Microfinancing: challenges and prospects. Appropriate conditions for changes from informal to formal microfinancing institutions

Mikrofinancování: výzva a prosperita. Vhodné podmínky pro transformaci neformálních mikrofinančních institucí na formální

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Abstract: "The International Year of Microcredit 2005 underscores the importance of microfinance as an integral part of our collective effort to meet the Millennium Development Goals. Sustainable access to microfinance helps to alleviate poverty by generating income..." (Kofi Anan). One of the important factors which influence disbursement of public debts in the LDCs are Microfinancing institutions. The article characterizes the progress of discharge of bankrupt from the macroeconomic point of view, and in the situation for microfinancing industry. One of the main question is when and under what conditions it is the suitable to accelerate the transformation of informal MFIs to formal institutions. In the conclusion, the basic conditions and hypothesis, which are necessary for functioning of formal MFIs, are mentioned.

Key words: microfinance, microfinance industry, risk mitigation, formal and informal MFIs, sustainability

Abstrakt: Rok 2005 byl Valným shromážděním OSN vyhlášen mezinárodním rokem kreditu. Tato skutečnost zdůrazňuje významnost mikrofinancí v kolektivním úsilí světového společenství splnit rozvojové cíle milénia přijaté Organizací spojených národů. Mikrofinanční aktivity pomáhají trvale zmírňovat chudobu a zvyšují příjmy obyvatelstva. Jedním z významných faktorů ovlivňující snižování veřejného dluhu méně rozvinutých zemí světa jsou mikrofinance. Článek vychází a charakterizuje vývoj oddlužení z makroekonomického hlediska i z pohledu mikrofinančních aktivit. Jednou z hlavních otázek je, kdy a za jakých podmínek je vhodné akcelerovat transformaci neformálních mikrofinančních institucí na formální instituce. V závěru článku jsou pro transformaci formulovány základní předpoklady a rámcové podmínky.

Klíčová slova: mikrofinance, zmírnění rizika, formální a neformální mikrofinanční instituce, trvale udržitelný rozvoj

Poverty is mainly connected to historical development and its relation to the environment. The cardinal factor, which causes rural poverty, is the ineffective or unsuitable utilization of natural and other resources, the historical and cultural background, social shortcomings, etc. It can overcome by through an international aid. It is mainly to do with scarcity of resources:

- Natural resources – water, biodiversity, etc.
- Human resources – education and training, skills, health, etc.
- On-farm resources – livestock, arable land, pasture, structures, facilities, own financial resources, etc.
- Off-farm resources – foreign material and *financial capital.*
- Community-owned resources – public infrastructure.
- Social and political capital – state influence, private sector and market influences.

All problems of poverty have some features or characteristics (education, agriculture, environment, social security, health service etc.) in common. It could be, for example, political scene, social initiative, financial guaranty and etc. The financial resources which are provided through the activities of microfinancing, it is the theme of this article.

We have some of basic view of financial evidence that determines the solution to situation in LDCs. For simplification, there are presented two main situations (Robinson 2000):

1. Macrofinances – debts in excess in the LDCs, these countries are not able to solve the situation by themselves (it is not the problem only of developing countries and the ethic problem of developed countries). But it is the issue of the developing world intercommunity in the future
2. Microfinances – 70% inhabitants of these countries has the daily income less than $2

MACROFINANCES

External debt has significantly affected and continues to affect the efforts aimed and the relief at the poverty-reduction and economic growth. A large proportion of the external debt of poor countries is currently considered as sustainable. So it makes sense to consider further significant reduction or to cancel such obligations completely. In the past, creditor governments and multilateral financial institutions were more inclined to pursue a gradualist approach.

Macrofinance – debt disbursements
(the World Bank, the International Monetary Fund and the Paris Club of the Creditors)

The international forum for defining aid is the OESD's Development Assistance Committee (DAC). In 2000–2005, the DAC members provide more than 95% of international aid. They provide two categories of aid:

– Official development assistance (ODA)
– Official aid or debt relief (OA, DR)

The main coordinators of international help for LDCs are the WBG and the IMF

There are areas of cooperation between the WB and the IMF, e.g.:

– The Heavily Indebted Poor Countries (HIPC) Initiative
– Poverty Reduction Strategy Paper (PRSP)
– Multilateral Debt Relief Initiative (MDRI)
– Trade Issues and etc.

