Microfinance FAQs

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http://www.microfinancegateway.org/p/site/m/template.rc/1.26.9183/

What is Microfinance?

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1. What is microfinance?

"Microfinance" is often defined as financial services for poor and low-income clients. In practice, the term is often used more narrowly to refer to loans and other services from providers that identify themselves as "microfinance institutions" (MFIs). These institutions commonly tend to use new methods developed over the last 30 years to deliver very small loans to unsalaried borrowers, taking little or no collateral. These methods include group lending and liability, pre-loan savings requirements, gradually increasing loan sizes, and an implicit guarantee of ready access to future loans if present loans are repaid fully and promptly.

More broadly, microfinance refers to a movement that envisions a world in which low-income households have permanent access to a range of high quality financial services to finance their income-producing activities, build assets, stabilize consumption, and protect against risks. These services are not limited to credit, but include savings, insurance, and money transfers.

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2. What is the difference between microfinance and microcredit?

Microcredit refers to very small loans for unsalaried borrowers with little or no collateral, provided by legally registered institutions. Currently, consumer credit provided to salaried workers based on automated credit scoring is usually not included in the definition of microcredit, although this may change.

Microfinance typically refers to microcredit, savings, insurance, money transfers, and other financial products targeted at poor and low-income people.

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3. How is microcredit different from other targeted development lending?

In addition to the new techniques explained in **FAQ #1,** the microcredit approach has tried to avoid the pitfalls of an earlier generation of targeted development lending. The approach focuses on fostering better repayment discipline and charging interest rates that cover the costs of credit delivery, both of which support development of sustainable institutions that can continue to expand their services in the future.

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4. Who are microfinance clients?

Typical microfinance clients are poor and low-income people that do not have access to other formal financial institutions. Microfinance clients are usually self-employed, household-based entrepreneurs. Their diverse “microenterprises” include small retail shops, street vending, artisanal manufacture, and service provision. In rural areas, microentrepreneurs often have small income-generating activities such as food processing and trade; some but far from all are farmers.

Hard data on the poverty status of clients is limited, but tends to suggest that most microfinance clients fall near the poverty line, both above and below. Households in the poorest 10% of the population, including the destitute, are not traditional microcredit clients because they lack stable cash flows to repay loans. Most clients below the poverty line are in the upper half of the poor. It is clear, however, that some MFIs can serve clients at the higher end of the bottom half. Women often comprise the majority of clients.

Over the past decade, a few MFIs have started developing a range of products to meet the needs of other clients, including pensioners and salaried workers. Although little is known about the universe of potential clients, the number of households without effective access to financial services is enormous.

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5. How do borrowers use microcredit loans?

Most microcredit borrowers have microenterprises—unsalaried, informal income-generating activities. However, microloans may not predominantly be used to start or finance microenterprises. Scattered research suggests that only half or less of loan proceeds are used for business purposes. The remainder supports a wide range of household cash management needs, including stabilizing consumption and spreading out large, lumpy cash needs like education fees, medical expenses, or lifecycle events such as weddings and funerals.

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6. What kinds of institutions deliver microfinance?

Most MFIs started as not-for-profit organizations like NGOs (non-governmental organizations), credit unions and other financial cooperatives, and state-owned development and postal savings banks. An

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increasing number of MFIs are now organized as for-profit entities, often because it is a requirement to obtaining a license from banking authorities to offer savings services. For-profit MFIs may be organized as non-bank financial institutions (NBFIs), commercial banks that specialize in microfinance, or microfinance departments of full-service banks.

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7. Do MFIs do other things besides financial services for low-income people?

Some MFIs provide non-financial products, such as business development or health services. Commercial and government-owned banks that offer microfinance services are frequently referred to as MFIs, even though only a portion of their assets may be committed to financial services to the poor.

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8. How does microfinance help the poor?

The impact of microcredit has been studied more than the impact of other forms of microfinance. Microcredit can provide a range of benefits that poor households highly value including long-term increases in income and consumption. A harsh aspect of poverty is that income is often irregular and undependable. Access to credit helps the poor to smooth cash flows and avoid periods where access to food, clothing, shelter, or education is lost. Credit can make it easier to manage shocks like sickness of a wage earner, theft, or natural disasters. The poor use credit to build assets such as buying land, which gives them future security. Women participants in microcredit programs often experience important self-empowerment.

Empirical studies on the impact of credit are difficult and expensive to conduct and pose special methodological problems. Most impact studies to date have found significant benefits from microcredit. However, only a few studies have made serious efforts to compensate for the methodological challenges. In fact, many studies would not be regarded as meaningful by most professional econometricians. A new wave of randomized trial studies is now in process, which should yield a more definitive picture.

Even so, there is a strong indication from borrowers that microcredit improves their lives. They faithfully repay their loans even when the only compelling reason is to ensure continued access to the service in the future.

Other microfinance services like savings, insurance, and money transfers have developed more recently, and there is less empirical research on their impact. Client demand indicates that poor people value such services. MFIs that offer good voluntary savings services typically attract far more savers than borrowers.

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9. When is microfinance NOT an appropriate tool?

