MICROFINANCE

10 basic ideas

1. Microfinance is important.

To ensure a balanced economic development, the existence of financial institutions, collecting savings and extending loans on a local basis, is a decisive factor.

The mobilisation of local savings must always be the first development source of an economy. The accumulated savings are extended as small and micro loans on a regional level. This is the small-scale, but highly efficient way microfinance institutions (MFIs) do business. In doing so, microfinance reaches population strata, which normally do not have any access to financial services, for example in the rural areas. It is worth to mention that the word "micro" only refers to the size of deposits or loans, but not to the size of the MFI.

2. Microfinance is more than a niche.

The target group of microfinance does not only consist of marginalised strata of the population, but – depending on the level of development of a country – it includes large to very large parts of the population in urban and in rural regions.

The target group of microfinance are not beggars, but all people who are able to earn a living – even on a low level. Although the customers of microfinance are poor, they are customers, who have to be taken seriously, but they are no alms-receivers. Microfinance works in rural and urban areas. Microfinance is a proven way to bring savings and loan schemes to regions, where banks don't do business. But this also implies the necessity for MFIs to be locally present even at "unattractive" locations.

3. Microfinance does not only mean microcredit.

Microfinance comprises savings and loans and other services.

The microcredit, as a rule, is in the centre of international discussions. But microfinance includes all financial services, which are important to poor population strata. Hence, particularly the poor strata of the population have a need for secure savings. Customers need (and want to get) consulting services, too, for their business undertakings and they want to provide for live risks. MFIs, as a rule, respond to these needs by offering an extremely labour- (and consulting-)intensive credit technology and simple insurance products.

4. Microfinance – not the price, but the accessibility is the decisive factor.

In many countries, broad parts of the population do not have any access to financial services. Therefore, they are ready to pay a relatively high price for these services.

The interest amount in absolute terms is not the decisive factor. If customers cannot get any loan or only at very high costs (e.g. 20% per day), even interest rates of – for example – 60% p.a. are favourable. Deposit rates which are below the inflation rate are often accepted, as this is acknowledged as the price you have to pay for the secure safekeeping of money.

5. Microfinance is not (only) charity, but an interesting business.

The social mandate is an essential feature of many MFIs, at the same time, microfinance is able to – and should – be profitable in microeconomic terms.

A lot of MFIs were founded in order to enable certain target groups access to financial services. Many MFIs, and in particular the NGOs, put the social mandate in the foreground. NGOs often receive enormous contributions within the scope of development aid. But if these financial contributions are cut off, the NGOs, as a rule, disband. Particularly if an MFI pursues social targets, it must always observe the side condition to make “sufficient profits”. Only MFIs that operate profitably are able to survive in the medium to long run and can perform on a permanent basis.

To achieve at least cost-coverage is first of all in the focus of attention. To generate profits empowers the MFI to make further investments (e.g. to purchase IT equipment) and to supply broader and in single cases even poorer strata of the population with financial services. To this end, the MFI can involve cross-subsidisation within its institution.

Many MFIs in Africa, South America, Asia, but also in Southeast Europe show that MFIs are able to operate profitably on a permanent basis. But in their profit expectations, the people running these MFIs distinguish from “normal” banks; not the shareholder value, but the stakeholder value is the dominant factor.

6. Microfinance requires professionalism and discipline.

In order to enable MFIs to operate profitably in the medium run, they need to have sufficient professionalism and discipline.

MFIs can only subsist and survive against their competitors (banks and informal providers of financial services), if they work professionally. Only the MFI which knows how to run its business is able to survive without external help. In concrete terms, this means to build up a healthy loan portfolio and to efficiently mobilise savings. To be able to cope with large numbers of products offered requires a thorough training of MFI staff. A broad education is also necessary to fulfil the various (and along with the increasing institutionalisation even growing) customer demands, but also to meet the requirements of the regulatory authorities.

Internal discipline incorporates a functioning corporate governance and the renunciation of insider lending. It is necessary to insist on the customer’s discipline (to repay the loan), only then it is possible to create a stable basis to survive. Professionalism and discipline are therefore primary virtues of the microfinance business.

7. Microfinance means good organisation and technical equipment.

Microfinance is not characterised by high volumes, but by large numbers of customers.

The collection of a multitude of small deposits and the extension of many small loans does not require highly sophisticated analysis techniques, but rather an efficient organisation. As customers do not only live in the capital city or in urban centres, but are spread all over the country, an efficient organisation is of significance. These two aspects – large numbers of customers and a decentralised organisation – can only be managed with well-educated staff and an appropriate technical equipment. For that reason, microfinance does not mean paper and pencil, but robust hardware and powerful software.

8. Microfinance requires target group-oriented products.

Products tailored to the needs of the customers are an important precondition for the long-lasting sustainability of MFIs.

Microfinance means “target group-oriented products”, i.e. simple products, which can be offered to a large clientele, which can be “easily” understood and familiarised with and which can be efficiently administered with the help of EDP. These factors decisively contribute to the stability of MFIs. At the same time this offers the opportunity to supply customers in rural areas with financial services.

9. In the long run, microfinance can only be successful with own deposits.

In the long run, external refinancing must be exchanged by own sources of funding (e.g. savings deposits). During the set-up phase, MFIs need external financing in order to quickly achieve cost-coverage and positive economic effects. The compulsory savings deposits, which are sometimes demanded by MFIs, are generally too low to build up a sufficient funding base for the lending business in the short to medium run. Favourable or charge-free international funds are only available for a limited period of time. After such funding opportunities have come to an end, the institution in question is often no longer able to pursue its business purpose. In the medium run, MFIs must therefore tap own refinancing sources in order to survive without external help.

A possible way out is to combine lending with saving. At the same time, the collection of even the smallest amounts is an important offer to broad segments of the population. In this case, the extension of loans depends on (as a rule very low) existing deposits, on the other hand, the customer does not automatically have a right to get a loan, as the risk inherent in every single loan is to be examined separately.

10. Only formalised microfinance institutions are sustainable on a permanent basis.

Many MFIs start their business activities as informal NGOs outside the formalised banking sector and are therefore not controlled by the banking supervisory authorities. As in the most countries only licensed banks are permitted to collect savings, the informal NGOs are dependent on external funding sources. In order to become sustainable on a permanent basis – and at the same time be able to offer the customers an important product – the transformation into a formal bank has proven to be expedient. As a formal banking institution, the MFI is subject to the corresponding regulatory authorities and has to meet their quality requirements. In the long run, this is of benefit to the MFI and to its customers.

In many cases the legal and supervisory requirements for commercial banks, e.g. with respect to the equity capital base, cannot be met by the MFIs and these requirements are even not appropriate for them. For that reason, there is a growing tendency to create special legal framework conditions for MFIs, catering to their specific situation and needs. Positive examples for this trend are the rural banks in the Philippines or the savings banks (cajas) in Mexico.

The formalisation process – like the general compulsion to act according to business principles – seems to be a psychological barrier for a lot of NGOs. In many cases, they were founded as opposite pole to the formal banks, and their social mandate dominates the way they see themselves.