



MICROFINANCE

EE390

Microfinance



- **Traditional scope:** The provision of financial services to micro-entrepreneurs and small businesses, which lack access to banking and related services due to the high transaction costs associated with serving these client categories
- **Development scope:** many poor and near-poor households have permanent access to an appropriate range of high quality financial services
- “No one ever ended poverty by going bankrupt”

Microfinance

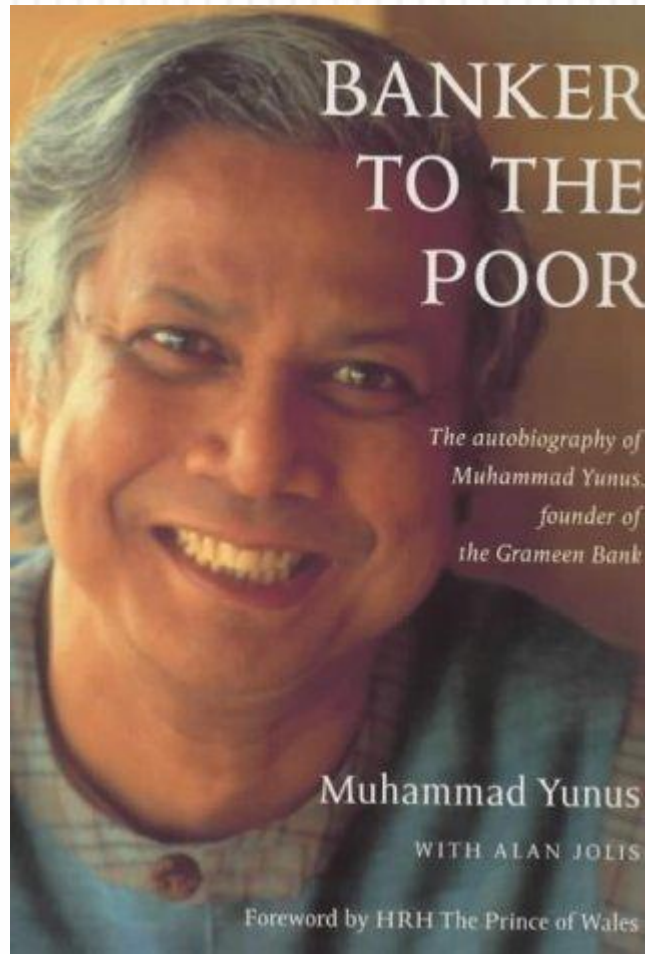


- *The poor are outside of Banking System*
 - No Collateral
 - No Access to Credit
- The Third Way Approach to poverty reduction
 1. Market Involvement
 2. Foster Community Development
- “Financial Inclusion”

Microfinance

Demand for microcredit

- *Lifecycle Needs*: such as weddings, funerals, childbirth, education, homebuilding, widowhood, old age.
- *Personal Emergencies*: such as sickness, injury, unemployment, theft, harassment or death.
- *Disasters*: such as fires, floods, cyclones and man-made events like war or bulldozing of dwellings.
- *Investment Opportunities*: expanding a business, buying land or equipment, improving housing, securing a job (which often requires paying a large bribe), etc.



Muhammad Yunus: “Credit is a Powerful Weapon”

Microfinance



Financial services?

- The first wave of microfinance was 'microcredit'
- The second wave of microfinance is 'microsavings'.
- The third wave → 'microinsurance'

Microfinance



- There are over 10,000 microfinance institutions serving in excess of 150m customers, 100m of them being the poorest families.
- Global demand is estimated at 500m families, so there is a long way to go.

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- Two major types:
 1. Group lending
 2. Individual lending

Group lending

□ Classic model:

solidarity group lending (Grameen bank and Acción International)

- borrowers are asked to form groups of three to seven members, most commonly five
- Borrowers in a group are jointly liable for all loans taken out; they are each liable for the others' loans
- When a loan is repaid, the borrower becomes immediately eligible for a larger one as long as all group members are in good standing and approve the individual loan requests

Group lending

□ Classic model:

solidarity group lending (Grameen bank and Acción International)

- Peer Lending Model
- Loans for One Year—Installments Paid Weekly
- Interest Rate of 20%
- Repayment = 2% of the Loan per Week
- Contribute to the Group Fund = 5% of Loan Amount
- Member = Savers + Borrowers

Group lending

□ Classic model:

solidarity group lending (Grameen bank and Acción International)

- Eight solidarity groups are federated into a larger group called the "center," which gathers each week with a loan officer to perform all financial transactions
- 'Center' as the secondary group can make up the default amount, repay installments in parallel with the program loan
- Willingness to provide such temporary loans has declined over time. Potential defaulters are expected to find alternate loan sources outside of the secondary group before the weekly group meeting to avoid disrupting it
- Multiple sources of 'peer pressure': 'enforce' → 'encourage'

