# Microfinance and sustainability

The potential for poverty eradication in the developing world

## Introduction

Poverty is not a *cause*, but an *effect*, resulting from poor planning, lopsided priorities, ineffective policies, and disastrous resource distribution.

As a result, one billion people in the world today live without access to clean drinking water, two and a half billion do not have access to basic sanitation and nearly two billion lack access to electricity.

Their way to lifestyle improvement, albeit incrementally, one day at a time, is through the delivery of sustainable solutions, addressing every aspect of everyday life.

This incremental process could be achieved, through systematic planning and delivery by development agencies in conjunction with public or private capital and grass roots communities. The alternative is, through the enabling of the individual, converting him or her into an entrepreneur with the potential of a subsequent emergence of a micro enterprise driven by that individual. Both approaches are contributing to the sustainability of the community and the region.

The former is achieved though large scale infrastructure development and the introduction of new economic drivers within a region, resulting in the creation of new jobs and income. This is largely the domain of the World Bank and it's agencies, as well as developing banks specialising in various parts of the world, and is not the subject of our discussion.

The latter, ie, the enabling of the individual, especially in the absence of infrastructure development and economic drivers, is achieved through the availability of microfinance — performing a key role within a delivery system aimed at achieving sustainability — and is the subject of this article.

During 2005, the UN International Year of Microfinance, more than 92 million families, most of them living on less than a dollar a day, benefited from small loans known as 'micro credit', marking a bright spot in international development efforts too often frustrated by missed targets and broken promises.

## Defining microfinance

The foundation of most developing country economies is that the population is generally poor, but working hard to support themselves and their families. Most of their employment and income generating opportunities are created by very small, informal, diversified, unregulated, unregistered, untaxed, unnoticed but profitable family businesses. However, as is the case in so many parts of the developing world, family businesses are operating without access to formal financial services.

***This, the unbanked majority***, is the potential market for microfinance.

Microfinance is fast becoming a key driver in the economic systems of the developing world; similar to the way that macrofinance performs a role in the developed world.

With the microcredit market worth some 250 billion US dollars, it is recognised as an asset class, considering investments already made by a number of leading world class banks, but it still has a long way to go in order to fulfill its true potential in contributing to sustainability in the developing world.

Microfinance is generally used as a collective term, including microcredit and microfinance institutions (MFIs), hence the following three definitions are offered with special reference to the developing world:

- **Microcredit** or microlending is the principle of giving small loans to the very poor to help them generate an income of their own.
- **Microfinance** is a broader concept and refers to the provision of financial services, in addition to extending loans, including savings, insurance and leasing facilities to clients who are excluded from the traditional financial system on account of their economic status, typically lacking collateral, steady employment and a verifiable credit history and therefore lacking even the most minimum qualifications to gain access to traditional credit facilities.
- **Microfinance institutions (MFIs) —** the major microfinance institutional models are: full service commercial banks; restricted service banks; regulated non-bank financial institutions; membership societies; and non-governmental organisations (NGOs)/projects. Whatever the microfinance institutional model, the objectives are the same, ie:

Microfinance institutions serve as formal business financing sources for microenterprises, offering communities safe and remunerative depositories for household savings and provide complementary financial services. If structured effectively, microbanking institutions are financial intermediaries for low-income citizens, integrating formal financial markets with informal real markets and delivering financial services to previously 'unbanked' entrepreneurs and communities. They allow the working poor to benefit from economic opportunities and to participate in economic growth. Microfinance allows the poor to accumulate assets, either by savings mobilisation or the productive investment of loan capital, so that they can increase their standard of living and improve their quality of life

**A brief overview of microfinance**

The idea of making small loans to the very poor was first explored in Bangladesh in 1976 when the Grameen Bank was set up by the economist Professor Muhammed Yunus. The strategy of the Grameen Bank was to make up for a lack of borrower collateral to secure loans by creating social collateral through peer pressure support.

