Microfinance

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Introduction

Microfinance, according to Otero, "is the provision of financial services to low-income poor and very poor self-employed people". These financial services, according to Ledgerwood, generally include savings and credit but can also include other financial services such as insurance and payment services. Schreiner and Colombet have defined microfinance as "the attempt to improve access to small deposits and small loans for poor households neglected by banks". Therefore, microfinance involves the provision of financial services such as savings, loans and insurance to poor people living in both urban and rural settings who are unable to obtain such services from the formal financial sector. The terms microcredit and microfinance are often used interchangeably, but it is important to highlight the difference between them because both the terms are often confused. Microcredit refers to small loans, whereas microfinance is appropriate where non-Government organizations (NGOs) and Microfinance Institutions (MFIs) supplement the loans with other financial services (savings, insurance, etc.). Therefore, microcredit is a component of microfinance in that it involves providing credit to the poor, but microfinance also involves additional non-credit financial services such as savings, insurance, pensions and payment services.

Microfinance is widely acknowledged to be a sound and well-tested institutional mechanism to extend financial services to low-income clients, including consumers and the self-employed, who traditionally lack access to banking and related services. In more concrete terms, it is a movement whose object is a world

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in which as many poor and near-poor households as possible have permanent accesses to an appropriate range of high quality financial services, including not just credit but also savings, insurance, and fund transfers. Those who promote microfinance generally believe that such access will help poor people out of poverty. Microcredit emphasizes the provision of credit services to low income clients, usually in the form of small loans for supporting to develop micro-enterprise and income-generating activities. The use of the term 'microcredit' is often associated with an inadequate amount of the value of savings for the poor. In most cases, the provision of savings services in 'microcredit' schemes simply involves the collection of compulsory deposit amounts that are designed only to collateralize those loans. Additional voluntary savings may collect but the clients have restricted access to their enforced savings. These savings become the main source of capital in the financial institutions, called microfinance institutions.

There are several benefits of microfinance, especially to fund the unbankables. In essence, the benefits of microfinance help manage the assets of the poor and generate income. Through microfinance institutions such as credit unions, financial non-governmental organizations and even commercial banks, poor people can obtain small loans and safeguard their savings. A microfinance initiative can promote larger poverty-reduction movements by increasing the financial knowledge of an average citizen. The other benefits of microfinance projects are that they allow low-income families to save their money, as most of the poor live day-to-day with the little money that they earn and cannot afford to save. Poor people need such alternatives in order to turn their savings into large lump sums or receive large sums and repay monthly with low interest rates. Banks and other money-lending institutions have high interest rates and simply would not extend loans to poor people with little or no assets or employment. Microfinance helps the poor people save funds or get an access to loans over a period of time with low interest rates. Also, the poor could solve their own issues by working together as a community and this creates trust and social capital

in their communities. It also leads to stability and growth in their households, as well as their communities.

There are seemingly two ways in which the needs of the poor are not being met by microfinance in several instances. Firstly, the poor need to store savings for the long run, such as for their retirement, widowhood or for their children, but they are unable to save enough money to meet these needs. Secondly, the poor people's ability to save fluctuates with time and so they may not be able to save at any fixed rate. These two shortcomings create financial difficulties for the poor and they often get excluded or exclude themselves. Poor people have to take a risk to turn their savings into large lump sum of money because there is no perfect system that would protect their deposits. Linked to this, there are a large number of implementation and institutional issues that would need to be addressed for a comprehensive understanding on microfinance, largely for the benefit of the financial institutions and other cooperative/collaborative agencies/functionaries that are either directly or indirectly involved in the planning, execution, management and regulation of microfinance as an industry.

The Task Force on Supportive Policy and Regulatory Framework for Micro-Finance, constituted by NABARD (National Bank for Agriculture and Rural Development) defines microfinance as "the provision of thrift, saving, credit and financial services and products of very small amounts to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve their standard of living". The emphasis of support under microfinance is on the poor in 'pre-micro-enterprise' stage for building up their capabilities to handle larger resources. This perception is quite significant, keeping in view the limitations of any approach of micro-enterprise development to help the poorest of the poor in self-employment. The Task Force has not specified limit for the 'small' amount of financial services envisaged. Services of microfinance are being provided by various MFIs.

