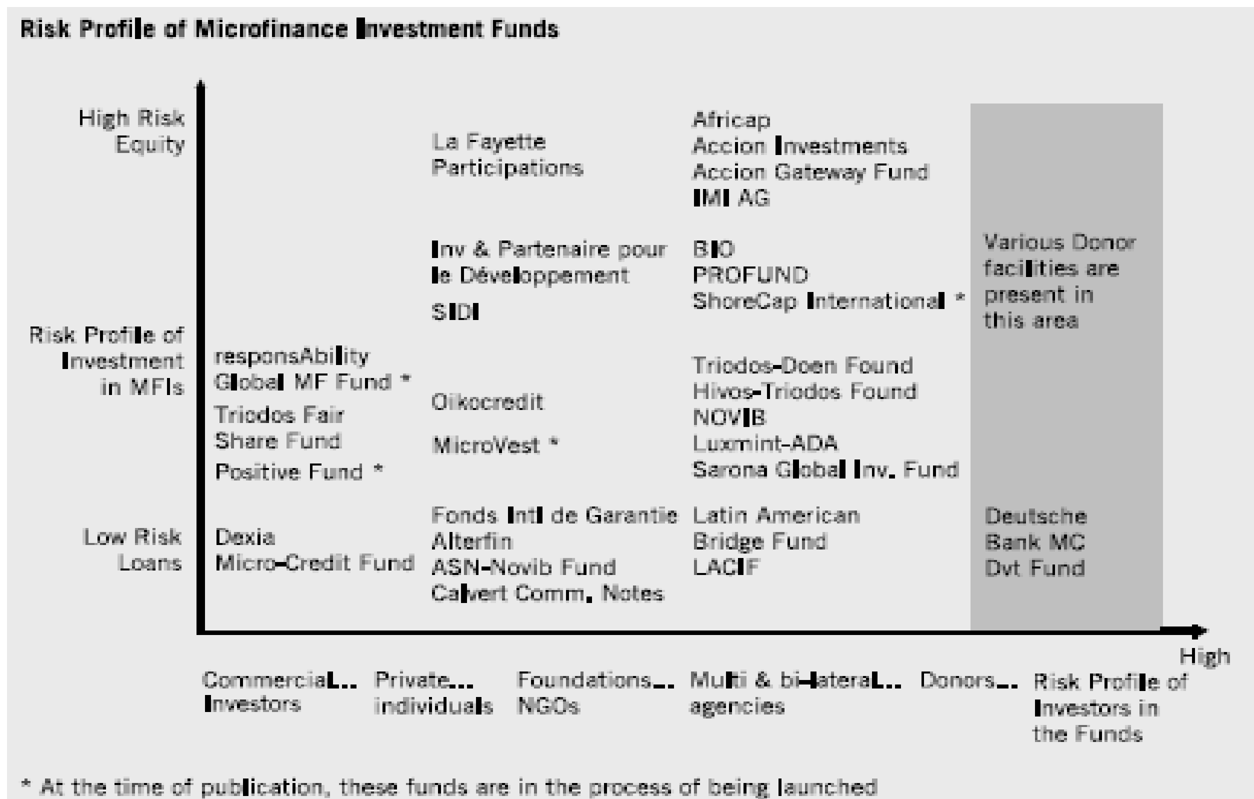
Appendix

Social Funds are Oikocredit, Alterfin, FIG, the Calvert Community Investment Notes or Luxmint.

Social Investment Funds are Profund, IMI AG, the Dexia Micro-Credit Fund, etc

Accion Gateway- Accion Investments in Microfinance- Africap- Alterfin- ASN-Novib Fund- BIO (Belgian Investment Company for Developing Countries)- Calvert Social Investment Foundation – Community Investment Notes- Deutsche Bank Microcredit Development Fund- Dexia Micro-Credit Fund – Blue Orchard Debt Sub-Fund- Fonds International de Garantie (FIG) - Hivos-Triodos Foundation- IMI AG- Investisseur et Partenaire pour le Développement- La Fayette Participations- Latin American Bridge Fund- Latin American Challenge Investment Fund (LACIF)- Luxmint – ADA- MicroVest - NOVIB- Oikocredit- Partnership Fund, Guaranty Fund and FONIDI Fund (Desjardins)- Positive Fund- Profund- responsAbility Global Microfinance Fund- Sarona Global Investment Fund- ShoreCap International- SIDI- Triodos Fair Share Fund- Triodos-Doen Foundation