The essence of micro-banking is to replace sophisticated credit-evaluation techniques and collateral regulations with lower cost procedures.

A solidarity group of five or so borrowers would agree and mutually guarantee each others loans. The loan defaults and repayment rates stand at greater than 90%. This initiative showed that the poor need not necessarily be bad debtors.

Today, microfinance is seen as a crucial poverty alleviation strategy. In 2000, there were 1,580 Micro Finance Initiatives reported worldwide, serving over 30 million people including more than 19 million of the poorest. Not all use the Grameen Bank

method. Other approaches to evaluate future borrowers include individual references, personal guarantees and rotating savings credit associations (ROSCAs) where loans are provided from a communal savings pot.

The generally positive results from these projects have led to a high level of donor support for microfinance initiatives, and significant amounts of money have been pledged. However, the donor community has also brought with it expectations and requirements which may need clear and specified results in a short time period. This may not always be possible given the time required to build up self sustained microfinance institutions.

**Defining sustainability**

By sustainability we understand the equilibrium achieved between the three key 'continuously shifting economic plates', ie, economic efficiency, human well-being (or social justice) and environmental integrity, generally referred to as the triple bottom line, previously explained in more detail in Volume 4: Issue 2 (2006) of *Private Capital Journal*.

**The interaction of microfinance and sustainability**

We now consider the interaction between microfinance and economic efficiency, human well-being and environmental integrity, respectively. In each case the potential contribution of microfinance to these three aspects and hence to sustainability overall is considered.

**Microfinance and economic efficiency**

In the absence of regional income generation at the personal level, like infrastructure developments, and in the absence of economic drivers like ecotourism or big scale agriculture, microfinance is virtually the only enabler assisting the individual on a personal level. In this sense, microfinance, providing the right quality and quantity of credit at the right time and the right place, has contributed to numerous case studies of small successes, being the first steps to poverty eradication and an improved life style.

To be realised is that the debate is still continuing on ***outreach*** *v*ersus ***impact and efficiency.*** Under scrutiny are two issues: the extent to which microfinance services have reached the poor clients for whom they are intended; and the impact that such outreach is likely to have. An important distinction is that although microfinance programmes may have the social objective of reducing poverty, the intention of many is to achieve this not by targeting the poorest of the poor, but by targeting the poorest of the economically active.

Economic sustainability is a means to a much broader end — the sustainable community. It also requires the use of appropriate technologies and encourages the use of renewable resources as inputs to production. It actively discourages the generation of pollution arising from economic activity, specifically air, water and soil pollution. For sustainable development to occur, development must be financially sustainable and carried out within the community's means.

**Microfinance and human well being**

In the context of this discussion, human well being is firstly defined by the minimum elements defining basic human rights – ie, the availability of, and access to, clean water, sanitation and health services. This is followed by the first steps towards 'lifestyle improvement', eg, access to electricity and information and communication technologies services, the availability of which enables the delivery of basic skills training, access to information and further enabling knowledge acquisition and hence education.

A first response is that providing these facilities and services should be the product of infrastructure development and maintenance, typically the domain of local government, development agencies and NGOs.

Microfinance has a role to play in the absence of the above, as so often found in remote rural areas in developing countries.

Adopting a poverty eradication focus through the organising and development of sustainable communities as the primary platform, provides for the most effective delivery towards these objectives. Many cases are available presenting examples of the successful implementation of 'microfinanced, micro infrastructure' projects, where the joint initiative, support and collateral of the community enables the implementation of projects to address the basic human rights objectives, as listed above.

**Micro finance and environmental integrity**

Maintenance of environmental integrity is about democracy and the community, but also about the natural world within which our communities exist and with which they interact continuously, as in the case of remote rural communities. In so many parts of the world, this relationship is permanently damaged (think of the deforestation of parts of Africa, the Amazon and Indonesia), with lives ruptured from the sources of sustenance. We are reaching for global sustainability at all levels in the developed world, but ultimately it must find its way to new relationships on the ground, in countless local places, especially rural communities, to really be effective.

