

The Business of Microfinance

WHITE PAPER

Vishal Sehgal, February 2008

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THE BUSINESS OF MICROFINANCE

Microfinance serves as an umbrella term that describes the provision of banking services by poverty-focused financial institutions (microfinance institutions – MFIs) to poor parts of the population that are not being served by mainstream financial services providers. The core service of microfinance is the provision of microcredit. Typically, these are small loans to the working poor. The borrowers are small entrepreneurs that include street vendors, traders, service providers, small farmers, fishermen, herders. Initially microfinance focused only on rural areas but increasingly the urban poor are also becoming a focus group for such services. As the practice has matured and reached a larger number of people, several other financial services such as microdeposits and microinsurance are also being offered to the clientele.

Deutsche Bank Research (December 2007) estimates the volume of total microfinance loans to be around USD 25 bn in 2006 having risen sharply in recent years from an estimated USD 4 bn in 2001. According to Dr Akula of SKS Microfinance (India), the total market for microfinance in India now stands at around USD 2 bn. As per Deutsche Bank Research, there are 7 Indian MFIs in top 20 MFIs world wide with the half a million to a million borrowers each and a gross portfolio size of approx USD 25 million to USD 92 million. The average borrowing size is around USD 100 and a write off ratio of less than 1%.

Microfinance is based on recognizing that the working poor can act in an entrepreneurial manner and are, in principle, creditworthy. For these micro-borrowers, microcredit is often the only alternative to paying excessive interest rates charged by unofficial money-lenders or pawnshops in developing countries. Dr Akula

underlines that the rapid expansion of the microfinance sector is a reflection of the fact that the “people do not want handouts – they do not mind paying interest; they just want to get on with running businesses”. The fact is that the microfinance world abounds with the stories of how people have built businesses with the credit that became available to them – not only small businesses but also large telecom networks. The grameen telecom is an example of a business built on the core strength of small entrepreneurs using the telephone as a means of generating livelihoods financed by microfinance.

The importance of microfinance lies in the fact that it provides a model of development that is Bottoms up. It promotes entrepreneurship and gives people the means to fight poverty. Currently, the steadily growing popularity of microfinance has reached a global audience. The United Nations (UN) proclaimed 2005 the year of microcredit in an attempt to globally promote the benefits and potential of the microfinance industry. In doing so, the UN acknowledged that, unlike top-down development initiatives such as debt forgiveness or international aid, microfinance stands out for its bottom-up approach. It emerges locally and enables micro-borrowers to improve their situation through their own efforts rather than relying on external development strategies. In their collectivity, micro-loans lead to large-scale economic improvements and foster growth in target countries. In 2006, Prof. Yunus and the Grameen Bank were awarded the Nobel Peace Prize for their “efforts to create economic and social development from below”. The Nobel committee honoured the contribution microcredit has made to the advance of democracy and human rights worldwide. (Deutsche Bank Research (December 2007).

Women make up the vast majority of borrowers, especially in Asia. Shares of female debtors are as high as 99%. The predominance of women reflects the fact that women are more reliable debtors because, due to stronger social and family ties, they often follow a more conservative investment strategy which in turn results in lower default rates for MFIs.

Models of Microfinance Lending

In contrast to commercial banks, micro-lending institutions usually refrain from taking collateral. Instead they follow a model called the Self Help Group Model or Group Lending Model. In this model an MFI lends a small loan to an individual, who belongs to a group of 5 to 20 people. As soon as the individual borrower proves reliable, credit is extended to additional people within the group. This procedure creates an incentive for the group to monitor each other's behavior and to ensure borrower discipline, as the group is jointly liable for the failure of any single member to repay her microloan. The average loan size starts from USD 100 and can reach several hundred dollars.

As the market matures, there are now MFIs that follow the individual lending model taking into account the fact that there are different products possible for different needs – such as urban settings and small businesses.