Financial services, particularly credit, are not appropriate for all people at all times. For loans that will be used for business purposes, microcredit best serves those who have identified an economic opportunity and can capitalize on it if they have access to a small amount of ready cash. Regardless of how loans are used, MFIs can provide long-term, stable credit access only when clients have both the willingness and ability to meet scheduled loan repayments.

Microfinance is particularly inappropriate for the destitute, who may need grants or other public resources to improve their economic situation. Grants are a more efficient way to transfer resources to the destitute than are loans that many will not be unable to repay. Too much risk is placed on the MFI and client, when the only way a client can repay a loan is by starting a successful business. Basic requirements like food, shelter, and employment are often more urgently needed than financial services and should be appropriately funded by government and donor subsidies.

Governments and development agencies often use microfinance as a tool to address socio-economic problems such as relocation of refugees from civil strife, generating employment among demilitarized soldiers, or assistance following a natural disaster. Microfinance may or may not be able to respond to these situations effectively, and certainly not as a stand-alone intervention. Implementing a successful microfinance program to address these types of situations depends upon a number of factors, the most important of which is a client base capable of making regular repayments.

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10. Why do MFIs charge high interest rates to poor people?

Concerns often arise as to why microcredit interest rates are higher than the bank interest rates that wealthier people pay. The issue is cost: the administrative cost of making tiny loans is much higher in percentage terms than the cost of making a large loan. It takes a lot less staff time to make a single loan of $100,000 than 1,000 loans of $100 each. Besides loan size, other factors can make microcredit more expensive to deliver. Credit decisions for borrowers who have neither collateral nor a salary cannot be based on automated scoring. These decisions require substantial intervention of a loan officer in judging the risk of each loan. MFIs may operate in areas that are remote or have low population density, making lending more expensive. This is often why traditional banks tend to stay away from such areas. If an MFI wants to operate sustainably, it has to price its loans high enough to cover all its costs.

Although microcredit interest rates can be legitimately high, inefficient operations can make them higher than necessary. As the microcredit market matures in a given country, administrative costs usually drop as managers learn from experience and in some cases because competition forces lower pricing and greater efficiency.

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11. Why does the microfinance industry place so much emphasis on sustainability?

From a development perspective, financial sustainability is not an end in itself. Rather, it is a tool for reaching the maximum number of clients. MFIs may only operate for a limited time, reach a limited number of clients, or be driven more by political goals than by client needs if services are not priced at sustainable levels.

Donors and governments cannot likely provide enough subsidized funds to meet the huge demand for microfinance. Even if there were enough donor and government money, it would be better spent on other development priorities that, unlike microfinance, cannot be delivered without continuing subsidies. Sustainable MFIs have the potential to attract non-subsidized resources to finance expansion of outreach. Experience has even shown that borrowers are more likely to repay lenders who operate without subsidies at they are more confident the institution will be around to give them future loans.

The trade-off between financial viability and reaching very poor people is much less acute than many once thought. A number of financial providers have managed to offer high-quality financial services to very poor people while also covering their costs. Moreover, correlation between MFI profitability and client poverty level has proven to be a statistically weak one. This may be more driven by the vision of particular MFIs than by any inherent unprofitability of low-end microcredit.

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12. Is the microfinance industry sustainable?

Is the microfinance industry financially sustainable—is it profitable after making adjustments for subsidies not likely to continue in the future? Most MFIs are still unprofitable, especially if one includes the many small MFIs that do not report to the international databases described in **FAQ #17**. A more meaningful way to look at profitability is to consider the overall number of overall clients served by profitable MFIs, rather than the number of profitable MFIs themselves. In 2006, 44% of all microborrowers captured by the MIX database (**see FAQ #17**) are being served by profitable institutions. If one narrows the focus to private MFIs such as NGOs and licensed institutions, then more than 3/5 of the borrowers are already being served profitably, and the long- term trend is upward.

Are MFIs as profitable as banks? Measured by return on assets, MFIs are on average more profitable than the commercial banks in their countries. This does not show that microfinance is inherently more profitable than commercial banking. Rather, the differential is likely due to microfinance being an immature industry in most countries where providers' profits have not yet been squeezed down. Measured by return on the equity invested by shareholders, MFIs are on the average less profitable than banks, but this is mainly because MFIs are not yet as fully leveraged as banks—i.e., MFIs fund their assets with more of their own money and less of the money deposited by savers. Even so, well-managed microfinance have already shown to be profitable enough to integrate into mainstream financial sectors.

13. Do governments do a good job of delivering microcredit?

There are several highly successful government MFIs, such as Bank Rakyat Indonesia's microfinance department. However, the vast majority government microfinance programs do a poor job of delivering retail credit. Such programs are usually subject to political influence, high default, continuing drain on national treasuries, and sometimes lending based more on the borrowers' influence than their actual qualifications. Among government programs reporting to international databases, only 1/8 of clients are being served sustainably. There are structural dynamics that make it hard for governments to deliver good retail credit. Sound credit administration requires screening out borrowers who are not likely to repay, charging interest rates high enough to cover costs, and responding vigorously to late payments. These requirements usually run counter to the practical incentives and imperatives of even the sincerest working politician. The government-run MFIs that deliver good microcredit tend to be insulated from politics, managed by technocrats, and strongly and explicitly focus on sustainability.