To be more sustainable, our planning and management must be aimed at reducing the consumption of material and energy resources, including minimising the use or waste of non-renewable resources, ie, the consumption of fossil fuels plus substituting renewable resources where feasible. This applies equally to the remote and rural parts of the developing world.

The overall primary objective has to be biodiversity conservation and no provision of microfinance, whether to an individual lender or micro enterprise, should be at the cost of the environment.

MFIs, supported by their sponsors, have to develop suitable strategies to promote both environmental sustainability and poverty reduction, but without compromising their own financial sustainability.

In developing suitable strategies, technology, in a variety of forms, has a major role to play. Two examples are:

- The use of technology to train small farmers, typically micro lenders, in sustainable agricultural practice.

- The use of applicable renewable energy technologies to provide basic electricity supply needs, enabling basic lifestyle style improvement as previously defined.

**Microfinance — sustainability delivery system**

The juxtaposition of investing in microfinance and sustainability is schematically depicted in the diagram, representing the microfinance sustainability model for the delivery of long-term sustainable solutions, primarily aimed at poverty eradication and subsequent lifestyle improvement in the developing world.

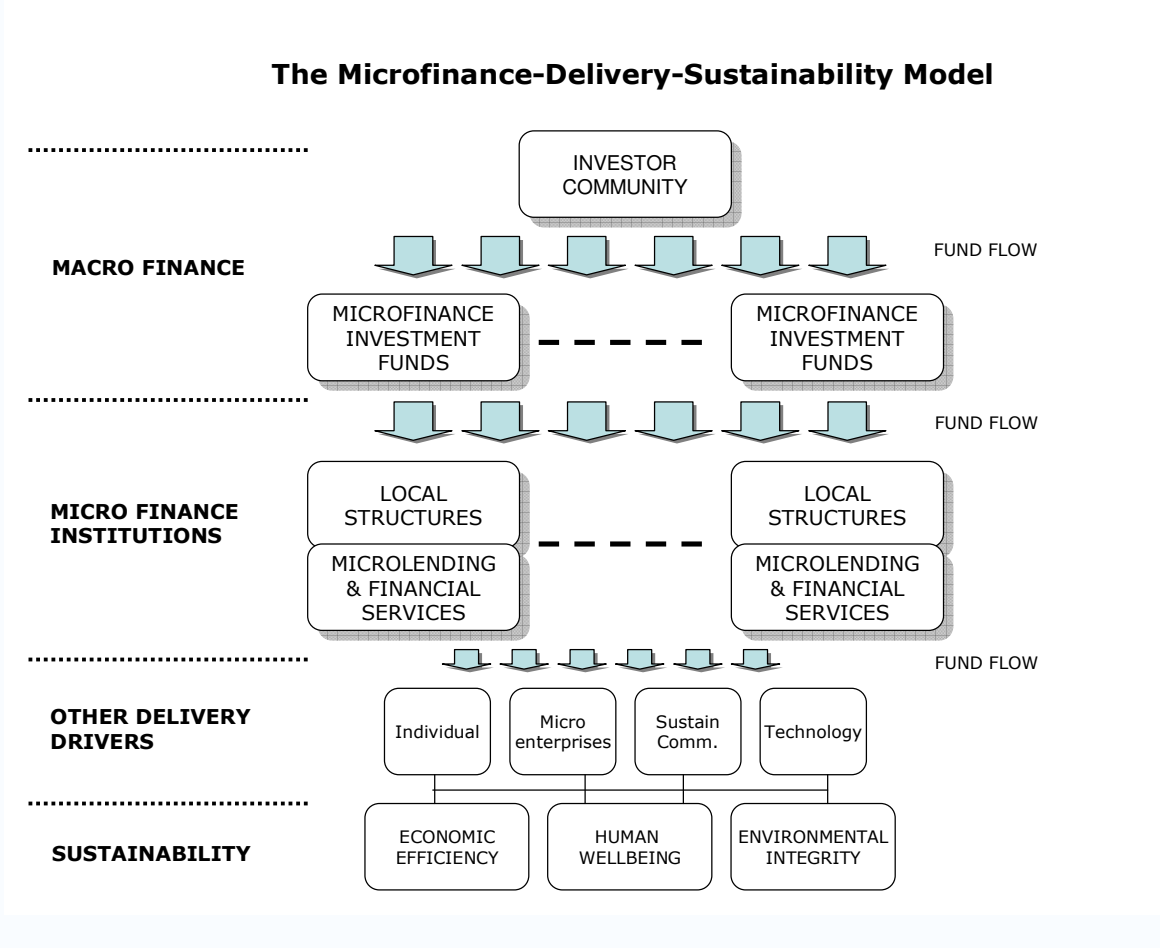
**Key drivers in the model**

As shown in the diagram, key drivers in the delivery system are the investor community, macrofinance institutions investing in microfinance, MFIs represented by local structures, microfinance including micro credit and micro services, and other delivery drivers

The group, 'other delivery drivers', ie, the individual, microenterprises, community development and the availability of technology, are considered the most important and deserve further discussion.

**The individual**

The primary differentiator between microfinance and the conventional credit disbursal mechanism lies in the 'joint liability' concept. A group of individuals (almost always women) get together to form an association of persons. The groups in India, for instance, are called 'Self Help Groups' (SHGs), all the members of which undergo a training programme on the basic procedures and system requirements. Loans to individuals within the SHG are approved by the other members of the group, who are also jointly responsible for its repayment. The members of the SHG save regularly. To minimise the financial burden there are limits to the amount lent and the repayment is typically over 50 weeks. There are nearly 300,000 SHGs that have been in existence for over three years in India, perhaps an indication of the sustainability of the SHG system itself.