Check:

Regulated entity

Trusted or proven sponsor

Transparent structure and objectives

Open ended, indefinite duration of fund

Guarantee mechanisms

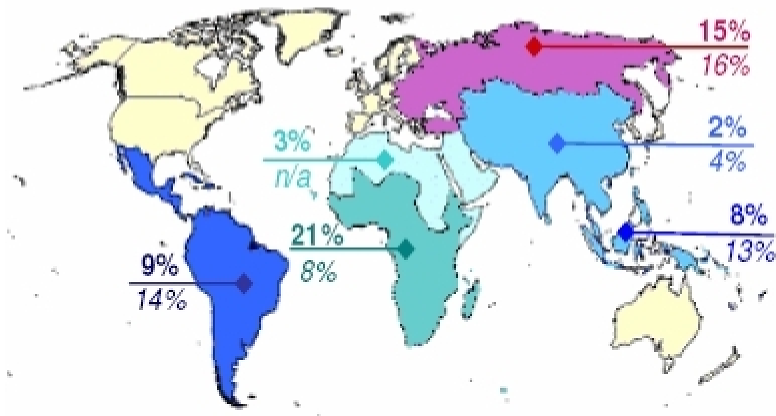
Distribution arrangements and target market

Regular valuations and redemption possible.

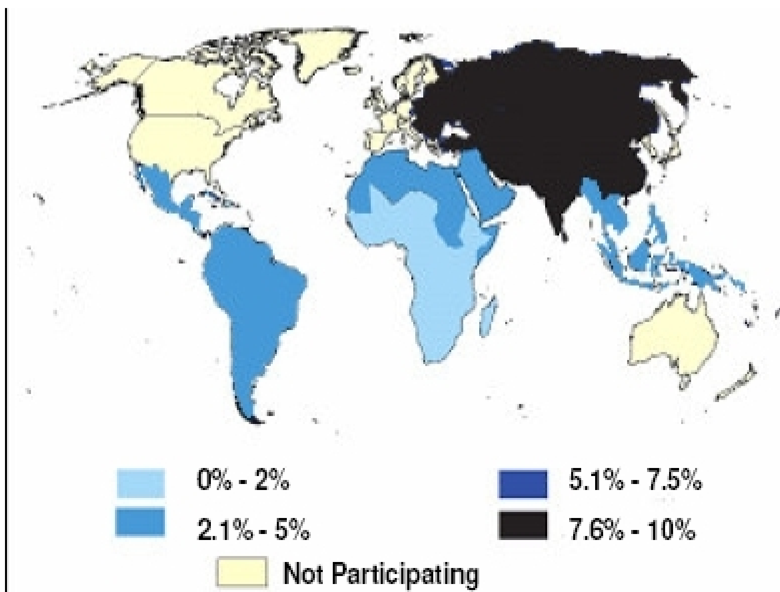
Sufficient seed capital

Critical mass

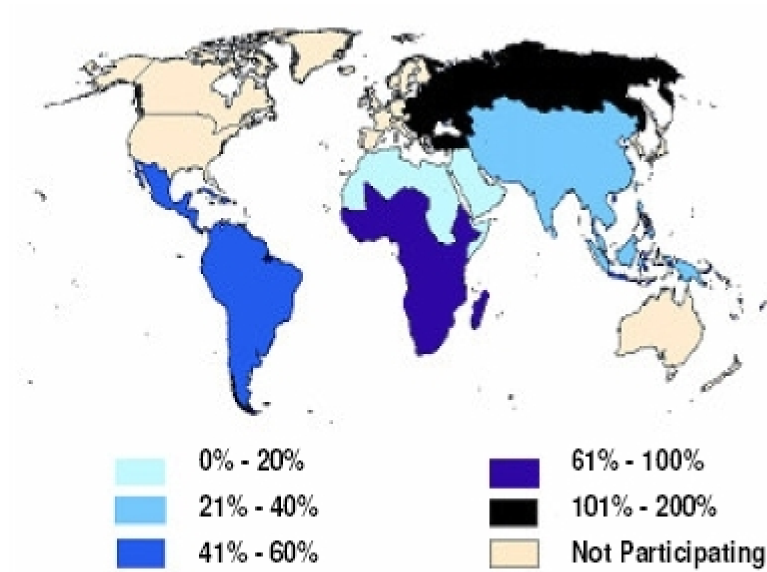
The global picture in pictures.



