Business & Finance

Microfinance: A Changing Landscape for Development

Maria Otero and Monica Brand

Microfinance is the provision of financial services to low-income and very poor self-employed people. A development approach that provides small loans at cost-of-lending interest rates, microfinance is a financially viable and socially empowering way to fight poverty. Its power lies in the fact that it is based on human self-initiative, the one asset found even in the most disadvantaged pockets of society. Informal microenterprises—fruit stands, shoe repair shops, small-scale clothing manufacturers—account for 60 percent of employment in some developing countries.[1]

Instead of redistributing existing wealth, microfinance creates new wealth—right where poverty exists. It derives its power from some of the most resourceful and resilient people in the world: the working poor. Traditionally, a microentrepreneur in Latin America will pay one dollar in interest daily for every ten dollars borrowed from moneylenders to buy the knick-knacks to sell in a kiosk, the feed to fatten chickens, or the yarn to sew sweaters. Microfinance institutions (MFIs) replace moneylenders by offering financial services to the working poor in a more client-friendly manner. MFIs charge less than the informal moneylenders and invest the proceeds in expanding services to a larger number of people, increasing their impact and financial viability. The results are impressive.

Maria Otero
is President and CEO of ACCION International, a non-profit organization that provides financing to the working poor in Latin America and Africa.

Monica Brand
is Senior Director of the Research and Development Department of ACCION International.

Many MFIs boast a repayment rate of better than 98 percent.

Since its inception in the 1970s, microfinance has evolved in astounding ways, incorporating into its practice social and economic development concepts as well as principles that underlie financial and commercial markets. This combination has led to the creation of a growing number of sustainable and profitable MFIs around the developing world. As microfinance continues to evolve as a development strategy, it will be successful only if it is able to strike the right balance between the two frameworks that underlie its practice: development and finance.

Many MFIs boast a repayment rate of better than 98 percent.

The answer to the capital needs of marginal populations is based on innovative efforts centered on three intersections between microfinance and development: reaching the poor, building institutions, and deepening the financial system's reach. All three characteristics must be present for microfinance institutions to achieve both their development and financial goals. Without them, the combined strength of microfinance and development will evaporate and microfinance will become either a set of highly profitable financial institutions that have abandoned their market or a system of insignificant donor-dependent and localised credit programs. Keeping the collective eyes of microfinance professionals on these intersection points is the primary challenge of this field today.

Reaching the Poor. The first intersection is microfinance's objective to alleviate poverty at the client level. Indisputably, microfinance, at its core, combats poverty. In the main, urban clients of MFIs are poor city-dwellers housed in overcrowded slums or squatter settlements, lacking access to basic services such as healthcare, electricity, and running water. These individuals lack education and other skills that are essential to enter the mainstream economy. Many of them are women, poorly trained and playing dual roles of provider and caregiver. These poor people are more exposed to the threats of bad sanitation, and disease than the rest of the population. When disaster strikes in the form of inflation, floods, earthquakes, or other outside forces, they are the most vulnerable.

Rural clients are landless or landed-poor. Their land is often unproductive or lies outside irrigated areas. Many farm in arid zones or on steep, hilly slopes, lands that are ecologically vulnerable. Opportunities for off-farm employment are few and must be self-generated. Many of the rural poor mix various earning activities to generate the cash they need to survive. They live in large households. Their children are especially susceptible to disease and often suffer from malnutrition. Many depend on their children for work and must weigh the opportunity cost of sending children to school, as an investment for the future, against the present benefits of keeping them at work.

Microfinance enables poor people who start their own small businesses to create capital, protect the capital they have, deal

with risk, and avoid the destruction of capital. It attempts to build assets and create wealth among people who lack both. For the very poor, microfinance becomes a liquidity tool that helps smooth their consumption patterns and reduce their level of vulnerability.[1]

At a more subtle but no less important level, increasing material capital strengthens a poor person's sense of dignity and contributes to empowering him or her to be a productive participant in the economy and society. With a source of income, a person can provide for the family, improve the household's access to basic needs, and plan for the future. When these conditions are present, a person who is part of the marginalized sector of the society becomes better equipped to be an active citizen.