Success of the Grameen Bank

- Over \$3.8 Billion in Loans have been provided
- 2.4 Million Families in Rural Bangladesh have been served
- 98% Repayment rate
- Microfinance Initiatives have been started in 100 countries worldwide
- Global Movement embraced by Governments, NGOs, and International Organizations

Group lending

□ Classic model:

Village lending (FINCA, International; Bolivia)

- Village banks bring together 15 to 30 people, give them a single loan, then delegate authority to them for on-lending to individual members
- Members elect the office holders of the village bank
- Loan sizes are allowed to differ among individual members
- All loans carry the same repayment and interest rate terms

Group lending

□ Classic model:

Village lending (FINCA, International; Bolivia)

- Borrowers are generally offered a loan ladder, a sequence of 3 to 5 loan cycles with a maximum loan size specified for each cycle
- Example: the first loan at most \$150 and the third at most \$1400
- Village bank members act as co-guarantors and help decide how much each person borrows

Group lending

□ Classic model:

Village lending (FINCA, International; Bolivia)

- large spreads in loan size within the jointly liable group, which can expose the poorest members to excessive risk
- most village banking MFIs try to keep the maximum-to-minimum loan ratio below 10

Group lending

□ Classic model:

■ Common forms

- regular, compulsory public meetings, typically weekly or biweekly, where loans are repaid and disbursed and savings collected
- loan officer to refuse to end the meeting until all scheduled loan repayments are made—by someone: “***Joint liabilities***”
- reduces problems arising from “informational asymmetries” between lender and borrower
- Members have superior knowledge of the character and economic circumstances of friends and neighbors

Group lending

- Group lending with individual liabilities?: Association for Social advancement (ASA)/
 - ▣ centers without joint liability attracted more new clients
 - ▣ Reputation cost of default
 - XacBank in Mongolia: posts names of clients and their installment repayment reports on the walls of its branches
 - "the Bombays" in the Philippines “: always picked the busiest hour of the day to collect so that there would always be witnesses to her embarrassment
 - ▣ self-selection appears to screen out bad risks → protect the problem of ‘adverse selection’

Group lending

□ Common forms

- the importance of reputation, honor, and shame → protect “free rider”
- “Peer pressure”,
 - is not simply the pressure from fellow group members who are afraid of losing access to future loans or having to cover loan defaulted,
 - it is pressure arising from public transactions in communities where individuals worry about reputations

Group lending

- Self-help Groups (SHG)
 - ▣ Group lending → public banking for the poor
 - ▣ SHG
 - The system evolved from the efforts of NGOs to organize the rural poor, especially women, into groups for purposes of social and economic empowerment through group savings, education, and microenterprise support
 - NGOs train the group in saving, lending, and accounting, then link the group with a bank where the it can deposit its accumulated savings into a collective account.

Group lending

- Self-help Groups (SHG)
 - ▣ Group lending → public banking for the poor
 - ▣ SHG
 - The bank then grants a block loan to the group, typically four times as large as the savings balance, for which members are jointly and severally liable
 - The group decides how, and on what terms, to distribute the loan to individual members
 - the job of the partner NGOs is to form groups, not run them on an ongoing basis

Individual lending



- individual microlending offers smaller loans
- relies less on traditional sources of security, such as marketable collateral, credit bureaus, and formal legal recourse ["asset-based credit" (ABC)]
- relies more on informal assessments of character and business operations → group self-selection mechanism ["integrity-based credit" (IBC)]
- Good for where social bonds may not be strong enough to support group lending

Individual lending



- MFIs prefer to use such collateral as a threat rather than a way to cover losses from default
- It is only when lending to small or medium enterprises that loan sizes may be large enough for collateral to become valuable in the traditional sense

MFI business



- Lenders face three costs:
 - Financial (costs of capital)
 - Default (which appears in accounting through loan loss provisioning), and
 - Operational or transaction costs

MFI business



- While, one of the principal challenges of microfinance is providing small loans at an affordable cost;
- The global average interest and fee rate is estimated at 37%, with rates reaching as high as 70% in some markets
- Sustainability: its ability to cover its operating costs—and possibly also its costs of serving new clients—from its operating revenues

Conclusion

- Key Factors of Microfinance
 - Pro-poor objectives
 - Peer selection
 - Peer monitoring
 - Dynamic incentives
 - Regular payment schedules
 - Collateral substitutes
 - Financial profitability & sustainability

Thailand

- Formal village funds
- Kruchob's saving network:
 - "saving habits": 1 baht a day
- Buddhism influences → Aj.Subin (Trat province)
 - "trust" local fund
 - Buddhist day meeting