Implementation of the MDRI will require an action by the Executive Board and the contributors to the Subsidy Account PRGF Trust. To be in the position to deliver debt relief under the MDRI by the beginning of 2006 will require the early adoption of number of decisions by the Board. It will also require the timely consent by all contributors to the Subsidy Account of the PRGF. Trust to the amendment of the PRGF Trust Instrument that would allow the transfer of a portion of their resources to a new administered account for the use in providing the MDRI debt relief to the HIPCs with incomes above the MDRI threshold

The financial structure for the MDRI would build on that already existing for the provision of assistance under the HIPC Initiative. However, the modalities contemplated would entail the reallocation of certain PRGF Trust resources and the accelerated delivery of the HIPC debt relief resources.

Previous history

The IMF and the WB together with the Paris Club creditors systematically solve the high insolvency (passive balance) of LDCs from the end of the eighties of the last century (Table 2.). The individual stages are known under the local names, where the agreements about the passive balance had been settled.

– **Toronto terms** (reduction of the foreign debts – 33.33%)
– **London terms** 1991 (reduction of the foreign debts – 50%)
– **Naples terms** 1994(reduction of the foreign debts – 67%)

Stock treatments may be implemented, on the case-by-case bases, for countries having established a satisfactory track record with the Paris Club and the IMF. One of the results was the base for Lyon terms.

– **Lyon terms.** In 1996, the Paris Club creditors' countries, in the framework of the initiative **HIPC** (Heavily Indebted Poor Countries – initiative) accepted to rise the level of cancellation up to 80% for the poorest countries with the multilateral institutions.
  – For the poorest, the level of cancellation is at least 50% and can be raised to 67%. Creditors agreed in September 1999 that the Naples terms treatments would carry a 67% debt reduction
  – Stock treatments may be implemented, on case-by-case bases, for countries having established a satisfactory track record with the Paris Club and IMF
– **Cologne terms.** 1999 **(**reduce international debt – 90%).

The Executive Board endorsed the implementation modalities for the initiative on November 7, 2005, and adopted the requisite decisions to implement it on November 23, 2005.

The decisions on the framework for the MDRI will become effective if the 43 members who contributed to the Trust Subsidy Account of the Poverty Reduction and Growth Facility (PRGF) consent, because the debt relief under the MDRI will be financed in part with the resources transferred from the account.

At the end of 2005, only 20 countries currently are eligible for the MDRI. Other HIPCs will be qualified for MDRI debt relief once they reach the completion point under the HIPC Initiative (Table 1.).

The target date to start the implementation of the MDRI is January 3, 2006.

The data presented here are the most widely-used, official-source development data from the World Bank and other international agencies.

MICROFINANCING – ONE OF THE MAIN FACTORS INFLUENCING THE SUCCESSFULNESS OF DEBT CLEARING

Almost one half of inhabitants in the world have \$2 daily income and half of that has only \$1. In Sub-Saharan Africa (SSA), the situation is worse than the world average. More than ¾ of inhabitants has income lower than \$2 per day and 65% of that is under 65% (Binger A) according to the HID.

Human Development Index (HDI) is very prevalent index among the economists. The HDI is a summary

Table 1. Implementation status of HIPC as of end August 2005 – countries at complement point

Countries at completion point			Countries at decision point		Remaining countries	Countries with sustainable debt
Country	decision point date	completion point date	country	decision point date		
Benin	July 2000	April 2003	Burundi	Aug 2005	Burma	Angola
Bolivia	Feb 2000	Jun 2001	Cameroon	Oct 2000	Burundi	Kenya
Burkina F.	July 2000	April 2002	Chad	May 2001	CAR	Vietnam
Ethiopia	Nov 2001	April 2004	DRC	July 2003	Comoros	Yemen
Ghana	Feb 2002	July 2004	Gambia	Dec 2000	R. Congo	
Guyana	Nov 2000	Dec 2003	Guinea	Dec 2000	Ivory Coast	
Honduras	July 2000	April 2005	G. Bissau	Dec 2000	Laos	
Mali	Sept 2000	Feb 2003	Malawi	Dec 2000	Liberia	
Mauritania	Feb 2000	Jun 2002	Sao Tome	Dec 2000	Somalia	
Madagascar	Dec 2000	Oct 2004	S. Leone	Mar 2002	Sudan	
Mozambique	April 2000	Sept 2001			Togo	
Nicaragua	Dec 2002	Jan 2004				
Niger	Dec 2000	April 2004				
Rwanda	Dec 2000	April 2005				
Senegal	June 2000	April 2004				
Tanzania	April 2000	Nov 2001				
Uganda	Feb 2000	May 2000				
Zambia	Dec 2000	April 2005				