## Microenterprises

Microenterprises are small businesses employing up to 10 people, in urban or rural areas, generally family owned and operated. Their total assets rarely surpass US$10,000. They are active in the trade, production or services sectors of the so-called 'informal economy' which can be seen as the most important place of value creation and the nurturing ground of entrepreneurship in developing countries.

Industry specialists estimate that there are about 500 million micro entrepreneurs in the world. Each one necessitates an average micro-credit of US$800 per year to finance its activities, shifting the enterprise's focus from survival and emergency to stability and sustainability.

## Community development

The availability of adequate and timely microfinance services for low-income households has many effects on the development of a community. It can directly affect community organisation and development as a part of its microfinance activities. It can also indirectly enable and facilitate community development as a result of the credit itself.

Microfinance therefore enables collective action, the coming together of the community which is an important ingredient of participation of the community in its development. Formal and informal education and training are also enabled for leaders and other members of the community in skills that will allow them to locally design, develop and manage community projects.

The enablement has wide effects on environmental development. This can be seen in greater awareness of the community in its internal potential, in its ability to interact together to solve its own problems. It also illustrates the power of the local decision-making process that takes place at community level.

**Availability of technology**

Technology is being used in a broad sense and the areas discussed below are considered the most important.

**Health systems**

In the developing world, ill health is a constant threat; its effects are devastating to both individuals and livelihoods. Millennium Development Goals address child mortality, maternal health and combating AIDS/HIV, malaria and other major diseases.

Multiple opportunities exist for the health improvement of the poor. An example is a new device being marketed to purify water in developing countries. It looks like a large plastic flute and contains internal filters that remove bacteria from the water as it is drunk. The device is priced at around US$3.50, and is designed to purify 700 liters over the course of six months to a year. Unfortunately, even this relatively low price is still beyond the reach of many individuals, providing another microfinance opportunity.

