How Microfinance Works

Over 55 percent of the world’s population lives in rural areas(Morvant-Roux,2017) where most households are excluded from the formal financial system. Access to financial service by poor households is therefore a necessity, given that it’s an opportunity for these excluded segment of the population to reduce their vulnerability and increase their income. Access to financial services can permit poor households to better their health, nutrition and education; reason why it has become a key element of different World Bank initiatives aimed at poverty alleviation and as well ensuring a better social and economic well-being of the poor.

Microfinance in recent years has experienced a tremendous growth and has attracted the attention of policymakers and academician who now see it as a means of promoting rural development due to its embeddedness in rural communities. Formal banks initially considered this sector very risky and had no interest in the sector are now investing in it, either in the form of equity or debt. However, while the sector has witness a huge success, it has often been criticize that must of these institutions are concentrated in urban and semi-urban areas, providing financial services mostly to client who are off the base of the poverty pyramid. Providing microfinance service is very costly due to the specific nature of its client and more challenging when the target population are in rural areas.

Though the industry has been successful, it has equally witnessed several crisis in different regions of the world, with almost similar characteristics leading to defaults in some cases and transformation in others. Hence, in order to lay grounds for a solid financial viable and social responsible microfinance institution, lessons can be drawn from such crisis while taking into consideration the specificity of this sector. Setting up a rural microfinance requires that we take into consideration the supply side and the demand side of microfinance services respectively The supply side refers to the interest of the banking institution and the demand side, the needs of the rural population. On the supply side, several factors will have to be taken into account.

I. Characteristics of a rural Market

A review of the context is necessary, that is acknowledging the existing infrastructural development and the economic activities. In most rural areas the economics activates are very limited and most at times rudimentary. The market characteristics can be composed of the following variables:

1. Target Population

Outlining the market population of a microfinance institutions can be considered as the most essential criteria to be taken into consideration when setting of a MFIs. Having the target group at hand will not only facilitate the designing of products but equally will permit an institution to know its market size. More so, rural communities are always characterised by low population density; hence, targeting specific group of the population will not only have social repercussions; but also economic implications. It has a two sided effect: first, each group of the population has its specificities and may be viable differently in utilizing micro-loans, and secondly, each groups will have different repayment patterns; thereby impacting the sustainability of microfinance. This therefore implies that the financial viability of an institution does not depend uniquely on its social desirability to lend to a specific group but to the different components of the population. This guarantees the existence of a broad and diversified market that assures a better financial performance as well as social performance.

2. Economic Activities of the Target Group

   The rural population is always associated with agricultural and small business activities, whereby the cash flow is either periodically, irregular and uncertain. The reality of a local or rural economy is that, we could have a market for financial services where the demand is low; with households mainly engaged in subsistent farming and limited opportunities for off-farm activities. Serving such a population require the establishment of a low cost organization that can sustain the cost of intermediating small pool of capital that can satisfy the cash needs of small scale customers. On the other hand, the economy might be very diverse with a high demand for financial services, where high cost organization can serve profitably large pool of capital to small customers with larger volume of transactions. Having a mastery of the different economic activities embedded in a rural area permits an institution to have an idea of the cashflow and hence the debt capacity of the different households, which is a determinant of the demand for financial services. This equally helps the institution to tailor savings, credit product and services that are suitable for the rural population and that can easily adapt to seasonal constraints, low profitability in activities like agriculture and climate hazards

II. Socio-Political and Cultural influence

Local environments can impact the demand and supply credit, hence influencing the way financial services are set up in a rural context. The Social, political and cultural aspects on an environment plays a very important role on the financial and social integration of a microfinance; which can be positive as well as negative, thus understanding the various comportment is vital for the long term viability of such an institution. Most microfinance crisis that occurred in countries like India, Nicaragua and Morocco for example, are all related to non-repayment of loan instigated to an extend by political elites, social groups, as well local leaderships. Elected leader, local political leaders by their proximity to the local population; their charisma can influence and exert some peer pressure on the local; thus permitting an institution to gain legitimacy (Morvant-Roux et al,2012). Such leadership can facilitate or slow down the launch of microcredit either by acting as a moral authority to intervene and incite poor payers to repay or can induce the call for non-repayment as it occurred in India and Nicaragua; where local elites and political leaders called on the local population not to reimburse their loans.

The examination of informal financial practices is also instructive. The most common informal borrowing sources are shopkeepers and family members, who respectively account for a majority of all lending sources within a rural population. Due to some cultural and social characteristics, households at times consider such sources to be trust worthy because they are cost free, extremely flexible and play a central role in smoothing out households cash flows. More so, The local perception of debt differ in some context, due to social or cultural reasons; debt can be considered normal within community where as in other rural areas, the reluctance to go in for debt can be viewed as a matter of safeguarding one honor and dignity(Morvant-Roux et al,2012). Hence, outlining and understanding these specific societal element, turn to shape the way micro-services can be offered sustainably in a rural context.

III. Legal and Regulation Framework

The legal and regulatory framework of any society can be considered as an important incentive that can galvanize any potential investor, because it gives some guarantee that financial loses as a result of litigations might be minimal and that the rule of law can prevail. The degree and quality of access to financial services available to low-income rural households and their small businesses is influenced by the standards of the legal and regulatory framework. A sound and unambiguous legislative framework is considered as a prerequisite for an efficient regulatory system. This permits a supportive system for all type of institutions; regulated and non-regulated to provide sustainable financial services under a uniform and shared performance standard.