Sources: World Bank, Database 2004

Table 2. External Public Debt of Developing Countries, in billion US$

Debt	1970	1980	1990	1995	1996	1997	1998	1999	2000	2001	2002
Multilateral	8	61	242	356	345	353	420	424	410	402	409
Bilateral	26	127	397	566	543	529	527	533	512	5O5	508
Private	14	189	510	588	569	609	676	665	669	672	680
Total	48	377	1 149	1 510	1 457	1 490	1 623	1 622	1 591	1579	1 597

Source: World Bank, Datastatistics 2004

composite index that measures a country's average achievements in three basic aspects of human development: longevity, knowledge, and a decent standard of living. Longevity is measured by life expectancy at birth; knowledge is measured by the combination of the adult literacy rate and the combined primary, secondary, and tertiary gross enrolment ratio; and the standard of living by GDP per capita (in purchasing power parity PPP USD).

Many factors have influence on the successful discharge on bankrupt (cut public debts in to sustainable net present value of the debt) in LDCs. One of the most important factors activate 2 milliard inhabitants, just mentioned. It deals mainly with rural inhabitants without the access to standard financial institutions. Their financial resources are usually the resources of the MFIs. Economic specialists sometimes are not able to estimate correctly the effectiveness of activity of MFIs on economy of LDCs. Economic specialists overestimate or underestimate.

Microfinance is the supply of loans, savings, and other basic financial **services to the poor.** People living in poverty, like everyone else, need a diverse range of financial instruments to run their businesses, build assets, stabilize consumption, and shield themselves against risks. Financial services needed by the poor include working capital loans, consumer credit, and savings, pensions, insurance, and money transfer services (Haning 1999).

Microcredit generally means:
– Small size loans;
– Shorter repayment periods;
– Flexible and easy to understand regulations and needs;
– Small scale activities based on local conditions and needs;
– Clients are small entrepreneurs and low-income households;
– Loans used to generate income, develop enterprises and used by the community for social services such as health and education (Bliss S.).

Key principle of microfinance:
– The poor need variety of financial services, not just loans (but also savings, transfers, insurance etc.).
– Microfinance is a poverty instrument against poverty (access to sustainable financial services – increase income, build assets, reduce vulnerability, better nutrition, health, education etc.).
– Microfinance means building financial system that serves the poor (microfinance should become an integral part of the financial sector).
– Financial sustainability is necessary to reach a significant numbers of poor people (sustainability is the ability of microfinance provider to cover all of its costs and the ongoing provision of financial services to the poor).
– Microfinance is about building permanent local financial institutions (building financial systems for the poor means building sound domestic financial intermediaries that can provide services to poor people on a permanent base).
– Interest rate ceilings can damage poor people's access to final services (it costs much more to make many small loans than a few large loans; when governments regulate interest rates, they usually set at the levels too low to permit sustainable micro credit; at the same time, microlenders should not pass on operational inefficiencies to clients in the from of prices – interest rates and other fees – that are far higher than they need to be).
– The government's role is an enabler, not as a direct provider of financial services.(National governments play an important role in setting a supportive policy environment that stimulates the development of financial services while protecting poor people's savings; governments can also support financial services for the poor by improving the business environment entrepreneurs, clamping down on corruption, and improving access to markets and infrastructure).
– Donor subsidies should complement, not compete with private sector capital; (donors should use appropriate grant, loan, and equity instruments on a temporary basis to build the institutional providers, to develop supporting infrastructure, and to support experimental services and products; to be effective, donor funding must seek to integrate financial services for the poor into local financial market).
– The lack of institutional and human capacity is the key constraint.
– The importance of financial and outreach transparency (accurate, standardized and comparable information on the financial and social institutions providing services to the poor is imperative; bank supervisors and regulators, donors, investors, and more importantly, the poor who are clients of microfinance need this information to adequately assess risk and returns).

