Microfinance – Demonstration of 'at the bottom of pyramid' theory

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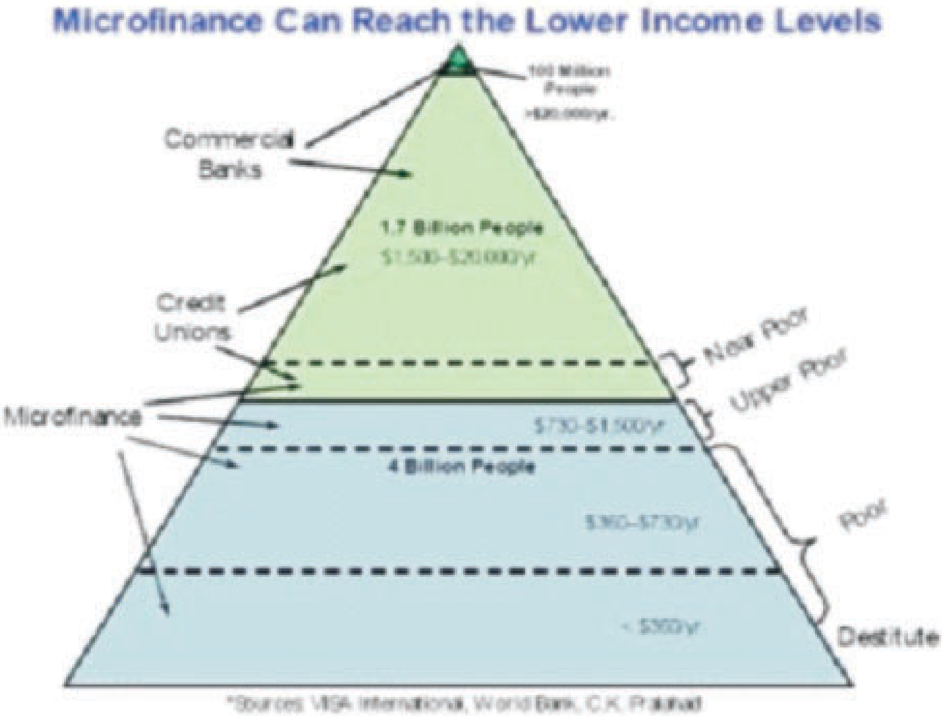
What is Microfinance?

Microfinance is the supply of loans, savings, and other basic financial services to the poor.In short,Microfinance is a positive demonstration of 'at the bottom of pyramid' theory of Late Prof.C.K.Prahlad.



Poor people too need financial services to expand, diversify their business, run their businesses, build assets, smooth consumption, and manage risks. Traditionally, poor people were not considered viable market by banks hence they had to resort to informal ways of raising money like borrowing from moneylenders or through a variety of informal relationships like savings clubs, rotating savings and credit associations, and other mutual savings societies. But these tend to be erratic and somewhat insecure.

Thus, microfinance came to their rescue.

The History of Modern Microfinance

Credit unions and lending cooperatives have been around hundreds of years. However, the pioneering of modern microfinance is often credited to Dr. Mohammad Yunus, who began experimenting with lending to poor women in the village of Jobra, Bangladesh during his tenure as a professor of economics at Chittagong University in the 1970s. He would go on to found Grameen Bank in 1983 and win the Nobel Peace Prize in 2006.

Since then, innovation in microfinance has continued and providers of financial services to the poor continue to evolve. Today, the world bank estimates that about 160 million people in developing countries are served by microfinance.

Microfinance Providers

A microfinance institution (MFI) is an organization that provides microfinance services. MFIs range from small non-profit organizations to large commercial banks.

Why don't banks serve poor people?

Formal financial institutions were not designed to help those who don't already have financial assets - they were designed to help those who do.

Grameen Bank in Bangladesh was formed out of a project providing small loans to women in the village of Jobra. Bancosol, a commercial bank in Bolivia, is also a bank which provides microfinance services for the poor of Bolivia.

However, the majority of formal banks do not provide microfinance products as microfinance is an expensive enterprise - you can make a lot more money on a large loan than a small loan, and you won't make much money holding savings accounts with very little funds in them. Banks can make more money if they only provide financial services to those who already have money.

Interest Rates (They're High)

The nature of microcredit - small loans - is such that interest rates need to be high to return the cost of the loan.

There are three kinds of costs the MFI has to cover when it makes microloans.

1. The cost of the money that it lends
2. The cost of loan defaults

The above two are proportional to the amount lent.

For instance, if the cost paid by the MFI for the money it lends is 10%, and it experiences defaults of 1% of the amount lent, then these two costs will total $11 for a loan of $100, and $55 for a loan of $500. An interest rate of 11% of the loan amount thus covers both these costs for either loan.

3. The transaction costs, it is not proportional to the amount lent.

The transaction cost of the $500 loan is not much different from the transaction cost of the $100 loan. Both loans require roughly the same amount of staff time for meeting with the borrower to appraise the loan, processing the loan disbursement and repayments, and follow-up monitoring. Suppose that the transaction cost is $25 per loan and that the loans are for one year. To break even on the $500 loan, the MFI would need to collect interest of $50 + $5 + $25 = $80, which represents an annual interest rate of 16%. To break even on the $100 loan, the MFI would need to collect interest of $10 + $1 +

$25 = $36, which is an interest rate of 36%. At first glance, a rate this high looks abusive to many people, especially when the clients are poor. But in fact, this interest rate simply reflects the basic reality that when loan sizes get very small, transaction costs loom larger because these costs can't be cut below certain minimums. It is estimated that manpower constitute 70% of operating costs for the MFIs.