Building Institutions. The second point of intersection between microfinance and development occurs at the institutional level. Microfinance proposes to create private, sustainable, and permanent institutions that specialize in delivering financial services to the poor. Against a broader development backdrop, these institutions become a means to an end, not an end in and of themselves. They constitute part of the unattained and long-sought-after vehicles needed to incorporate the poorer sectors into the economy. They put capital in the hands of those who otherwise would not have it to employ immediately in productive ways, and they enable people with few assets to save.

It is for this reason that institutional sustainability becomes so crucial to microfinance. If microfinance institutions are not financially solid, able to cover their costs, and capable of delivering financial services over the long term, they become a transitory means of reaching the poor and lose their punch as a component of a broader development strategy. Moreover, only by becoming financially self-sufficient and ultimately profitable will these institutions be able to continue accessing private capital markets—the only source large enough to address a problem as immense and endemic as world poverty. This major link between finance and development begins to unravel unless microfinance institutions attain self-sufficiency in their operations.

In order to strengthen institutional viability, many programs, such as ACCION International, work with affiliate MFIs to implement innovative strategies that both increase the efficiency of their internal operations and address the unique nature of their target microenterprise markets through new product development. Among the innovations that MFIs have developed to maximize efficiency are cost management schemes, re-engineering efforts, and creative uses of technology such as smart cards, credit scoring, and handheld computers.

On the client side, MFIs have developed an array of new products, including solidarity groups based on "social" collateral for those micro-entrepreneurs that are asset-poor and thus lack traditional forms of guarantees; individual loans for those clients whose businesses have grown or who need more tailored credit terms; and lines of credit for those whose cash needs fluctuate and who have demonstrated the capacity to manage this variability. Such initiatives seek to create financial institutions for the poor that become true intermediaries between the informal sector and the conventional economy.

Link to the Financial System. The final intersection between microfinance and development occurs when a microfinance institution becomes a regulated institution that is part of a country's financial system. This connection is made possible by the recognition in the last decade that healthy financial systems are an important piece of the development puzzle and that financial sector improvement and reform should be a priority in all developing countries.

When MFIs become part of the financial system they can access capital markets to fund their lending portfolios, allowing them to dramatically increase the number of poor people they reach. They can also capture savings, providing another important financial service to the poor, and access these deposits as another source of lending funds.

In Bolivia, a microfinance institution, BancoSol, has successfully tapped international capital markets to expand its funding sources. In the first two years of BancoSol's operations, heavy reliance on the interbank market made it particularly vulnerable, given its status as a new institution focused on a segment long considered unbankable. Support provided by the ACCION Latin America Bridge Fund was key to the bank's funding, as was the purchase of certificates of deposit by BancoSol's shareholders and others.

Created in 1984, ACCION International's Latin America Bridge Fund is a guarantee fund that helps meet its affiliates' growing demand for capital to fund their microloan portfolios. The first of its kind, the Bridge Fund is capitalised by donations and private deposits. The Fund issues letters of credit that allow ACCION affiliate MFIs to borrow directly from local banks, dramatically increasing their pool of capital for microloans and effectively linking microenterprise with the formal banking sector. The Latin America Bridge Fund is currently capitalized at over $6 million and pays a range of interest rates to its lenders. In 2001, the Bridge Fund has received approval to extend new letters of credit totaling $3.5 million to some of the larger, faster-growing MFIs to support portfolio growth.

By inserting themselves into the financial systems of their country, these microfinance institutions dramatically deepen the reach of financial systems to populations previously excluded from banks and other financial institutions. One essential means of alleviating poverty is the creation of a broader, more inclusive financial system that does not restrict the allocation of capital to a tiny group of elite but instead integrates the poor as a market segment and reallocates resources from other sectors.

Deepening the reach of the financial systems is, in relative terms, a recent achievement for microfinance. It is made possible only after creating financially-viable institutions. Only after it was demonstrated that MFIs could manage risk effectively and would not become a systemic risk did their incorporation into financial systems become possible.

Reality: Challenges Faced by MFIs. With profits comes competition. Microfinance's success has attracted new players that are dramatically changing its landscape. Clients have become more discriminating now that they have choices, deserting institutions that do not respond to their needs. The resulting downward pressure on prices and the scramble to enhance product offerings has put severe pressure on institutions that were born in donor-driven,

monopoly-like environments. As a result, it is estimated that of the many thousands of MFIs currently in operation, only about 200 will survive in a financially sustainable way—without continued donor subsidy.