The microfinance gives new questions

In the recent years (2000–2005), we can see some serious problems in the field of microfinancing activities. Loans were made by international aid institutions and commercial banks to namely formal MFIs in dollars, and were distributed to local borrowers in local currencies. Of course that major part of stakeholders wants to refund their financial resources in the term of payment. It is influenced by the cut in the course of dollar to other world courses. By the cutting in the course of the local currency, eventually pegging currencies (West and middle Africa) the "little" debtors are not able to square up the debts and owing to commercial banks cannot meet the liabilities without using of backup facility.

Another situation is at the voluntaristic informal MFIs. Their financial activities are based on own system of money accumulation. The priority interest leans on active help of the members MFI and on the small, usually family entrepreneurial business. It is for example: MFIs namely ROSCA, ASCRA, SFGA and others (Bauman 2001). These organizations operate outside the financial system of that country. They do not have tax liability, do not keep up the external control. Here there seems to be another risk, if they have a money access to the membership base. If the type NGOs is the guidance type, the members of the informal MFIs are not exposed to the great risk. That situation is considered as temporal, with the possibility to change its character on formal organization, as for example village banking. In the case that the financial resources are coming from external resources or forestaller, the organizations MFIs are in danger. If the organizations MFIs are in insolvency, this forestaller will come and will confiscate its assets (lands, cattle…). Here we cannot speak about the increase of indebtedness, which is immediately visible, but it will decrease the living standard. The indebtedness of the state will show secondarily, in a more complicated form. It could lead to rural convulsion.

There are various types and division of the MFIs, for example according to Professor Keller:

– **Credit Projects** (credit projects are implemented by a supporting organization by state development agency or NGO**).**
– **Credit Unions** (Credit unions are owned and controlled by their members and function according to democratic rules).
– **Village Banks** (Village banks are semi-formal, member based institutions that are promoted by international NGOs – e.g. FINCA).
– **Solidarity Members Groups** (There are differences between individual lending and solidarity group lending. The majority are rural MFIs, such as Grameen Bank).
– **Linkage types** (This alternative retail group-based model builds on pre-existing informal self-help groups (SHG), such as SFGAs, ROSCAs, and ASCRAs etc.)
– **Microbanks** (represent a wide array of institutions. They differ from commercial banks in two aspects: First they acknowledge and wish to serve the demand for financial services for micro and small-scale enterprises on a high level and second they use collateral substitutes and others financial instruments just like other MFIs).
– **Contact Farming** (in so-called bottleneck markets**,** agribusiness firms play a viable role in rural finance and technology transfer through contract farming).
– Downscaling commercial Banks, Microbanks for whole-sale traders, agro-processors and larger farmers, etc.

If we speak about the efficiency of MFIs, it is necessary to reason out that two main groups exist: formal MFIs and informal MFIs. Presently, the trend is to transform informal to formal MFIs. Both groups have its foundation.

– Informal MFIs are the contribution mainly for very poor and solitude region LDCs. The financial system does not function here because its function is nonconformist to the economic background of that region.
– The contribution of MFIs is also the function of nonformal initiatives and nonformal NGOs. Their activity is invocated by the necessity to survive or enthusiasm, the sense of responsibility etc.

Formal MFIs. Along the growth and evolution of MFIs, formal financial institutions are becoming increasingly involved in microfinance operations. These developments have led to the view that a strategy for developing microfinance, including a regulatory and monitoring framework, has to be an integral part of the financial sector strategy rather than being in isolation. Formal MFIs have also its importance, mainly:

– Microfinance is an integral part of the financial system. Microfinance has become more mature and dynamic, offering a wider range of financial services such as loans, savings, insurance and remittances for poor and low-income people. It is increasingly diverse in its organizational types and their associated objectives, methodologies, products, target groups and scales of operation.
– If it is an integral part of financial systems, Microfinancing industry has to be managed expertly and has to be compatible with the tax system.
– Microfinance sustainability. Sustaining the provision of microfinance services is an important goal of

any microfinance operation. There is an important issue for many MFIs, as reliance on subsidies and donor funding may not continue indefinitely. The key questions relate to the balance between the financial sustainability of MFIs and their social goals. Financial sustainability is the base for poverty eradication relief (starting point to go to profitability as in commercial operations).The extent of financial sustainability and profitability, in turn, depends on the cost and price structure of financial products and services, which are determined in the MFI's social goals. Subsidization is important but not leads to financial sustainability.