Training in health technology is another area — an example is the Summa Foundation, a Ugandan not-for-profit investment fund, which responded to the attempts of the Ugandan Government to ensure that small-scale private providers supply a substantial portion of health care in the country. These providers did not have access to capital that could help them improve the quality or increase the range of their services, so Summa designed a loan and business-skills training programme that targets these providers. The loans varied from $30 to $5,000. To date, 280 private providers have been given loans and business-skills training, including midwives (49%), nurses (29%), clinical officers (11%), and doctors (11%).

Issues related to HIV/AIDS tend to evoke an image of concern for health and community welfare. Unfortunately many microfinance practitioners see this as having nothing to do with them because of the apparent health and welfare focus. Yet, with the HIV prevalence, AIDS deaths and orphaning rates as high as they are in several countries, it is a given that the pandemic has serious economic implications for the general population, including households that constitute the primary marketplace for microfinance institutions.

**Basic services**

The application of microfinance to sanitation is an example. Potential clients of microfinance for sanitation or sanitation-related services include small-scale private providers and households. Microfinance has been used for the construction of

household latrines, construction of public toilets, manual latrine-cleaning services and suction truckers which are used to empty pit latrines. Leveraging household and community resources for sanitation improvements has been reported in countries such as India, Lesotho, Vietnam, Bangladesh, Pakistan and Burkina Faso. Revolving funds for sanitation schemes at village level do not require collateral. Money is saved and borrowed on a rotation basis with no interest to cover the cost of a basic septic tank, for instance. Individual households often contribute labour in order to provide these services.

**Energy supply using renewable energy technologies**

Energy provision is one basic need where microfinance has not received sufficient support. The remoteness of rural locations usually makes energy supply via a centralised grid system difficult; therefore people often rely on expensive fossil fuels such as diesel and kerosene. From the environmental and also economic point of view, the use of renewable energies would be the best solution. However, in remote areas people often do not have adequate financial means to afford renewable energy technologies, thus microfinance should be seen as a way forward for the provision of improved energy services in remote settlements. People quickly equate energy provision with lighting, television and other 'quality of life' benefits.

However, the provision of energy does not lead only to social but also to economic improvements by the productive use of energy. Improved energy services support the profitability and productivity for micro, small- and medium-sized enterprises and cottage industries. Energy can, therefore, have a very positive impact on income, health and food security. Increased income and fulfillment of social needs in turn allow a greater use of modern energy and more widespread investments in renewable energy which bring further environmental and development benefits.

Microfinance projects are in existence supporting renewable energy technologies such as solar/photovoltaic systems, wind energy, micro hydropower, biogas or biomass used for cooking, lighting, power telecommunications equipment, radio, television, household electrification, health clinics, water pumping, milling and grinding, water disinfection, fencing, computer education and operating machinery.

The United Nations Environment Programme's Rural Energy Enterprise Development (REED) initiative operates in Africa as AREED *(*African REED*)* to develop new sustainable energy enterprises that use clean, efficient, and renewable energy technologies. AREED offers rural energy entrepreneurs in Mali, Ghana, Tanzania, Senegal and Zambia a combination of enterprise development services and start-up financing. This integrated financial and technical support allows entrepreneurs to plan and structure their companies for growth and makes eventual investments by mainstream financial partners possible.

**Information access, education and training**

Much of the gap between developed and developing countries and between the rich and poor within countries arises from the difference in access to knowledge and education, a fact recognised by the Millennium Development Goal of universal primary education. The convergence of communication and information technologies and the availability of the worldwide web, have ushered in a 'global knowledge economy' which can address these gaps within and between countries and become a catalyst for social development.

The 'digital divide', is the divide between rich and poor in access to such systems, meaning that those who stand to benefit most from current scientific and technical information are those with least access to it. The statistics are daunting: in 2000 around 80% of the world's population had no reliable access to telecommunications. As a result, a Millennium Development Goal specifically addresses access to electronic communication and information systems.