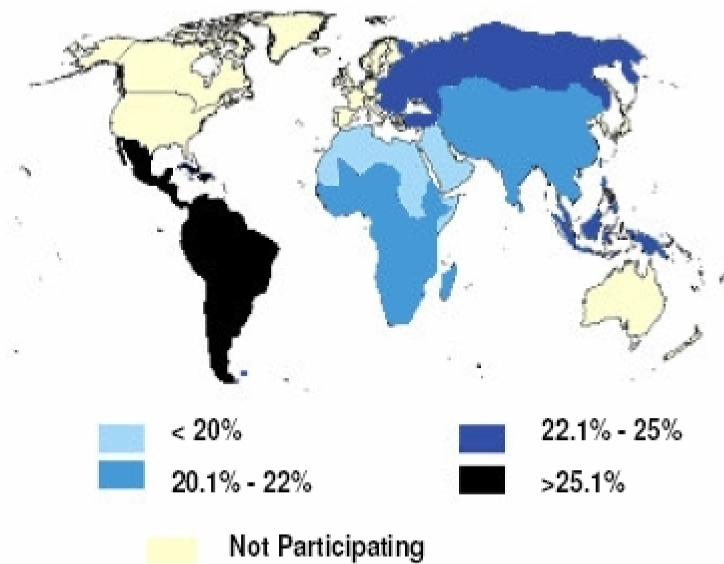
Returns



loan size to gnp/head



income over assets



MFI Operations Characteristics and Issues

Micro-lending

Over the years, NGOs in micro-finance have developed innovative lending methodologies to reach poor clients with micro-loans. Some of the principal characteristics of micro-lending are:

- Short-term, working-capital loans.
- Lending based on character, rather than collateral.
- Sequential loans, starting small and increasing in size.
- Group loan mechanisms as a collateral substitute.
- Quick cash-flow analysis of businesses and households, especially for individual loans.
- Prompt loan disbursement and simple loan procedures.
- Frequent repayment schedules to facilitate monitoring of borrowers.
- Interest rates considerably higher than those for larger bank customers to cover all costs of the micro-finance program.
- Prompt loan collection procedures.
- Simple lending facilities, close to clients.
- Staff drawn from local communities, with access to information about potential clients.
- Computerising with special software to allow loan tracking for larger programs.

Although all the banks have instituted some micro-finance techniques and innovations, only a few have carefully thought through all of the elements of their financial product. After the conference, many bankers acknowledged a need to adjust their loan prices and their operating procedures.

Micro-deposits

The new micro-finance bankers knew relatively little about dposit mobilisation methodologies that reach the low income and/or micro-enterprise client. Perhaps best known is the Bank Rakyat Indonesia Unit Desa savings program, which has the following characteristics:

Features attractive to the micro-client:

- Liquid passbook savings accounts and low minimum balances.
- Depositories conveniently located.

Secure deposits.

Real, positive interest rates on deposits.

Operational features of the program:

- Savings accounts with very low minimum balances.
- Lower levels of interest, compared with commercial banks, because of higher administrative costs.
- Simple, hospitable buildings and mobile units with low overhead.
- Simple administrative forms and procedures.
- Incentives for savings, such as lotteries

Human Resources

Until recently, micro-finance methodologies have been labour-intensive, and all the bankers interviewed evinced special concern for recruitment, training, and motivation of staff.

Staff Recruitment and Training

Most banks hired micro-finance staff from outside the bank and preferred young university graduates with little, if any, banking experience. The lack of a banking background apparently made them more receptive to the special mission and practices of the micro-finance programme.

Fourteen of the seventeen banks (both large and small) reported in-house, on-the-job training for new staff. This specialised training is costly, but probably a necessity. All banks require their staff to be familiar with

micro-finance methodologies and operating systems and procedures, and they hold meetings clearly articulating the institutional mission in micro-finance.

Staff Remuneration and Incentives

Studies of successful micro-finance NGOs reveal that credit officers' salaries tend to be lower than those found in conventional commercial banking. This finding stems from the fact that these programs, by nature, are highly labour intensive and hence costly.