The factors that have differentiated the strong institutions from the more vulnerable are well documented and widely understood. One of the most critical success factors is strong leadership, characterized by a balanced focus on sustainability and outreach and an ability to empower and motivate middle management to make decisions. Good governance, characterised by transparency, accountability, and rigorous adherence to stated objectives, is a natural corollary to this factor.

Another critical element is robust credit technology, which is based on logical, efficient processes and a well-designed management information system well tailored to the needs of the target market. This latter point highlights how important it is for MFIs to have a strong understanding of the market and differentiate themselves from the competition. Taken together, these last two factors will help ensure strong portfolio quality, which is crucial to institutional longevity.

Institutions that have been able to attain these goals have been able to attract capital from more conventional sources and reduce their dependency on donors. Thus, because of innovative investment vehicles like the Bridge Fund, access to capital is no longer the principal impediment to continued advancement in the field. However, even strong institutions are facing new challenges that will determine whether they can continue increasing their outreach and link to the financial systems.

MFIs must confront these new challenges in order to push forward the frontier of microfinance. The first challenge for MFIs is to develop a deeper understanding of their market so that they can survive when competition hits. MFIs must differentiate the needs and preferences of distinct market segments and tailor products accordingly. Yet understanding alone is insufficient given the ferocity of competition in some markets like Bolivia and Nicaragua. Thus, MFIs must dedicate resources to the development of new products that simultaneously respond to clients' needs while helping to generate new revenues.

Microfinance's success has attracted new players that are dramatically changing its landscape.

Innovation is needed as much on the supply side of the equation as the demand side, as efficiency has taken on a new importance in today's competitive microfinance market. In addition to the competitive pressure on prices, the desire to extend their reach to more destitute clients has increased the urgency among MFIs to cut costs. Thus, from a poverty perspective, one of the benefits of increased competition is that the cost of credit has come down dramatically for the clients. However, for the MFIs, the pace of these price wars has outstripped their ability to improve efficiency, leaving institutions struggling to cover their costs.

This new impetus to dramatically improve efficiency has prompted two responses among MFIs: re-engineering and the use of technology. Re-engineering involves the often radical redesign of business processes to improve efficiency, product quality, revenue generation, and customer service. In the U.S. financial sector, re-engineering involving consolidating, streamlining, and automating lending operations was critical for banks faced with deregulation and an onslaught of competition in order to prevent further erosion of profit margins.

A core component of re-engineering in corporate America was the application of technology to automate, integrate, and redesign business processes to improve efficiency, customer service, and product quality. Similarly, many MFIs are applying both old and new technologies to better utilise scarce resources. Some of the newer experimental technologies include the use of Palm Pilots to create "paperless" microloan processing systems and credit scoring to partially automate the decision-making process. For example, building on the extensive databases of a few of its more established affiliates, ACCION is developing a pilot credit scoring system to develop automated decision trees to facilitate loan decisions.

The ability of microfinance institutions to maintain the double bottom line of increased outreach and financial sustainability has allowed them to connect the informal economy to conventional markets. By strengthening the intersection between poverty reduction, institution building, and access to commercial markets, MFIs have the capacity to create structural changes in how capital is made available to people previously excluded from the financial mainstream. Microfinance addresses the seemingly intractable problem of creating the infrastructure to reallocate resources and to create wealth among poorer sectors. Its strength and sustainability depend on the systems themselves. Most importantly, however, microfinance's success lies in the perseverance and entrepreneurial spirit of the working poor whose businesses fuel their countries' economies.[3]

NOTES

1 International Labor Organization, "Empleo y Protección Social en el Sector Informal: El Empleo en el Sector Informal – Retos y Programa Futuro," Comisión de Empleo y Politica Social (ESP) (Geneva: ILO, March 2000) 2, <www.ilo.org>.

2 These findings are emerging from the work conducted by Jennefer Sebstad and Monique Cohen, "Microfinance, Risk Management and Poverty," prepared for the *World Bank's World Development Report 2000 on Poverty*, 1999. Data from four countries demonstrates that finance for the poor serves to reduce their risk, especially when they face personal emergencies.

3 This article is based on a piece by Maria Otero published in *Journal of Microfinance*, Vol. 1, no. 1, fall 1999.