Building an inclusive financial sector has gained growing global recognition and momentum in bringing to the fore the

need for development strategies that touch all lives, instead of a select few. The overall strategy for financial inclusion, especially amongst the poor and disadvantaged segments of the population should comprise ways and means to effect improvements within the existing formal credit delivery mechanism, as well as an evolution of new models for extending outreach, and a leverage on technology solutions to facilitate large-scale inclusion. Only two to five percent of the 500 million poorest households in the world have access to institutional credit, of which, women receive a disproportionately small share of credit from formal banking institutions. The Women's Self-Help Group movement is bringing about a profound transformation in rural areas of India.

Microfinance Institutions thus play a significant role in facilitating inclusion, as they are uniquely positioned in reaching out to the rural poor. Many of them operate in a limited geographical area, have a greater understanding of the issues specific to the rural poor, enjoy greater acceptability amongst the rural poor and have flexibility in operations providing a level of comfort to their clientele. Though MFIs advocate embeddedness of microfinance under the broad parameters of financial inclusion, there are certain implicit challenges, and associated issues linked to this would need to be considered. These include legal and gender issues, increasing accessibility of the poor, rate of interest, unbalanced geographical growth, choice of productive activities, assessment of demand, subsidy, capacity building, records maintenance, auditing, transparency, absenteeism policy, absence of proper database, low outreach, loan default and poor recovery regime, low education level, language barrier, late payments, and geopolitical factors.

The concept of microfinance involves informal and flexible approach to the credit needs of the poor. There is no single approach or model that fits in all the circumstances. Therefore, a number of microfinance models emerged in different countries/ states according to the suitability to their local conditions. Broadly, the microfinance delivery methods can be classified into the following six groups: Grameen Bank Model, Joint Liability Group Model, Individual Lending Model, the Group Approach

Model, Village Banking Model, and Credit Unions and Co-operative Model. In India and elsewhere, there is a wide variety of institutions in public as well as private sector which provide microfinance to the poor. These institutions can be broadly divided into two types. First type is the traditional formal financial institutions, while the second type is Microfinance Institutions. The former type of institutions comprise commercial banks, regional rural banks and co-operative banks. They provide microfinance services in addition to their general banking activities and are referred to as microfinance service providers. On the other hand, MFIs are different types of financial institutions whose main financial activity is providing microfinance only. Many of these institutions are NGOs, Mutually Aided Co-operative Societies (MACS) and Non-Banking Financial Companies (NBFCs). In case of traditional financial institutions both private and public ownership are found, but the MFIs are mainly in the private sector.

Microfinance has its root in Bangladesh, where experimenting with microloans for the rural poor started in the 1970s. From there, the concept spread rapidly across the globe. In 1976, Muhammad Yunus launched the research project to provide microcredit and banking services to the poor people. In addition to that, microcredit programme is based on unique mechanism such as group lending, social collateral and distinctive payment methods. It is not based on checking credit history, income sources and bank balances but works on character-based lending and thus managed to give loans to those who lack credit histories. It is also useful for those who have no access to conventional finance. In 1983, Muhammad Yunus formally established a Grameen bank which has become a milestone in the development of the microfinance industry. The objective of this bank is to give small loans at affordable rates of interest to poor people, especially women. The high number of clients and regular repayments are impressive achievements for the bank. The microcredit programme has not been restricted to Bangladesh as the similar activities are also under way in different parts of the world, including Indonesia (1972), India (1990s) and, more importantly, in Latin America (1990s) where microcredit

operations were rapidly developed. Today, most borrowers still live in rural South Asia and the East Asia and Pacific (EAP) regions. Over a period of a couple of decades, microfinance has expanded also in Latin America and the Caribbean (LAC), in Eastern Europe and Central Asia (EECA), and in Sub-Saharan Africa. The expansion of microfinance was accompanied by a shift from group to individual lending. Because group lending is more difficult to apply in urban areas, and wealthier borrowers prefer individual contracts, individual lending is predominantly used in these cases.