For large banks with integrated micro-finance programs, however, salary levels can present some difficulties. In one case, salary scales were different and a performance-based bonus remuneration scheme existed for the micro-finance staff. This disparity created some tension with non-micro-finance bank staff who earned conventional, fixed salaries. Most others use the same salary structure of the rest of the bank. In at least three cases, no bonus system existed, perhaps because the salaries were considered adequate already. Banks that have independent micro-finance units are able to have their own lower salary scale and introduce bonus schemes without drawing much attention from the rest of the bank staff.

Cost-Effectiveness

There are several strategies to reduce costs. First, many banks had high salary structures that could be reduced by recruiting staff who do not necessarily have university degrees. A caveat is in order, however, because the salary savings gained through hiring less-educated staff could be more than offset by lower productivity. Other banks could experiment with alternatives to lengthy individual business analysis techniques. Most could improve staff productivity levels through improved operating procedures and incentive systems.

Banks could explore new methodologies to expand lending. For example, the smart card option of Financiera Familiar appeared to be an excellent cost-cutter for processing repeat loans. It was also well received by clients, who enjoyed carrying their plastic status symbol

Independent profit or cost centres may be a cost-effective strategy for many of the large, multi-service banks. Although initially costly, the separation of programs helps isolate the costs of the micro-finance program and identify appropriate cost-saving measures.

Although micro-finance bankers complain of high costs, it is unclear that their programs are in fact costlier than those of financial NGOs or specialised institutions. Costs for micro-finance are simply higher than those for conventional banking. What is also unclear, however, is whether the integrated structures are fully aware of the costs of the micro-finance programme. Until there is greater separation of costs in these programs, and until banks with micro-finance programs feel freer to share income and expense data, the question of costs will remain open.

Monitoring Borrowers

Scoring models can help microlenders in poor countries as much as they have helped credit-card lenders in rich countries. A scorecard can be used that predicts the probability that loans from a microlender will have arrears of 15 days or more. Although arrears in micro finance depend on many factors difficult to include in scorecards, inexpensive, simple-to-collect data does have some predictive power. In micro finance, scoring will not replace loan officers, but it can flag high-risk cases and act as a cross-check on loan officer’s judgement.

Appendix:

Six Guiding Prinicples of Cooperative Financial Organizations

Voluntary membership: People can join a cooperative if they share its common bond (some cooperatives are specifically for the benefit of a certain community, group of workers or relegion). Members must agree to the minimal requirements for membership and must be willing to support the cooperative's goals. Also, members may cancel their membership as long as they have met their obligations to the cooperative (eg. repaid any loans).

Democratic Control: The Cooperative provides on vote to each member, regardless of the amount of savings. Also, a member's family may paricipate in the cooperative, but each family has only one vote. This democratic control helps make sure the cooperative works for the benefit of all members.

Political and religious neutrality: The cooperative accepts members regardless of politics, race or religion. The cooperative remains neutral on these issues and does not discuss or promote one belief ovber another. The cooperative respects the beliefs of others.

Limited Interest on Capital: The main purpose of cooperative is to serve its members, not to make a profit. Therefore, the interest charged on loans is kept to a minimum and is based on the cost of administration plus the interest paid to savers. The main goal is service, not profits.

Fair Distribution of Earnings: At the end of each year, after paying all expenses (eg. interest payments to savers, administrative costs, salaries for hired staff and contributions to the cooperative reserve fund), the cooperative will sometimes have surplus or extra income. This surplus income is not rpofit but is refunded equally to the members who paid interest on loans. The cooperative distributes this interest refund according to how much interest each borrower paid. This helps to reduce the cost of loans. The surplus can also be used to increase the interest paid to savers.

Cooperative Education: A cooperative will succeed only if its members know their rights and responsibilities and understand how the coopeative should work. This includes their role in working together to make the cooperative work as well.

Source:

UNCHS [Habitat] *(1989) Community Credit Mechanisms*. Nairobi: United nations Centre for Human Settlements, p. 2

Unitas – What is Microfinance

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Poverty in the Developing World

Poverty crushes the human spirit. Three billion people — half the world's population — live on less than $2 per day, unable to meet their basic human needs. Malnutrition, lack of health care, substandard housing and illiteracy breed desperation, disease and daily suffering. Poverty traps future generations in a vicious cycle without hope or opportunity. In an increasingly globalized world, no one is immune to these problems.