Profitability and Sustainability of MFI

It is true that programs serving very poor clients are somewhat less profitable than those reaching better-off clients, but this may say more about managers' objectives than an inherent conflict between serving the very poor and profitability. MFIs serving the very poor are showing rapid financial improvement. Microfinance programs like Bangladesh Rural Advancement Committee and ASA in Bangladesh have already demonstrated that very poor clients can be reached profitably: both institutions had profits of more than 4% of assets in 2000.

There are cases where microfinance cannot be made profitable, for example, where potential clients are extremely poor and risk-averse or live in remote areas with very low population density. In such settings, microfinance may require continuing subsidies. Whether microfinance is the best use of these subsidies will depend on evidence about its impact on the lives of these clients.

Evidence that Microfinance Works

Among the poor, those participating in microfinance programs who had access to financial services were able to improve their well-being-both at the individual and household level-much more than those who did not have access to financial services.

In Bangladesh, Bangladesh Rural Advancement Committee (BRAC) clients increased household expenditures by 28% and assets by 112%. The incomes of Grameen members were 43% higher than incomes in non-program villages.

In El Salvador, the weekly income of FINCA clients increased on average by 145%.

In India, half of SHARE clients graduated out of poverty.

In Ghana, 80% of clients of Freedom from Hunger had secondary income sources, compared to 50% for non-clients.

In Lombok, Indonesia, the average income of Bank Rakyat Indonesia (BRI) borrowers increased by 112%, and 90% of households graduated out of poverty.

In Vietnam, Save the Children clients reduced food deficits from three months to one month.

Benefits:

1. Empowers Women, thus promoting gender-equity and improving household well-being
2. Helps very poor households meet basic needs and protect against risks
3. The use of financial services by low-income households is associated with improvements in household economic welfare and enterprise stability or growth

Challenges:

1. Populations that are geographically dispersed or have a high incidence of disease may not be suitable microfinance clients.
2. Dependence on a single economic activity or single agricultural crop, or reliance on barter rather than cash transactions may pose problems.
3. The presence of hyper inflation, or absence of law and order may stress the ability of microfinance to operate.
4. Microcredit is also much more difficult when laws and regulations create significant barriers to the sustainability of microfinance providers (for example, by mandating interest-rate caps).
5. To discourage members approaching several MFIs simultaneously, the 'Micro Finance Institution Network', a group of MFI-NBFCs, is planning to set up a database of borrowers to ensure that the borrowing limit doesn't cross Rs 50,000 per borrower.
6. The MFIs face enormous challenge in finding and retaining skilled human resources. Sa-Dhan (Sa-dhan is Indian national network of over 200 MFIs, playing a key role in policy advocacy and addressing issues such as code of conduct among members, data collection and transparency for the sector.) has estimated the human resource requirements at 2,40,000.
7. When MFI clients deposit their savings in other financial institutions which are weak and not covered by a credible deposit protection scheme. Clients may not have ready access to their funds and thus lose a source of loan repayment for their MFI loan if the bank where they keep their deposits runs into difficulties (Bruett 2004).In such cases, loan recovery rates may suddenly fall.
8. Sharp imbalance in most MFIs between their growth plans and the level of attention given to the risk management demands generated by those growth plans.

Andhra Pradesh Microfinance Crisis in South India

The recent crises of Microfinance in AP is an example of economic, social and humanitarian disaster.The failure by the poorest communities to repay loan resulting into suicides is due to following reasons :

1. Multiple loan taken by poor people to repay previous loan amount and not for investing in a productive purpose.
2. Profits made by CEOs and key private investors attached to the main MFIs.
3. Aggressive loan recovery techniques.
4. Political crisis in microfinance in Andhra Pradesh in India in 2006

A major crisis broke out in March 2006 for MFIs in this state when the authorities in the Krishna district closed down about 50 branches of two major MFIs in the district. The chief minister of the State said that the MFIs were exploiting the poor through exorbitant interest rates and unethical means of loan recovery. The affected MFIs were able to open the closed branches after some time.

Conclusions:

1. As has been already stated in the report the plan to maintain a database of borrowers so as to ensure that the borrowings don't exceed a particular limit and also to keep a check the number of MFIs lending money to the same borrower simultaneously must be implemented soon. Infact it makes sense to use Unique Identification Number for this purpose.
2. MFIs must shed off the attitude of complacency and over-confidence to progress further.
3. MFIs should recognize the inherent risks in agriculture and accordingly design the risk management structure to deal with this. Thus, the senior management should focus more on systematic risk management rather than focusing on aggressive loan selling schemes.
4. MFIs must understand that Crisis Management is not same as Risk Management.
5. Learning from past mistakes in the industry is helpful. To facilitate such learning, both regulators and other industry stakeholders, including MFIs themselves, should seriously consider measures to develop a centralized risk information facility while simultaneously complying with the confidentiality of information between competing institutions.

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