Microfinance industry is one of the fastest growing set of finance-driven initiatives aimed at alleviating poverty, contributing to economic growth and supporting future growth through financial inclusion. A growing number of MFIs are attempting to build the human capital entrepreneurs in order to improve the livelihood of their clients and help further their mission of poverty reduction. Increased household income, access to health care and education, and better living conditions are just a few ways in which microfinance and complimentary services are helping the poor and underserved population around the world. United Nations' Millennium Development Goals (MDGs), in the context of microfinance, are centred on the reduction of extreme poverty, promotion of gender equality and empowerment of women and the development and implementation of strategies for decent and productive work for the youth.

It is hoped that MFIs will assist in the achievement of these goals as they are a viable tool used in eradicating poverty, and improving social and economic welfare of the people. The concept has become a top agenda item at the international fora and thus the UN has enlisted microfinance as one of the surest ways of meeting the MDGs if it is carefully implemented through sustainable institutions. Over the past 30 years, microfinance has grown to a $30 billion industry involving over 3,000 organizations. Half of these MFIs, however, have nothing more than anecdotal stories about the impact of MF on poverty. The connection between MF and poverty eradication is far from resolved. Measuring the mission impact is a crucial issue facing

every MFI. They serve the dual goals of financial return and social mission achievement.

Microfinance has a very important role to play in development according to proponents of MF. Based on the studies, UNCDF states that MF plays three key roles in development, viz. it helps very poor households meet basic needs and protect against risks; is associated with improvements in household economic welfare; and helps to empower women by supporting women's economic participation, and so promotes gender equity. Otero—the great proponent of MF—illustrates various ways in which microfinance, at its core, combats poverty. He states that it creates access to productive capital for the poor, which together with human capital, addressed through education and training, and social capital, achieved through local organization building, enables people to move out of poverty. By providing material capital to a poor person, his/her sense of dignity is strengthened to empower the person to participate in the economy and society.

A livelihood security approach to MF aims for a holistic analysis and understanding of the root causes of poverty and how people cope with it. Very often several parts of the world identify livelihood shocks such as natural disasters and drought, tsunami, the social, political and economic context, and people's livelihood resources like education and local infrastructure as factors affecting people's livelihood security. Therefore, when analyzing the impact the MF is having on livelihood security, as is the objective of this book, a holistic analysis of people's livelihood security must be conducted, rather than just focusing on the material/economic impact of MF on the livelihood of the poor. The world at large has experienced that poverty and livelihood security consist of economic and social conditions. Therefore, when analyzing the impact of MF, social impact must be assessed. A wider social impact assessment is important for an organization's internal learning process, as an MFI would be aware of the full range of changes associated with its efforts, and use these to improve its performance. Hence, we must consider social impact to relate to human capital such as nutrition, healthcare and education, as well as social networks. The impact must be assessed on each of these issues if a true picture of the

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impact of MF on the livelihood support system for sustenance is to be obtained with a reasonable degree of authenticity.

In making such an effort, one must in particular move beyond individual or household analysis to include community, market/ economy and national/state levels, if the wider effects of MF interventions are to be understood properly. Impacts at household level are more crucial for recognizing MF impact, especially in socio-economic terms. Health and education are two key areas of non-financial impact of microfinance on a household level. Wright has stated on the basis of some research that has been conducted on the impact of MF interventions on health and education that nutritional indicators seem to improve where MFIs have been working. Littlefield, et al. acknowledged the sparse specific evidence of the impact of MF on health but where studies have been conducted, they conclude: "Households of microfinance clients appear to have better nutrition, health practices and health education than comparable non-client households."

Measuring mission impact is a crucial issue facing every MF Institution. MFIs serve to achieve the dual goals of financial return and social mission achievement. The techniques for measuring financial return are well understood. A controversy persists, however, about what are the true impacts of MF on poverty—the level of social mission achievement. Over the past several years, MF has been under increased scrutiny as the global development community has gradually realized that MF is not the once acclaimed anti-poverty silver bullet. Three of the most significant criticisms of MF that the domains of popular news media, practitioners, and academia have put forward, are the following: Some MFIs are profiting greatly from lending to impoverished clients; the unjust profiting of MFIs can lead borrowers to stop repaying their loans; and it is unclear whether microfinance truly succeeds in lifting people out of poverty.