Most of the world's poor are self-employed. Each day, without the security of formal jobs, they eke out livings, whether it is by raising chickens, selling produce in markets or weaving baskets. Despite working from dawn to dusk, there is no money left over to improve their quality of life or expand their businesses. All they earn goes toward basic survival.

So why then can't the poor improve their lives? In most cases, it is because local money lenders, often the only available capital source, provide business loans at exorbitant annual interest rates of 300 percent - 3,000 percent. Under this system, virtually all of a borrower's financial gains are passed directly to the money lender. Individuals do not reap the rewards of their own hard work.

Focusing on income-producing solutions for the working poor is a powerful way to alleviate the pain of poverty for an entire family.

Poverty Statistics

- Three billion people – half the world's population – live on less than $2 per day.
- 29,000 young children die every day from preventable malnutrition and disease.
- 900 million people live in slum-like conditions without access to clean water and sanitation.
- 104 million primary-age children are not in school.
- According to 2001 World Bank numbers:

Poverty Indicators	**U.S.**	**Poor Countries**
Annual per capita income	$30,600	$410
Literacy rate	97%	30%
Deaths per 1,000 children under 5	6	107
Children under 14 in the workforce	0%	19%

- The U.S. gives a smaller percentage of our GDP in foreign aid than any other developed country.
- Only 2.2% of U.S. philanthropic giving leaves our borders.

Micro Finance History

Micro finance is the practice of extending small loans to the poor for income-generating activities often coupled with other financial services such as savings and insurance.

During the 1970's, social innovators revolutionized the banking industry. They created micro finance institutions (MFIs) that lent money at reasonable interest rates to poor women who could not offer collateral. Not only did the borrowers expand their businesses and increase their incomes, but their high repayment rates demonstrated that the working poor are capable of transforming their own lives given the chance. This model of lending disproved all conventional thinking. micro finance was born.

More than a quarter century later, MFIs serve more than 80 million poor people in developing countries with over $7 billion in outstanding microcredit loans. They exist in many forms – credit unions, commercial banks and, most often, non-governmental organizations (NGOs). Repayment rates average higher than 95 percent while commercial loan repayments from large businesses often fall below 50 percent. The high repayment rates demonstrate that the working poor are willing and able to repay their loans, and that they are capable of transforming their own lives given the chance. Microcredit promotes self-reliance and empowers the poor to lift themselves out of poverty.

How Micro Finance Works

Micro finance products such as savings accounts, microcredit loans (usually $50 to $150), and health insurance empower the poor to lift themselves out of poverty. Through micro finance, they can secure better nutrition, education, healthcare and housing for their families. micro finance has helped millions in developing countries raise their standards of living and protect themselves from economic setbacks. The tragedy is that the vast majority of the world's poorest people still lack access to these basic financial services.

The traditional banking system requires that a borrower have collateral in order to receive a loan. The world's poorest people have no such collateral. Further, traditional banks are not generally interested in issuing small loans - $50 to $150 – as the interest benefits do not exceed the transaction costs. So how exactly does micro finance work?

First, many micro finance institutions (MFIs) utilize social collateral in the form of peer groups to ensure loan repayment. Borrowers take out loans in groups of five to eight individuals. If a borrower defaults on her loan, the entire group typically is penalized and sometimes barred altogether from taking further loans. This peer pressure encourages borrowers to repay loans in full and on time, resulting in the higher than 95 percent repayment rates. Among the few who default, the most common reason is an illness in the family, which disrupts their lives, rendering them unable to continue their business and repay their loans. The second most frequent reason is natural disaster or unanticipated crisis.

Microcredit loan cycles are usually shorter than traditional commercial loans – typically six months to a year with payments plus interest, due weekly. Shorter loan cycles and weekly payments help the borrowers stay current and not become overwhelmed by large payments.

Clearly the transaction-intense nature of weekly payment collections, often in rural areas, is more expensive than running a bank branch that provides large loans to economically secure borrowers in a metropolitan area. As a result, MFIs must charge interest rates that may sound high – often 30 percent to 70 percent annually - in order to cover their costs. These interest rates are still significantly lower than the 300 percent to 3,000 percent annual rates the borrowers were previously paying money lenders and are typical of the local credit card interest rates.

Why Target Women?