– With sustainability, there is connected mitigation of risk. It is not simple to give an answer how to minimalize risk. For each group of MFIs it has its own conclusion. For formal ones, these rules are valid:
  – Risk Avoidance. To realize the financial operations with the domination of US dollar is not the right way. There are two possibilities, one of them is the diversification of international currency and the other is the use of local currency. Anyway, it is necessary to use also other financial instruments (insurance and the system of security etc.).
  – Off-Setting Risk. For example long hedging, potential risk result from currency devaluation to reimburse business in the capital market of that country or higher fees etc.
  – Risk Diversification. It means the diversification of allocation resources, in general. Financially, resources from international funds from developed countries we have to divide according to the level of the particular countries of the world (West Africa, East Africa etc.).
  – Consultant Service and Advisory. It is not possible to spread the financial resources and only to supervise. There is necessary the active special approach.
  – Liberalization of political atmosphere. The possibilities of creation the risk environment we have to moderate by the help of international activity. It is a whole complex of problems of developing countries.
  – Historical Background. To give support to the traditional approach and the structure of country, and to implement modern technology in a suitable way, the principles (above) are not valid for formal MFIs .
– Microfinance and commercialization. Commercialization is a practical solution to the problems of limited sustainability and outreach. The commercial principle in their microfinance activities responds to concern the lack of accountability and transparency for which MFIs have often been criticized. These issues are partly attributed to the fact that MFIs often have no owners whose capital is at a risk. Commercialization requires the establishment of performance partly steady-standard relating to the portfolio quality, efficiency, sustainability and outreach (for the poorest of the poor, MFIs may establish special ways because lot of cases need specific access).
– Many others arguments exist and take the part with the pressure not to carry over MFIs on formal form.

There are many organizations whose objectives are to speed up the transformation, for example:

UNITUS. Unitus is a global microfinance accelerator that acts as a social venture capital investor for the microfinance industry. Unitus identifies the highest-potential microfinance institutions (MFIs) in developing countries and helps to accelerate their growth by capital investments and capacity-building consulting, thus empowering them to help the poor people worldwide. In doing so, Unitus aims to demonstrate that MFIs can be run as profitable, large scale poverty-focused business with links to local capital markets. As of September 2005, Unitus had seven MFI partners, worldwide serving more then 475 000 poor clients. Based in Redmond, Washington, USA, and with an office in Bangalore, India, Unitus relies on innovative financial instruments, and the financial resources of the like-minded individuals and foundations, to fulfill its mission (UNITUS 2005).

CGAP. Consultative Group to Assist the Poor is a consortium of 29 public and private development agencies working together to expand the access to financial services for the poor in developing countries. CGAP was created by these aid agencies and industry leaders to help create permanent financial services for the poor on the large scale (often referred to as microfinance). CGAP serves four group of clients (UNITUS 2005):
1. Development agencies;
2. Financial institutions – including MFIs;
3. Governments policymakers and regulators;
4. Others services providers, such as auditors and rating agencies.

These four groups are the architect vibrant microfinance sector, as it is being integrated into the formal financial system of all countries. To each of these client groups, the CGAP provides specialized services-advisory services, training, research and development, consensus building on standards, and information dissemination.

The main issue of this article is to show how non-formal MFIs conditions have to be fulfilled and what prerequisites has to have the economic environment for the successful and efficient transformation of the MFI into a formal form. The answer is included in the conclusion.

CONCLUSION

Critical triangle – environment of the MFIs activity

MFIs are active mainly in poor and vast regions, for that reason they have an influence on the environment. Microfinancing activities can be and are in the Critical Triangle and the contemporary characteristic for SSE. Its activity has not the characteristic of SE (Figure 1).

Steady-state economics (SSE) or standard economics (SE)

Economics, whith stocks of artifacts and people, are static, only the quality of those stocks is rising. People die and artifacts depreciate and births must replace deaths and production must replace depreciation – SSE or Economic which growth is held to be the cure for poverty, unemployment, dept repayment, inflation, balance of payment deficits, pollution, depletion, the population explosion, crime, divorce and drug addition – SE (Johnson 1998)?

