Small investment, great effect

Using microfinance to move out of poverty

The United Nations declared 2005 the year of microcredit. This was a call for easier access to financial services, particularly for the urban and rural poor. Microfinance is an effective tool for reducing poverty and a priority sector of German development cooperation.

Photo: Egbert

Microfinance institutions are especially designed for poor target groups.

The stark reality is that most people in the world still lack access to sustainable financial services, whether it is savings, credit, or insurance. The great challenge before us is to address the constraints that exclude people from full participation in the financial sector. Together, we can and must build inclusive financial sectors that help people improve their lives». (Kofi Annan, UN Secretary-General, 2003)

Many people in our partner countries neither have their own bank accounts nor are they able to take out loans, transfer money or insure their families against risks such as illness, accident or death. All too often, access to the financial services that are so central to sustainable development are either denied or made very difficult. Consequently, people frequently have no choice but to resort to local moneylenders charging usurious rates of interest or to use informal – and therefore insecure – ways of performing transactions such as payments.

The International Year of Microcredit, declared by the United Nations for 2005, spotlighted these inadequacies and emphasized the central role played by a healthy and stable financial sector in effectively reducing poverty in our partner countries. It aimed to provide ready and secure access to financial services for significantly more poor people in the future. Germany was supporting this United Nations initiative with many activities and events (see www.bmz.de/en/issues/Microcredit/index.html) .

What does microfinance mean to us today?

Microfinance includes the entire spectrum of financial services for broad sectors of the population, but particularly for the poor. It refers not only to small and micro loans, but also to savings products, insurance and money transfers. In short, microfinance means specialist financial institutions offering financial services to disadvantaged people at market conditions.

Conventional commercial banks often have little interest in offering microfinance services, since most poor people

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have no collateral such as property, land or other assets. At first glance, the poor therefore appear to be fundamentally uncreditworthy. In addition, the processing of the – mostly small – amounts that are deposited or withdrawn by the poor often ties up considerable (human) resources. These services are comparatively cost-intensive and are therefore perceived as significantly less profitable than transactions with large, established corporate or private clients. From the perspective of conventional banks, the structural characteristics of poor customer groups do not justify a substantial commitment to the microfinance sector.

However, international experience gained from what, by now, are several decades of microfinance promotion, paints a more varied picture. Many microfinance projects that have been successful have shown that the poor are indeed bankable. In addition, in recent years a wide range of efficient and professionally run microfinance institutions (MFIs), which provide financial services at reasonable cost, have become established in developing and transition countries. Cooperative, municipal, public and private microfinance institutions coexist successfully. These range from small village banks with a few hundred clients to large MFIs with countrywide branch networks. Some mobilize loan funds from local savings, while others use funds from the international donor community. Many also receive technical advice. Microfinance is now primarily understood as a question of appropriate financial institutions and not first and foremost as one of financial flows (to be mobilized externally). Furthermore, the distinction between what is still «just» a microfinance institution and what is a «proper» bank is becoming increasingly blurred.

Lessons learned from four decades of development cooperation

Put simply, the microfinance concept emerged and grew during the 1960s and 1970s from the failed efforts of many local and regional development banks to reach poor target groups. Support programmes run by state development banks were followed from the mid-1980s by the development of privately run MFIs of various types and with various objectives. From the beginning, the emphasis in these micro banks was on economic sustainability.

The main challenge in providing financial services to poorer target groups was not posed by the level of the interest rate, as had initially been assumed, but by the need to provide simple, unbureaucratic and reliable access to savings products, small (micro) loans, payment transaction services and so forth. Simple application procedures, low transaction costs and addressing the collateral problem using appropriate micro loan techniques, such as group credits or character loans, have become established worldwide as the ingredients of success for sustainable MFIs. In this respect, some experiences of traditional or newly founded savings and loan institutions in developing countries – such as the Grameen network that emerged in Bangladesh in the 1970s – provided reference points which were at least as valuable as knowledge from foreign advisors. While in the 1980s and 1990s the development of MFIs was very much at the heart of sectoral efforts in development cooperation, nowadays issues relating to the financial system, that is questions about the most effective interplay of the legislature, the executive and jurisdiction as well as the central banks and financial supervisory authorities with financial intermediaries and service providers, are coming to the fore. Modern projects therefore take a simultaneous multi-level approach in which, depending on the type of problem, the partner country carries out simultaneous and coordinated reform measures at different levels of interaction.

Photo: BMZ

Access to financial services can also mean access to education.

With its 1994 financial sector concept Germany is one of the countries that associated its support strategies with a financial system approach early on. The financial sector concept as updated in 2004 retains this focus (see box). It stipulates that individual projects should always be embedded in a sectoral policy approach directed towards the development of the overall financial system, and not just towards improved services for individual target groups.

Practice has shown that this approach is becoming increasingly important. Several donors have now responded to the internationally recognized positive experiences of Germany's financial sector promotion and are pushing strongly for the development of financial systems at many different levels. The Key Principles of Microfinance that were emphasized again by the G8 at their 2004 Sea Island Summit confirm the benefits of a financial system perspective and document the high level of performance achieved by German financial sector promotion (see box, p. 28).