Over the past several decades, microfinance, i.e. credit targeted toward small-scale entrepreneurial activities of the poor who may otherwise lack access to financing, has become a pillar of economic development policies. In recent years, there

has been a concerted effort to expand such programmes with the goal of alleviating poverty, and promoting development. Between 1997 and 2006, access to MF grew by up to 29 percent a year, reaching a scale at which macroeconomic considerations become relevant. The Microcredit Summit Campaign, as of 2010, reported 3,552 institutions serving 155 million borrowers, which, including borrowers and their households, impacted 533 million people, roughly the size of Latin America. For various countries, MF loans represent a significant fraction of their GDP. Despite the growth and prevalence of MF and its importance in academic and policy circles, quantitative analyses of these programmes are almost exclusively limited to micro evaluations. The macroeconomic effects of economy-wide MF have still been largely unexplored.

Poverty alleviation has been one of the key development challenges over the decades. One of the identified key constraints facing the poor is lack of access to formal sector credit. It will facilitate them to take advantage of economic opportunities to increase their level of output, and hence move out of poverty. Credit is considered to be an essential input to increase productivity, mainly land and labour. It is believed that credit boosts income levels, increases employment at household level and thereby alleviates poverty. Credit enables poor people triumph over their liquidity constraints and helps them undertake some income-generating activities. The MF impact on poverty alleviation is a keenly debated issue as we have seen, and it is generally accepted that it has not lived up in general to its expectation. However, when implemented and managed carefully, and when services are designed to meet the needs of clients, MF has had positive impacts, not just on clients, but also on their families and the community as a whole. There is however a need for greater assessment of these wider impacts if the true value of MF to development is to be understood. One such tool for measuring wider impact is a livelihood security analysis based on a livelihood framework which analyzes how a project impacts the livelihood of beneficiaries. Key challenges facing MFIs today that are affecting their impact on poverty alleviation were seen to be an over-emphasis on financial sustainability over social

objectives, and a failure of many MFIs to work with the poorest in society. Therefore, there is a greater need for MFIs to carefully design services that meet the needs of the poor and this can only be done when MFIs understand their needs and the context within which the poor are working. If MFIs are to meet their overall development objectives then they need to ensure financial sustainability and outreach of financial services designed to meet the needs of those deprived of such services.

Microcredit is the most well-known aspect of MF and has been able to spread rapidly around the globe because variable quality of institutions offers little financial downside for clients. However, managing this expansion of credit services, and building upon it to offer other products like savings and insurance, has been approached very differently by countries around the world. If an MFI is mismanaged, or goes bankrupt, the customer's situation is left unchanged. Products like savings, pensions, and insurance for the poor have been less welcomed by regulators and the traditional financial sector because of the added responsibilities of such products. MFIs which offer such products must be subject to prudential regulation to ensure their solvency so that customer deposits or other obligations are not lost, damaging the financial situation of the client. Here, we will briefly view the development, structure, and result of four approaches from Bolivia, Cambodia, Bangladesh and the Philippines. Improving the access of low-income producers and the poor to basic financial services is viewed as an ingredient of the World Bank's efforts to promote economic growth and reduce poverty. The World Bank's approach emphasizes a market-driven approach in which the financial sustainability of financial intermediaries becomes paramount. In many cases that market approach is possible because of the use by MFIs of group lending and other techniques to offset borrowers' lack of collateral. The World Bank's overall strategy for helping countries develop micro, rural and small and medium enterprise (SME) finance includes a number of key measures in the overall legal and regulatory framework in building up institutional capacity and in the introduction of financial systems infrastructure.

Various aspects of MF and micro-enterprises have been discussed in literature. However, a few empirical studies conducted with valid database have quantified the MF impact on poverty; only some have focused on the relation between MF and socio-economic indicators; a few have concentrated on the sustainability and profitability; and few others have estimated the return to capital invested in micro-enterprises. MF surely brings some changes, which could be positive or negative on individuals, households and institutions. Some studies focused on the growth of income and expenditures of the borrowers due to MF. Hulme and Mosley, for example, analyzed the impact of MF on poverty alleviation using sample data for Indonesia, India, Bangladesh and Sri Lanka and found that growth of income of borrowers always exceeds that of control group and the increase was larger for better-off borrowers.

