Microfinance: The Journey from Non-Profits to Major Financial Institutions

By Paulette L. Stenzel

Executive Briefing: The microfinance industry began through individuals and non-profit organizations that wanted to help the poor obtain loans for microenterprises. Today microfinance is a growing industry returning profits to investors and offering basic financial services to the poor. Since its inception, microfinance has expanded and matured in its global reach, legal structures, and product diversity. The sustainability of the industry illustrates that programs designed to promote social equity can evolve into viable business models.

Microfinance empowers the poor by lending them the capital they need to escape poorly paid, hard labor jobs, and continuing to meet their capital needs. The ongoing relationship between microfinance institutions and the poor demonstrates that microfinance is a sustainable, long-term solution to alleviating poverty. It enables the poor to increase their productivity and begin wealth creation. It continues to help borrowers by lending them greater amounts in accordance with their capital needs.

History of Microfinance

Microfinance can be traced to the early 1700s, when financial organizations began to extend small loans with short repayment periods to the rural poor. Credit unions, the predecessors to microfinance institutions (MFIs), were started in 1846 in Germany as cooperative credit organizations that helped local farmers purchase livestock, seeds, and equipment. However, the credit union’s reach was limited to developed countries, and hundreds of millions of people around the world continued to be excluded from the formal financial sector.

In 1974, Professor Muhammad Yunus visited the poverty struck village of Jobra, Bangladesh and lent twenty-seven dollars to forty-two basket weavers. Professor Yunus was so inspired by his experience that in 1983, in Bangladesh, he established one of the world’s first MFIs: the Grameen Bank. The bank had two mandates: (1) to empower the surrounding rural poor, particularly women, by providing them with access to credit; and (2) to maintain a sustainable operation. The Grameen Bank and Professor Yunus were awarded the Nobel Peace Prize in 2006 for “their efforts to create economic and social development from below.” The Grameen Bank has been highly successful in empowering the poor and sustaining itself. Thus, it has led to an expanding microfinance industry. ACCION International of Latin America, SEWA Bank of India, and Bank Rakyat of Indonesia have been influential in regional growth of microfinance. In 1992, ACCION helped establish PRODEM (Fondo Financiero Privado – Private Financial Fund) in Bolivia as a non-governmental organization (NGO). PRODEM became BancoSol, the first commercial MFI. Sustainable NGOs followed PRODEM by converting to for-profit businesses. To finance the increasing number of MFIs, microfinance investment funds (MFIFs) were created.

How Microfinance Operates

Microfinance is characterized by the lending of small sums of money over short periods of time to borrowers who have little or no physical collateral. Over the past two decades, microfinance has grown to provide a diverse array of financial services, including microcredit, microsavings, microinsurance, and handling of remittances. These financial services allow the poor to create and expand businesses, provide a safe and secure way to save money, preserve financial stability in times of crisis, and transfer money reliably.

Microfinance differs from conventional financial services in that its purpose is to serve the poor. The three billion-person market for microfinance is comprised of economically active entrepreneurs who have the capacity to repay small denomination loans but have been excluded from the traditional financial market. The fact that the poor do not have assets to offer as financial collateral was a barrier to lenders prior to the microfinance movement. The Grameen Bank overcame that obstacle by creating the notion of group lending. It loans money to groups of individuals who agree to be held jointly liable for any individual’s default on his or her own loan. Repayment rates to Grameen Bank are at 98%.

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eight percent. Group lending, designed for the poorest borrower, is a successful lending tool. In group lending, some borrowers use their loans more effectively than others to increase their wealth. To fulfill the needs of the more financially successful individuals, MFIs may provide individual loans. MFIs that engage in individual lending gather information on borrowers through home visits and character references. They monitor loans closely, require frequent repigrations, and usually require collateral.

When microfinance began, it was not seen as a profitable endeavor. It takes time for a fledgling non-profit MFI to develop into a profitable entity because its supply of capital is limited to the funds that NGOs and private donors make available. When an MFI becomes a commercial institution, its available capital depends significantly on its profitability. If investors view a MFI as a profitable investment, the MFI can gain access to greater capital and reach increasing numbers of poor people. Consistent profits earned by MFIs demonstrate the worthiness of investing in microfinance.

One hurdle faced by MFIs is that microfinance has not been considered an asset class for debt and equity investors, in part because investors say MFIs lack transparency. To increase transparency in the sector, the MicroFinance Transparency organization was established in 2008 by Muhammad Yunus and Chick Waterfield, a professor at Colombia University. It will publish the annual percentage rates and costs of loans issued by MFIs.

The Role of Microfinance in Today’s World Economy

In 2007, MFIs provided services to thirty-three million borrowers and forty-eight million savers. The vast market potential and profitability of the sector has already started to attract large-scale investors, including traditional commercial banks, private-equity shops, and pension funds. Simultaneously, microfinance investment managers are helping to bridge gaps between investors and MFIs. For example, BlueOrchard, a limited liability company based in Switzerland, works with over 120 MFIs around the world to help them connect with capital markets.

The increased availability of capital has led to industry growth rates of thirty to forty percent per year. In addition to high growth rates, the commercialization of the industry has given rise to the issue of appropriate fulfillment of a double bottom line: earning profits and helping people.

Modern microfinance is a sustainable method to alleviate poverty and promote economic development. MFIs started with and continue to operate through non-profit organizations, but their ranks have now extended to high-end financial institutions. These institutions work in partnership with the economically active poor, helping them to improve their lives and become active members of our economic system. ♦ gBR Article 03-08, Copyright © 2009.

Sources
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