A financial system approach requires a more extensive development cooperation toolkit. Innovative instruments such as

The BMZ «Financial System Development» sector strategy

The BMZ «Financial System Development» sector strategy, which was drawn up in 1994 and updated in 2004, is based on a multi-level approach. The underlying assumption is that any shortcomings that impede the effectiveness of financial systems are situated not only at the level of financial institutions, but also in their wider setting as well as at policy level. All these can impede the systems' effectiveness. It is possible to distinguish between the following levels of a financial system:

- The micro level, including financial institutions such as commercial or public banks, credit cooperatives, local financial institutions and NGOs active in financial services.
- The meso level, including financial sector institutions that offer services to financial institutions, such as training institutions, professional associations and refinancing and credit guarantee facilities.
- The macro level, including legislative bodies, the central bank, the banking supervisory authority and ministries whose political remits pertain to the financial sector.

This multi-level approach means that coordinated and complementary measures, adapted to the specific problem at hand, can be implemented at different levels of the system. However, it is crucial to assess the impact of each individual measure on the financial system as a whole.

refinancing guarantees and exchange rate hedges as well as local currency financing and regional funds play an increasingly important role alongside the traditional credit lines. These financing instruments are generally linked with training initiatives and advice aimed at institutional development and at strengthening partner organizations. Thus institution building has taken the place of channelling loans directly to specific target groups, which was the preferred method until the early 1990s.

Alongside the further development of instruments, targeted levels and players observed in Germany, a wealth of new initiatives has been launched at international level. Particularly noteworthy is the Consultative Group to Assist the Poor (CGAP), which was founded in 1995 and is now supported by 30 donors (see box). Within the framework of this consultative and coordinating body, participating organizations agree, under the umbrella of the World Bank, on fundamental issues relating to the development of microfinance. CGAP has significantly advanced the professionalization of microfinance by developing training materials and promoting quality standards.

German development cooperation contributions to this process have gained international recognition. The Microfinance Donor Peer Reviews have rated German development cooperation – represented by the KfW development bank and Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) – as displaying a high degree of effectiveness and professionalism in the preparation and implementation of microfinance projects. The reviews noted that the technical standards summarized in BMZ's sector strategy are exemplary on the world stage (BMZ: German Federal Ministry for Economic Cooperation and Development).

CGAP and international best practice

The key principles for microfinance were confirmed at the G8 Summit in Sea Island in June 2004. They had been developed by CGAP and were rendered operational as guiding principles, set within the framework of the Pink Book in December 2004. The objective is to raise awareness in the donor community of the principles of the sustainable development of financial systems, and thereby increase the effectiveness of donor involvement.

The key principles of microfinance are:

- Poor sectors of the population require a wide selection of financial products, not just loans.
- Microfinance is a very effective tool for reducing poverty.
- Microfinance means creating financial systems for the poor.
- Microfinance can be profitable; indeed, it must be profitable if much of the poor population is to be reached.
- Microfinance therefore means the creation of sustainable, demand-led local financial institutions.
- Microfinance is not a panacea.
- Interest rate ceilings make loan allocation more difficult and harm the poorer sectors of the population.
- Governments must facilitate the provision of financial services, without getting involved in their actual provision.
- Donor funds should supplement, not compete with, private capital.
- The lack of efficient microfinance institutions is the key bottleneck.
- Microfinance can be efficient if it is transparent and there are clear performance incentives.

For further information, see:
www.cgap.org/docs/donorguidelines.pdf

Principles, instruments and players in German development cooperation

The Federal Republic of Germany promotes the development and expansion of microfinance organizations through financial and technical cooperation. The extent of its involvement ranges from consultancy services and the provision of loan funds for existing microfinance institutions, to the establishment of new institutions and the holding of shares in microfinance institutions. German efforts aim to assist microfinance institutions effectively in achieving economic sustainability and technical autonomy and to enhance the legal and institutional conditions necessary for achieving this. Only sustainable microfinance institutions are able to make effective and lasting contributions to poverty reduction.

Support for the microfinance system is designed to be effective in the long term and is explicitly geared to be complementary to the development of the financial systems in partner countries by means of market forces. From a regulatory perspective, this means not interfering with the market, but using appropriate support to make the financial system more open and accessible for a whole range of potential users.

The following guiding principles apply:

- Strict orientation to demand;
- Responsibility rests with partner organizations;
- Promotion of competition and avoidance of market distortion;
- Partner-led process orientation;
- Activities are tailored to the specific setting, notably through differentiated approaches to institution building.

Support for the development of financial systems is one of the ten priority areas of action for poverty reduction established by the German Government's Program of Action 2015. Accordingly, the development of partner countries' national financial systems and of microfinance occupies an important place in Germany's development cooperation activities . The 2000 UN Millennium Declaration, the 2002 Monterrey and Johannesburg summits and the 2004 G8 Action Plan also sent out important development policy signals that emphasized the great significance of financial systems and microfinance for the Millennium Development Goals.