Micro-enterprise refers to any economic unit engaged in the production and distribution of goods and services at household level. It is primarily of self-employed nature, employing him/her in the enterprise and sometimes some family members. The enterprise runs on little amount of capital investment at a fixed market centre or mobile business locations. This sector is identified with features like reliance on indigenous resources, family ownership of enterprises, small scale of operation, labour-intensive, adapted technology, and minimum skill. Micro-enterprise, therefore, is particularly suitable for poor communities.

Micro-economic enterprises play a vital role in poverty reduction in both rural and urban areas, and reinforce urban-rural linkages for economic and social development in Nepal. The linkages are essential not only for utilization of local resources but also in acting as agents for the flow of goods and services between urban and rural areas. Their roles are important since they possess the features like self-employment generation, employment to poor and women, use of local resources, meeting basic needs of the poor, traditional enterprise/skill and craftsmanship, labour intensive, self-satisfaction on the job, entrepreneurship and innovative and fair income distribution among the poor.

In developing countries, such as India, China, Bangladesh, Indonesia, Sri Lanka, etc. there are nearly 90 percent of the people who lack access to financial services from the institutions, either for cridit or saving purpose. The situation is more critical for the poor who do not have any assets. In micro-enterprises generally there is need for small capital but it is still difficult for the poor people to manage even that small quantity of capital. Resultantly, this lack of capital hinders the growth of micro-enterprise. Entrepreneurship is one of the commonly used terms in business, management, economics and other related fields. Entrepreneurship means innovation, creativity, leadership, profit maximization or starting of a new business. It helps in the process to increase economic growth, employment generation, and increase national income. Among several agencies, the MFIs in particular promote, in a proactive and imaginative manner, the development of entrepreneurship and growth of micro-enterprises by extending customized financial services to the stakeholders.

MFIs support two types of micro-entrepreneurs: one is potential micro-entrepreneur, and the second an existing micro-entrepreneur. The micro-entrepreneurs mean the creation and the existing entrepreneurs mean the expansion of that entrepreneurship. The MFIs assist potential micro-entrepreneurs by providing financing and training to enable them to start a business activity. This help to potential micro entrepreneurs is for pro-poor mostly. The objective of targeting the poor is to enable them to start their own business, help them to increase their revenues and reduce their level of poverty. MFIs also provide services to existing micro-entrepreneurs. Other financial services available to the existing micro-entrepreneurs are money transfer using mobile banking to facilitate their transfers and other financial operations; and micro-insurance to insure their business operations and the unexpected events that affect the smooth functioning of the business, like the sickness or the death of the micro-entrepreneur. The MFIs also offer non-financial services to existing micro-entrepreneurs enabling them to expand and develop their activities and their skills as well as to empower them. The nonfinancial services provided to existing micro-

entrepreneurs include managerial training, technical assistance, and analysis of the sector of activity.

Microfinance has been globally established as a leading development tool to combat poverty, and more specifically, it aims at economically empowering the poor and releasing their entrepreneurial potential. It was not prominent before 1970s, but after its emergence in Bangladesh, it expended very rapidly in the world. From this modest beginning, more than 3,000 MFIs now operate around the world, with the Microfinance Summit Campaign Report estimating that they serve 128.2 million poor people in developing countries. However, with the creeping commercialization of the MF sector, most discussion now rotates around profitability, sustainability and risk minimization. It is being increasingly, forcefully argued that the commercialization allows greater opportunity for MFIs to fulfil their social objectives which increase access to a range of demand driven MF products and services to the poor. Commercialization offers a win-win position in increasing outreach and sustainability while delivering social benefits.

MF is promoted as a mechanism for triggering or sustaining social and economic development by supporting entrepreneurial activities. MF can have multiple spin-off benefits, including the potential to be a component of poverty reduction strategies, thus contributing to the Millennium Development Goals (MDGs). Whilst clients who use MF services differ according to age, income, ethnicity and whether they access MF services as individuals or in groups, its typical MF clientele in many parts of the world have been resource-poor female entrepreneurs. MF programmes contribute to the achievement of MDGs by giving low-income rural women and men a chance to develop both their on- and off-farm income-generating activities. An increase in women's income has been shown to have positive effects for children's nutrition, education and well-being, which also supports other MDGs. Although responding to major development challenges cannot be based solely on simply improving access to financial services, MF is an effective tool if used in conjunction with other development approaches and policies. In this regard MF

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