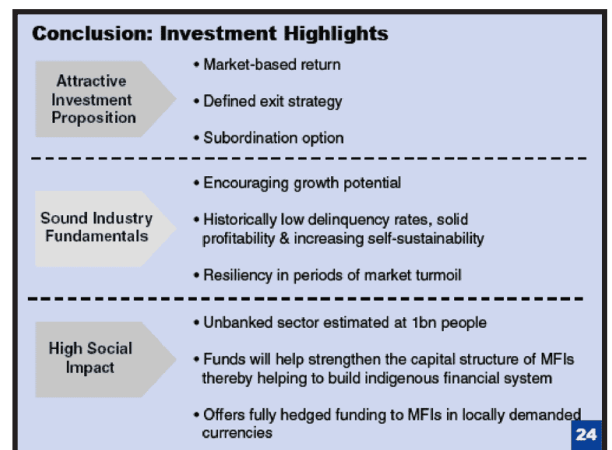
Future Growth

Despite the boost of the past decade or so, the further growth potential of the sector is huge. Deutsche Bank Research (December 2007) points out that although MFIs expanded their customer base in 2006 on average by around 23%¹⁸ the microfinance industry is still unable to meet more than a fraction of today's potential borrowers' demand. While MFIs currently serve an estimated 100 million micro-borrowers, the total potential demand is roughly estimated at 1 bn. This ratio illustrates the considerable unexplored growth potential. In geographic terms, the untapped demand is unevenly spread around the globe. The largest fraction of poor people is located in India (~310 m), Bangladesh (~70 m), Indonesia (~60 m), Nigeria (~45 m) and Brazil (~40 m). Assuming that national poverty rates are related to the portion of the population that already has access to microfinance services, penetration rates for different countries can be computed. While the penetration rate is the highest in Bangladesh at 35% it is as little as 2 to 3% in India, Brazil and Nigeria, i.e. in these countries only two to three persons out of a hundred are already served with microfinance while 97-98 people are potentially in need of it. To meet demand fully over the long run a total funding mix of debt, subordinated debt, equity, deposits and guarantees for MFIs of roughly USD 275 bn would be required. In the light of the current level of microfinance loans outstanding of around USD 25 bn, a funding gap of USD 250 bn results.

The increased demand of microfinance and the returns that the business offers has attracted a number of players into the segment. The key investors in the area of Microfinance now include:

- IFIs – KfW (German development bank), AECI-ICO (Agencia Espanola de Cooperacion Internacional and Institut de Credito Oficial), IFC (International Finance Corporation), The World Bank, EBRD (European Bank for Reconstruction and Development), OPIC (Overseas Private Investment Corporation) and 14 other IFIs who invested over USD 2.4 bn doubling their contribution in the past two years.
- On the other hand, a range of private investors made up of NGOs, individual donors, foundations, individual and institutional investors has evolved whose investments increased even more rapidly than those of IFIs, reaching an estimated USD 2 bn at year-end 2006. Among the largest vehicles, ProCredit is reported to have the largest loan portfolio of around EUR 757 m followed by the European Fund for Southeast Europe with EUR 245 m.
- A third category is that of the commercial banks that have become increasingly involved in microfinance mainly in four different ways. First, some banks directly grant microloans to the poor. Second, other banks such as Citibank or ICICI provide funding to MFIs. Third, banks distribute microfinance investment vehicles, e.g. Credit Suisse offers the Responsibility Global Microfinance Fund and Deutsche Bank distributes db Microfinance- Invest Nr. 1. Lastly, some banks such as ICICI, Deutsche Bank or Citibank have also been active in the securitisation of MFIs' loan portfolios. (Deutsche Bank Research (December 2007))

Although the industry appears to have worked well to date, growth of the sector also begs the questions over regulation for which there is currently no responsible agency. A report commissioned by the Swiss Agency for Development and Co-operation (SDC), CARE and the Ford Foundation called for greater transparency, more training for local partners and diversification of services. It remains to be seen whether this takes the form of an industry generated code of conduct or whether the governments will bring in formal regulation.



Source: Deutsche Bank Research (December 2007)

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WorldGSM™ is a complete solar powered GSM system entirely optimized for rural markets.

For the first time, operators can build profitable businesses serving low-ARPU users in difficult to reach communities.

The microtelecom revolution is ready to begin and VNL is leading the charge.

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