**Banking systems**

Larger banks have access to capital, scale, reach, and expertise that could alleviate many of the problems associated with microfinance. Their reluctance to respond to the unmet demand for microfinance services is due to the large costs of building and maintaining physical bank branches and the high transaction costs and low profit margin on small loans. With this in mind, many initiatives are currently using new information and communication technologies (ICT), such as smart cards, handhelds, and modified ATMs, to bypass the traditional methods of providing bank services. In doing so, they are lowering their overhead costs and expanding their reach, helping to extend the availability of microfinance.

In Bolivia, one MFI is providing ATM-enabled banking services to Bolivians that do not have access to the traditional banking system. PRODEM FFP was established as an NGO in 1986. Since 1999, it has been a regulated, privately-held financial fund focused on bringing microfinance services to underserved communities, both rural and urban. In a country where 70% of the general population and 94% of the rural population are classified as poor, PRODEM has designed its own ATM, tailored to meet the needs of its rural customers. The company provides its customers with a smart card, so that the ATMs are able to verify the customer's identity and complete transactions without being electronically connected to the central office, thereby allowing PRODEM to expand its reach into remote areas.

PRODEM finds that the ATMs allow it to serve customers who cannot come to their branches during normal business hours. Moreover, the ATMs are capable of 'speaking' to their users in their local language, thus enabling illiterate customers to access their services. Audio instructions are currently available in Spanish, Quechua, or Aymara. Combined with a touch screen interface, customers are able to deposit and withdraw funds without filling out a deposit slip or withdrawal form. Additionally, the ATMs facilitate money transfers, provide access to government programmes that provide work for low-skill workers and make payments to senior citizens.

**Microfinance technology**

In response to the statistic that microfinance reaches less than 5% of individuals around the world who could benefit from financial services, the Grameen Technology Center is helping transform the management of microfinance across the sector to facilitate aggressive and sustainable growth through the creation of the Mifos project. This project is aimed at:

- providing a management information system to improve operational efficiency and control;

- establishing data standards to improve information exchange in the industry and access to commercial sources of funding;
- building a global community for product development and customer support to advance the Mifos offering and stimulate adoption.

**Investing in microfinance**

Several international and regional funds have been established that invest in microfinance activities and institutions (MFIs). These funds are managed by non-profit organisations, commercial banks, and investment firms.

Within the development context and at a micro level, MFIs have attracted investment attention based on exceptional financial performance and positive social impact, hence offering a double bottom line. Many MFIs lack sufficient capital to expand operations and face diminishing funds from the international donor community. Commercial capital is the best and most viable source to grow and accomplish the mission of providing affordable financial services to poor people. Investors, however, are foremost concerned with financial returns and hesitant to invest in MFIs due to the high perceived risk. For foreign lenders and investors — institutional and individual — capital investment in a developing country MFI provides economic promise, but also carries extensive risk. Understanding, evaluating and mitigating the risks is a prerequisite for increasing investments in MFIs. Risks are typically divided into two categories: commercial and non-commercial.

Commercial risks include financial, operational and business risks whereas non-commercial ones encompass country and event risks.

**Conclusion**

The positioning of microfinance and its potential role towards sustainability, with special reference to the developing world, is hopefully better understood through the Microfinance Sustainability Model.

Estimates indicate that currently only 5% of the micro-credit demand is fulfilled. Given the 'demand', it is safe to expect that growth will continue at an accelerating pace.

This discussion concentrated on microfinance in the developing world. On a final word, it is interesting to note that microfinance is, however, not confined to the developing world only. Fundusz Mikro in Poland is one of the most successful micro-finance programmes in Eastern Europe. Rosalind Copisarow, its founder, has recently been involved in an effort to introduce microfinance to the United Kingdom. However, to date, there are few significant microfinance programmes in Western Europe, although there is significant poverty and unemployment.

The challenge here would be to develop a different kind of delivery model.