

Microfinance

Boosting the income of microentrepreneurs by giving them access to financial services

What is microfinance?

Microfinance (MF) is retail banking for developing countries; in other words, providing financial services for poor but economically active people.

Access to credit and other financial services is very important in development terms, since it promotes micro-entrepreneurial activity in developing countries and helps people create a more stable and sustainable income situation for themselves. Unlike people in industrialised nations, a large part of the population in these countries does not have access to financial services, mainly owing to the lack of adequate collateral. As a result, significant potential for development remains untapped.

MF covers various financial services adapted to the needs of people in developing countries and local

circumstances. The most important microfinance services are:

- Commercial loans (microcredit)
- Savings (microsavings)
- Other financial services, e.g.
 - Payment services
 - Insurance and pension funds (microinsurance)
 - Housing loans

The benefits of microfinance

Access to financial services can have a positive impact on the income of microenterprises, as it enables them to

- boost productivity
- attain more security, and
- become more independent.

MF thus makes an important contribution to alleviating poverty in developing and transition countries.

As the example of the basket-seller (see box) shows, microfinance enables customers to exploit the potential of their commercial activity more fully and increase their productivity and profitability. Studies in India, Kenya and the Philippines show that access to financial services can greatly boost the income of microenterprises. The main obstacle for microentrepreneurs is not interest payments or repayment of capital, but gaining access to credit in the first place. Basically, access to savings and credit facilities makes microentrepreneurs less crisis-prone. Crisis often means additional

Example: basket-seller

A woman in Zambia sells hand-woven baskets. As a widow she must provide for a family of seven – from children to grandparents – on her own.

At the moment she has no way of saving or borrowing money. This means she has to wait until she has sold two-thirds of her fifteen baskets before going to the next town to buy new ones with the proceeds. Every three days she has to close her stall for a day, because the town is half a day's walk away.

She would like to rent a small store-room on the market square. This would mean she could offer a larger selection and would only have to make the journey every two weeks.

She has worked out that she would have to borrow the equivalent of USD 150 for four months to cover the first rent payments and the initial consignment of baskets. The local money-lenders at the market would be prepared to lend her this amount at interest of 10% per day(!).

A local microfinance institution (MFI) offers her the necessary capital for 4% a month. She accepts the offer.

Because she can now sell a larger and more varied range of baskets, her monthly income grows from USD 50 to USD 110. Of this, USD 6 a month goes to pay interest to the MFI and to repay the principal in instalments. Given the increase in her income, she views this as a small price to pay.

Now she travels to her supplier twice a month, and can afford to take a ride in a truck. This saves her two days' travelling a week. The microcredit has enabled her to boost sales and thus her income.



Basket-weaver in Tanzania
Photo: Foundation Swiss Hand

costs for microentrepreneurs (for example if they have to sell off their means of production at rock-bottom prices or eat into reserves such as jewellery or livestock), and can trigger poverty. Increased security, on the other hand, can enable microentrepreneurs to engage in riskier but more profitable business (for example buying thirty instead of just fifteen baskets).

People who rent out equipment such as fishing nets often stipulate that the catch must be sold to them at an unattractive price by way of rent. Recipients of a microcredit can buy their own means of production. This gives them greater independence and in turn boosts their income even further.

Providers of microfinance

MF services are provided by local organisations in developing countries, so-called microfinance institutions (MFI). These are often former non-governmental organisations (NGOs) that have extended their work from helping microentrepreneurs to financing them. Sometimes local commercial banks and newly established organisations also offer microfinance services.

MFIs have very strong local roots and are staffed by local people.

Customers

The target customers of MFIs are microentrepreneurs, many of them women. Often they are self-employed and run small businesses in the informal sector. In many countries, such businesses represent one of the most important sources of income and job creation.

Contrary to popular opinion, these microentrepreneurs are very reliable, and at the same time demanding, clients:

- Default rates are only a few per cent

- Microentrepreneurs demand a variety of financial services adapted to their needs.

Microcredit

Microcredits are geared to the special needs and circumstances of microentrepreneurs:

- The amount of credit is low (typically between USD 50 and 1,000)
- The term of loans is short (a few months to a year)
- Interest and capital are repaid in a large number of small instalments
- Customer relations are close (the bank generally goes to the customer!)
- Appropriate mechanisms such as group lending and solidarity groups compensate for the lack of collateral.

Microsavings

Savings can either be voluntary or part of a compulsory savings scheme promoted by an MFI to provide collateral for a microcredit. Voluntary savings are a way for people to safeguard against crises (such as illness or natural catastrophes), to hedge riskier but more attractive business, or to provide for foreseeable, costly events in the future (e.g. children's education, the birth of a child, marriage or funeral costs).

Other microfinance services

There are also other ways in which MFIs can help microentrepreneurs flourish:

By providing market information (unlike their clients, many MFIs have a telephone) such as daily fish prices on various markets, they can help their customers sell their produce at the place where they will get the highest prices.

If, for example, someone sells a herd of cattle on a faraway market, they will have a large amount of cash on their hands

which makes the journey back expensive and risky. In such situations, MFIs can offer payment services to minimise the costs and risks of transferring money and thus boost the income of their clients.

Microinsurance is still under development in many countries, but can have considerable market potential.

Some MFIs increasingly furnish housing loans to people wanting to build, extend or maintain property.

Conclusion

Microfinance is a way for people with low incomes in developing or transition countries to boost the income they make on commercial activities and reduce their vulnerability to crisis.

Although MF is not the only instrument for combating poverty, and not necessarily the right solution in all situations, it makes an important contribution to alleviating poverty by helping people help themselves.

Investing in microfinance

The number of successful microfinance institutions and demand for microfinance are on the increase on all continents. To facilitate growth and the positive development effects microfinance creates, investments such as refinancing loans to MFIs are very important. Until now it has mainly been public-sector development organisations and banks that have been involved in this type of investment, with demonstrable success. However, the available funds – generally public – are nowhere near sufficient to satisfy demand. An increasing number of private-sector investors are now opting to invest their money in a way that makes an important contribution to alleviating poverty in developing and transition countries.