It is important to remember that these incentive problems for government providers pertain more to credit than to other services. For instance, good government savings banks are considerably easier to find than good government retail loan programs.

14. What is the government's role in supporting microfinance?

Government's most important role is not provision of retail credit services, for reasons mentioned in **FAQ #12**. Government can contribute most effectively by:

- Setting sound macroeconomic policy that provides stability and low inflation
- Avoiding interest rate ceilings - when governments set interest rate limits, political factors usually result in limits that are too low to permit sustainable delivery of credit that involves high

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administrative costs—such as tiny loans for poor people. Such ceilings often have the announced intention of protecting the poor, but are more likely to choke off the supply of credit

- Adjusting bank regulation to facilitate deposit taking by solid MFIs, once the country has experience with sustainable microfinance delivery,
- Creating government wholesale funds to support retail MFIs if funds can be insulated from politics, and they can hire and protect strong technical management and avoid disbursement pressure that force fund to support unpromising MFIs.

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15. How do savings services help poor people?

Savings has been called the “forgotten half of microfinance.” Most poor people now use informal mechanisms to save because they lack access to good formal deposit services,. They may tuck cash under the mattress, buy animals or jewelry that can be sold off later, or stockpile inventory or building materials. These savings methods tend to be risky—cash can be stolen, animals can get sick, and neighbors can run off. Often they are illiquid as well – one cannot sell just the cow’s leg when one needs a small amount of cash. Poor people want secure, convenient deposit services that allow for small balances and easy access to funds. MFIs that offer good savings services usually attract far more savers than borrowers.

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16. What is the microfinance industry doing to ensure that the poor do not fall prey to predatory lenders?

Many countries are concerned about the impact of excessive interest rates, abusive lending practices, and over-indebtedness on poor borrowers. Quite a few players in the industry are now focusing on consumer protection issues. Typical consumer protection measures include disclosure requirements, rules and prohibitions related to lending practices, mechanisms for handling complaints or disputes, and consumer education.

The ACCION International/ MicroFinance Network “Pro-Consumer Pledge,” FINCA’s “Consumer-Oriented Ethical Statement” and Freedom from Hunger’s “Statement on Ethical Treatment of Clients” are examples of network organizations articulating pro-consumer principles. The SEEP Network, through its Pro-Client Working Group, has resources on the subject.

Even in countries where consumer abuse is not yet a problem, promoting voluntary consumer protection codes and practices may reduce future pressure to over-regulate. An increasing number of individual MFIs are adopting voluntary pledges or codes that promote effective consumer protection and a consumer-oriented culture. For instance, the Bosnian MFI Prizma has worked with Freedom from Hunger to articulate “Our Commitment to Clients.“

Investors are in the process of signing on to CGAP's Investor Initiative for Client Protection in Microfinance. Finally, the slow but steady inroads of social performance measurement and management (FAQ #15) into the field of microfinance is focusing more attention on protection and transparency dimensions, as well as potential unintended negative consequences for clients.

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17. What is social performance measurement and why is it important for financial institutions?

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The Social Performance Task Force defines social performance as: "The effective translation of an institution's social mission into practice in line with accepted social values that relate to serving larger numbers of poor and excluded people; improving the quality and appropriateness of financial services; creating benefits for clients; and improving social responsibility of an MFI."

Most MFIs have a social mission that they see as more basic than their financial objective, or at least co-equal with it. There is a great deal of truth in the adage that institutions manage what they measure. Social performance measurement helps MFIs and their stakeholders focus on their social goals and judge how well they are meeting them. Social indicators are often less straightforward to measure, and less commonly used than financial indicators that have been developed over centuries. Today's increasing use of social measures reflects an awareness that good financial performance by an MFI does not automatically guarantee client interests are being appropriately advanced.

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18. Where can I find financial performance data on MFIs worldwide?

Increasing numbers of MFIs in developing economies are reporting their performance to international databases in recent years. The databases with the highest participation are:
The MIX Market (MM) database contains financial and other performance information from over 1,300 MFIs collected and processed by the Microfinance Information eXchange (MIX). Data for participating MFIs, including client outreach measures, simplified financial statements, and a number of standard financial performance indicators, is publicly available online at **www.mixmarket.org**.

The MicroBanking Bulletin (MBB) database has the smallest number of participating MFIs but excellent information quality. It contains information on more than 350 MFIs. The participating MFIs are identified and peer-group averages are reported in periodic updates of the Bulletin (**www.mixmbb.org/en/index.html**). However, individual company information is confidential. The MBB tracks a full range of financial information and indicators, and adjusts the financial statements that it receives to compensate for the impact of subsidies that will probably not be repeated if and when the MFI grows to important scale.

The Microcredit Summit (MCS) database contains limited information on a large number of MFIs (more than 2,000 MFIs). Summary information is published annually; and the annual reports can be found at **http://www.microcreditsummit.org.**