There are many reasons why women have become the primary target of micro finance services. At a macro level, it is because 70% of the world's poor are women. Women have a higher unemployment rate

than men in virtually every country and make up the majority of the informal sector of most economies. They constitute the bulk of those needing micro finance services.

Targeting women has also proven to be a successful, efficient economic development tool. Research performed by the United Nations Development Programme (UNDP) and the World Bank, among others, indicates that gender inequalities inhibit overall economic growth and development. A recent World Bank report confirms that societies that discriminate on the basis of gender pay the cost of greater poverty, slower economic growth, weaker governance, and a lower living standard for all people.

Women are usually the primary or only sole family caretakers in many developing countries. Helping them gain additional daily income improves the condition of their entire household. Putting extra income in women's hands is often the most efficient way to impact an entire family, as they typically put their children's needs before their own. Children are more likely to complete their education and escape the poverty trap than their parents. Giving women access to microcredit loans therefore generates a multiplier effect that increases the impact of a micro finance institution's activities, benefiting multiple generations.

Key Terms

Microcredit
The practice of extending small loans to poor people for income generating self-employment projects, allowing them to improve their standard of living.

Microcredit Loan
A small loan, typically $50 - $150, depending on the geographic location. These loans are made to the poor for income generating self-employment projects, allowing them to meet their basic needs, improve their standard of living and become economically self-sufficient.

Microenterprise
A self-employment project or very small business run by a poor borrower. Types of business vary widely by geographic location and may include shining shoes, selling items as a street vendor, selling agricultural products, weaving, sewing or baking.

Micro Finance
A general term describing the practice of extending small ("micro") loans and other financial services, such as savings accounts and insurance, to poor borrowers for income generating self-employment projects

Micro Finance Institution (MFI)
An organization engaged in extending microcredit loans – and often other financial services - to poor borrowers for income generating self-employment activities.

Non-government Organization (NGO)
In the micro finance industry, this term is generally used to describe an entity that usually works with the poor but is not formally administered by the government. Many NGOs, however, receive portions of their funding from government sources. micro finance institutions are an example of an NGO.

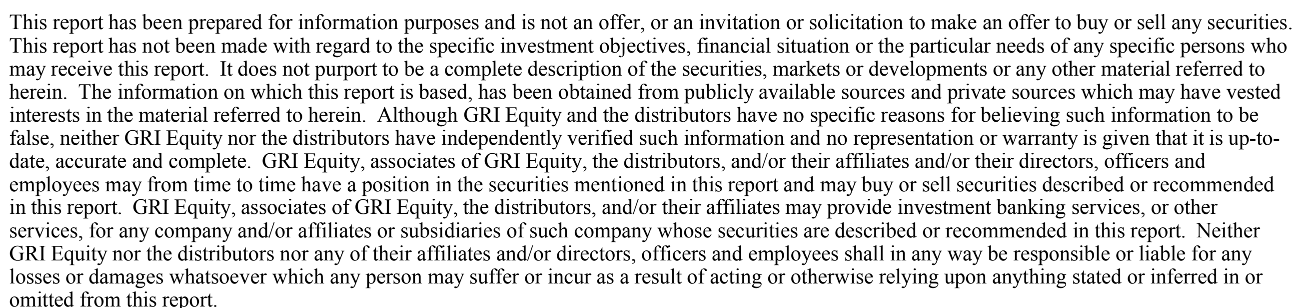
Peer Group or Solidarity Circle
A group of 5-8 borrowers who have received individual microcredit loans to finance their collective or individual income-generating activity. The peer group is designed to encourage solidarity among members who co-guarantee each other's loans. Often, if one borrower defaults on her loan, the entire peer group is penalized.

Poverty
A state of being in which one is unable to provide for basic human needs, including food, shelter, medicine and clothing.

Sustainability
Refers to the ability of a micro finance institution to develop a methodology that ensures loans successfully reach the poor while covering all of its costs without subsidy.

Transformation
The term "transformation", or commercialization, of a micro finance institution (MFI) refers to a change in legal status from an unregulated nonprofit or non-governmental organization (NGO) into a regulated, for-profit institution.

Unitus Donor-Investor
An individual or organization who contributes money to Unitus, investing in our ability to most efficiently leverage resources to accelerate MFI growth, empowering exponentially more poor borrowers to improve their standard of living.



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