Legal enforcement of contractual obligations and the ability to seize pledged asset is of great importance. Although from a conceptual point of view microfinance do not require collateral to grant credit or do not require the collateral to equal the value of the loan and shouldn’t be concerned by its ability to legally repossess a pledged asset,it can be generally agreed that a good law relating financial transactions influences to a certain extend the behavior of a borrower(Ledgerwood,1998). Some legal systems permit financial providers to formally charge its debtors in case of non-payment. It is useful for a microfinance institution to know the various legal means of pressure that can be employed so that borrowers can adhere to their contractual obligation. Due to the specific nature of microfinance activities, the regulation applied within the sector differs from one context to another. In some localities, microfinance activities are limited to credit operation only, and microfinance are prohibited from mobilization savings and operating other financial services. In order to be competitive and flourish in an environment that is conducive to financial intermediation,a microfinance institution should be sure governments and policymakers have put in place financial regulation that ensures market efficiency.

IV. Credit policy history

Repayment of loans in microfinance is very important, since the sustainability of such institutions depends greatly on the revenue generated from credit operations. Several microfinance studies have suggested that repayment history is the best predictor of future repayment performance. It is based on the notion that past behavior is indicative of future behavior for a population with similar characteristics. Due to the specific nature of microfinance activities, the sector is always face with situations of debt reliefs and such credit policy history and past experiences in debt cancellation has impacted local norms in certain case where repayment default is considered to be legitimate. Governments that forgive existing debts of the poor to state banks can have a tremendous effect on private sector MFIs, whose borrowers may mistakenly understand that their loans need not be repaid either. In general, both donors and practitioners should determine the consequences of existing or past credit subsidies or debt forgiveness. Although such altitude could be related to poor governance it is essential that a target market for a microfinance institution should have a responsible approach to debt in order to ensure the long term survival of such an institution. Bad credit records implies bad borrowers and borrowers mean bad loan portfolio.

On the demand side, we look at the product design and services. Product design is a crucial dimension of financial services when talking about how microfinance may help the poor to improve their welfare, given that the effectiveness of the poor’s cash flow management depends on the access to and design of financial products

V. Product Design and Diversification

Microfinance has as mission to deliver financial services to poor households who do not have access to formal banking systems. Like an other business, a microfinance institution(MFI) must strive to be sustainable in order to survive; however, in its search for profitability a MFI needs to have an impact on the livelihood of the population. More so, poor households require these financial services to be able to smoothen their consumption; invest in projects and big events and equally hope with risk and uncertainty. Therefore, the conceptualization of microfinance products and services must take the following elements into account:

- Secure: the financial location of this institution must be safe in order to gain the trust of

the local population, more so, galvanize the saving habits of the rural population.
- Easily accessible: Proximity of this institution is very vital given that most rural areas have very poor infrastructure which makes mobility a challenge. More so, low requirements in terms of documentation must be ensured; most of the population in rural areas are made up of individuals with limited academic qualification or educational standard
- Low cost of opening and holding savings accounts, so that the rural population will be able to afford these services and benefit from its existence.
- Flexible: must be able to handle or allow for small transactions; activities in rural areas are mostly on a small scale, periodic and in consistent; therefore is a required to adjust to the needs of the population.

The actual savings and loan products need to be designed according to the needs of the target markets. Nevertheless while most MFIs provide savings and credit services, it is vital consider an integrated approach of microfinancing that combines classic product such as savings and credits with non-financial services like insurance; entrepreneurship and other trainings.

Savings

Until recently, most MFIs were not into savings mobilization but the acclamation by practitioner and policy maker for MFIs to mobilize savings is an attestation that poor and rural households can save and do save. An inventory by the World bank on MFIs show that most of MFIs that are sustainable rely heavily on savings mobilization(Ledgerwood,1998). Savings which can be compulsory or voluntary savings constituted a very reliable and cheap sources of funding and equally make microfinance institution independent from donors and external investors. Compulsory savings is useful: to extort the savings habit from clients; serve as a guarantee for loan repayment and illustrates clients can manage cash flows while making periodic payments. Though compulsory savings are useful to demonstrate the value of savings practices to borrowers, most consider this as a fees they have pay in order to participate or gain access to loans since it can’t be withdrawn by a client with outstanding loan balance. Voluntary savings on its part are non-conditional and are provided to borrowers and non-borrowers who can generate an excess in revenue. The former is based on the idea that the poor must be disciplined financially and taught how to save whereas the later assumes that the poor possesses the capacity to save and only requires the services of an institution that meets their needs. However, for an MFI to mobilize voluntary savings, there need to be an enabling environment with appropriate legal and regulatory framework; suitable level of political stability.

Credits

The fundamental of credit which includes cash patterns of borrowers; loan size and repayment frequency, and underlying each element is an emphasis on understanding the behavior of consumers. Credit design should be such that it can suit the specificity of the market environment and equally determine the credit methodology that can be applicable in order to ensure a suitably repayment performance.

Insurance

Microinsurance which is the protection of poor household against specific risk can be offered in different forms. This insurance can be either health or a credit life insurance and they offer added value to poor household in a sustainable way; with very low premium. Such services do not only act as a diverse source of revenue for an institution but equally play a social role since it provide the rural population with the possibility of getting cheap and affordable health care. In addition to these basic financial products, other non-financial services such as trainings and the promotion of entrepreneurship should be incorporated. Providing training to clients helps them in capacity building and enables them to acquire new skills and better develop existing ones. Providing financial education helps build the financial capacity of these rural population, permitting them to better manage their cash flow and better understand financial transaction and improve on their financial responsibilities. Coupled with technical assistance, such services do not only promote self-sustainability but equally plays a great role in achieving the social missions of this institution. Microfinance activity is specific and to every context, the conditions of the sector are unique. The present criteria outlined here are not exhaustive and as such there exist other factors which might be considered in another context to be more important. Other criteria which could still be considered include capital; human resources; governance, political stability…etc. However, I believe for any prospective investor; the criteria developed above could be considered as the basics when developing a microfinance service project.