Within the framework set out in BMZ's «Financial System Development» sector strategy, the instruments, number and forms of cooperation between development cooperation players have grown steadily in recent years. BMZ's implementing organizations, such as the KfW development bank or the Deutsche Investitions- und Entwicklungsgesellschaft (DEG) grant loans with favourable terms to financial intermediaries and,

Photo: BMZ

in addition, raise further funds on capital markets in order to pass these on to MFIs. Together with the European Bank for Reconstruction and Development (EBRD) and other donors, KfW (on behalf of BMZ) supports the development of microfinance banks and provides related consulting services in many transition countries.
GTZ supports the development and expansion of microfinance institutions. Within the framework of financial sector reform measures, GTZ advises, among others, central banks and ministries and also supports, together with other donors, the creation of a (legal) framework for professionalization of microfinance institutions. In the recent past, sector-wide training programmes, credit guarantee institutions, ratings agencies and credit information bureaux have become established as service providers to MFIs. These service providers, some of which are privately run, also benefit from GTZ support.
Besides KfW and GTZ, charitable foundations in the banking sector as well as the Sparkassenstiftung für Internationale Kooperation (Savings Banks Foundation for International Cooperation) and the Deutsche Genossenschafts- und Raiffeisenverband (DGRV) also support the German Federal Government in its efforts to contribute to global poverty reduction through microfinance. They make important contributions to adapting models of financial institutions that have been successful in Germany to the conditions in developing and transition countries. Innovative approaches in microfinance, such as Public Private Partnerships (PPPs), in which equity participation gets private investors involved in MFIs, create further opportunities for cooperation.

Effectiveness

Microfinance provides effective support for national poverty reduction strategies in achieving the Millennium Development Goals. Access to microfinance services enables poor and economically active people to:

- invest in new business activities, thereby increasing levels of employment and income,
- build financial assets gradually and keep some of their financial reserves in a profitable, secure and liquid way,
- compensate better for fluctuations in their income and expenditure and therefore cope more successfully with risks and emergencies.

Studies have shown that access to financial services makes a wide-ranging contribution to poverty reduction. Many people who have access to financial services use some of their additional income to pay for better nutrition and health care as well as to educate their children. Women in particular benefit from easier access to (micro) financial services, as these enable them to pursue entrepreneurial initiatives. The increasing economic independence that results from these activities enables them to gain greater recognition from their families and from society. Women are therefore often the largest customer group for MFIs.

The impact microfinance can have

The National Bank for Agriculture and Rural Development (NABARD) in India intends to extend financial services to a third of the rural poor by 2007 with the support of the German technical cooperation project «Linking savings and loans self-help groups to banks». In March 2005, the programme had already reached 1.4 million self-help groups (of which 90 percent were women's groups) and so benefited approximately 21 million families. The concept is simple: women organize themselves into self-help groups, save small amounts together, open a group savings account with a bank and distribute loans among themselves.
After six months, the bank decides if they are creditworthy, and the group then enters into a customer relationship with the bank. As a result, the entire group then has regular access to financial services.
Multi-year studies have shown that improved access to financial services has enabled women to:

- make significant improvements to their income and employment situations,
- stabilize cash flow,
- reduce dependence on moneylenders,
- improve their families' nutrition,
- fund additional expenditure on education and health and
- gain acknowledgement for the role they play within the family and within society.

Outlook

Microfinance is one of the most successful instruments for poverty reduction in developing and transition countries. Access to financial services such as savings, loans, payment transactions and insurance gives poor people the opportunity to make independent and lasting improvements to their living conditions. This is of central importance for achieving the Millennium Development Goals.
Support for sustainable microfinance has already had considerable success. Based on surveys of the Microcredit Summit Campaign, an initiative supported by US NGOs, the number of microfinance clients has increased steadily in recent years. Studies have shown that in 2004 approximately 60 million poor people gained lasting and secure access to financial services through MFIs. In addition, not least due to the effective and efficient coordination work done by CGAP, international standards and key principles for action have been established to guide microfinance and the development of financial systems.
Challenges lie ahead, particularly in increasing the outreach of sustainable microfinance. It is alarming that around 1 200 million people still live in absolute poverty worldwide. This indicates that, in many places, the microfinance sector is still in its infancy, especially in rural areas, where structural aspects have so far significantly delayed the development and expansion of viable MFIs.
In addition to developing a common understanding of sustainable financial sector support among all parties – that is, also among NGOs and donors working on the ground – an enabling environment must be created in our partner countries. This demands a much higher degree of coherence between poverty policy and financial sector policy. Furthermore, it requires a strengthening of the microfinance sector as part of the financial system in order to achieve sustainability, effective outreach and demand orientation. There is also a need for a legal environment that ensures effective investor protection. Further requirements include the integration of MFIs into international financial markets, and the increased involvement of private investors while also paying heed to fiscal and development policy objectives.
The task that we were set in the International Year of Microcredit will only be fulfilled when loan customers in our partner countries have full access to financial services, without market-distorting interest-rate subsidies. The story of microfinance promotion is far from over.