Researchers have focused a considerable attention on analyzing, both theoretically and empirically, **poverty-agriculture-environment** interactions on an aggregate scale, typically for the selected dyads of the **critical triangle** (UNDP 2003).

Zeller's triangle – outer effectiveness of the MFIs

(Potential synergies among three objectives of microfinance policy)

The triangle of microfinance reflects three objectives of the **financial sustainability**, **outreach and welfare impact.** MFIs attempt to contribute to these objectives but many problems put one particular objective over other two (Zeller, Meyer 2002). Donors, governments, and other social investors differ in their relative emphasis on the three objectives (Figure 2):

– Some MFIs produce large impacts (especially if financial services are coupled with non-financing services).
– Others are highly financially sustainable (but they may have a high cost efficiency in reducing poverty).
– Welfare impact (it is the objective result for poor rural country, economy LDCs).

As you see, the optimal path-trend has to be trade-offs between impact, outreach and sustainability. There are also potential synergies among the three objectives of microfinance policy (Zeller, Meyer 2002).

PLS triangle – intra sound proportion MFIs

The prices of bank products and services are very important to ensure their profitability, solvency and liquidity to MFIs and to other finance intermediates (Figure 3).

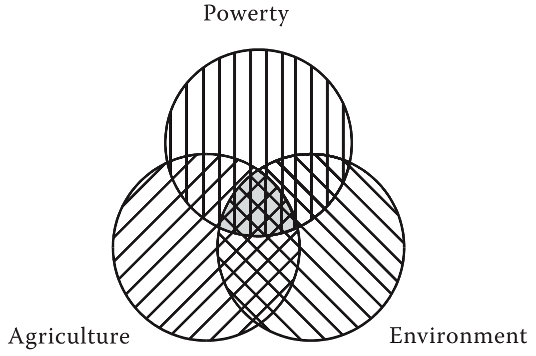

Figure 1. Critical triangel – encironmental of the activity MFIs

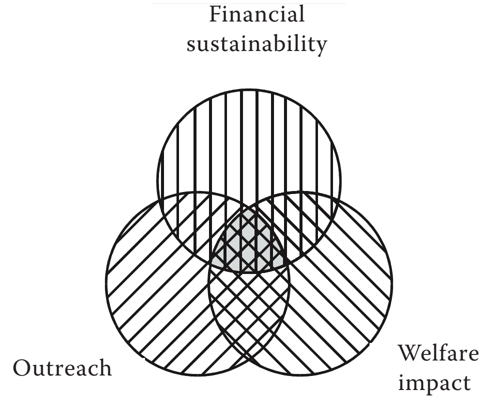

Figure 2. Zellers triangle – outer effectivness MFI

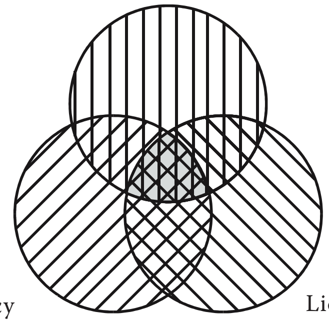

Figure 3. PLS triangle –intra sound proporcion MFIs

– **Profitability** – the realized desired profit; 'Return on Assets' is the key ratio of profitability, indicating how efficiently financial institutions are employed. 'Return of Equity' is a net income divided by total equity – it is a profitability ratio measuring how well the equity capital is used. Both ratios are the basic indicators of the management of the money and resources;
– **Solvency** is an ability to pay, the capacity to meet future obligations from earnings or income. It is the ability to meet due debt service payments;
– **Liquidity** is an ability of an organization to meet its current financial obligations. In banking, adequate liquidity means being able to meet the needs of depositors wanting to withdraw funds.

A sound proportion among the profitability, solvency and liquidity is very important for managing of MFIs and the competitive advance. If MFIs is not able to comply to the requests of the triangle, than it is better to remain in the form of self-help groups.

These three trios which form the continuum of factors together. In the analysis, that continuum is unsubstitutable. If one of them is disappreciated, we can see it in the internal unstability of MFI or anywhere. On the other hand, if informal MFI are able to comply with the conditions of Critical Triangle and Zeller's Triangle and PLS Triangle, it could carry out the transformation to formal MFI institution. It is an indicator of healthy economic setting.

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