Financing Micro-finance Programs

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Presented at the International Workshop on Microfinance in Poverty Reduction and the Challenges for MFIs in Vietnam, held in Ho Chi Minh City and organized by CEP Fund, HCMC, Vietnam during May 21-24, 2003.

Financing Micro-finance Programs:

Micro-finance programs are poverty focused programs that can be defined as a system of finance that provides credit and savings services to the very poor for generating self-employment and income. The role of micro-credit as a powerful tool for poverty reduction is now widely established and recognized. The global outreach of MFIs has increased from thousands two decades ago to about 60 million in 2002 with more than 30 million of these beneficiaries belonging to the poorest households. This is impressive but remains small compared to 1.2 billion poor in the world. Although the amount of funds circulating in the micro-finance industry has increased from a few million US dollars in the 1970s to billions in 2002, it is still far less than required. The sources of micro-finance funding, its transference to the poor, the need for diversification of funding sources and increase in funding amounts are issues addressed in this paper. It also incorporates Grameen Trust in this respect and the micro-credit situation in Vietnam.

Sources of Fund:

Historically speaking, micro-finance in some form or other has been in operation since time immemorial. The credit needs of the poor used to be met from different sources including moneylenders, if the poor could offer collateral. But the sources in many cases remained inaccessible and the system of poverty lending was exploitative in nature. With the advent of Grameen Bank and other such programs, micro-credit obtained an identity, a new meaning and a place in development literature and the banking world. It is collateral free credit exclusively for the poor to help overcome their lack of financial resources. As the concept became known, as the system became operational, and the impact became visible, many individuals and organizations found it attractive to address the problem of poverty with credit. While there has been no dearth of initiative in this regard, the paucity of funds for both operating and on-lending purposes has always worked as a limiting factor.

Stages in Micro-finance

Micro-finance programs and their need for funds can be considered in 3 stages of their growth: start up stage, scaling up stage and sustainable stage.

Start Up Stage:

The start up stage is very critical because this is the stage when one faces the real test of starting everything from scratch: identifying and organizing the poor, learning the techniques, raising funds, recruiting and training staff, providing credit, mobilizing savings, ensuring repayment, avoiding defaults, setting discipline and creating a foundation for growth. At this stage, the initial funding may come from the pocket of the one who is initiating the project, or from others as donation or equity. It may also come from organisational sources like donors, social investors, development foundations, and others as grants or soft loans. It may also come from saving deposits, after the program has been in operation for a while. Interest is also an important earning source for MFIs. But it can't be much at the beginning. It is very difficult for the starters to get funds from sources other than themselves unless a track record is established and legal requirements are fulfilled.

Starts up projects need a gestation period to grow. They have to pay for office space, stationary, staff, communications etc, as well as the most important task of organizing the poor and giving them small loans. It cannot meet all these obligations unless it has seed capital from its own and other sources. How much it can do depends on what amounts it can mobilize as seed money. How much it can earn as interest depends on what rate of interest it charges, what amount of loan it has as outstanding and what is the system of its interest payment. In any case it takes time to have sufficient income to cover all the costs. The gap between what it has to spend from day one and what it earns in course of its operation can't be filled overnight. There is the need for subsidy and subsidized funding during the initial years to carry on the operation. Up until now, donors have played a significant role in providing this funding. But as time has passed, their focus has shifted from start up to grown up projects and they have become more concerned about heath, education, environment etc. As a result, the start up projects are really in trouble and their rate of growth has been slowed down. How can this be turned around? How can these initiatives be saved and promoted? How can new initiatives like this be supported is a matter of concern for all those who believe in the great power of micro-credit as a tool for poverty alleviation.

The start up projects also face problems in mobilising funds for onlending purposes which is needed in increasing amounts. The equity they raise and the donations they may collect locally are far from adequate to support their existence and expansion. Their straggle to survive continues with maintaining almost 100% repayment rate and revolving the fund thus generated. If their little but significant efforts and achievements can be appreciated and supported, they can do much more in terms of outreach.

Some of them, however, accept saving deposits without knowing whether they can legally do it, and whether they can use it for on-lending purposes. Even if they can, the amount generated in the initial years as compulsory and voluntary savings may not be substantial to use as a loan fund.

The first generation of successful micro-credit organisations have enjoyed generous support from donors during their initial years. Some are still enjoying such support. But decreasing support has been found as discouraging for the growth of micro-credit industry.

Sealing up stage:

The projects that are doing well in terms of outreach, portfolio quality, cost recovery have the demonstrated capacity to do more and to scale up their operations. Ideally speaking, their demonstrated capacity should be treated as their ability to have easy access to commercial sources of funds. But practically this is not the case. It has remained as difficult as ever to leverage funds from commercial sources for their vertical and horizontal expansion.

Scaling up may be understood in both narrow and broad senses. In narrow sense it may initially be the scaling up of branch operations, and the going for institutional scaling up on a branch by branch level. Of course, this is predicated on achieving branch level viability. In the broad sense it may be scaling up of operations on a fast track approach. Operating a number of branches at a time, recruiting all the staff at the beginning and developing them as professionals to undertake the challenging task of maximising outreach and operating on sustainable basis. In the absence of a guarantee for the continued inflow of necessary funds for such an uphill task, it is always risky to go for such an ambitious plan. If it works, it is excellent! But if it does not work as planned because of shortage of funds, it is suicidal. Unless there is clear commitment available for the funds needed to be on fast track, it is wise to remain on single track and proceed branch by branch to avoid any crash due to lack of funds.

Scaling up funds may be generated from different sources for both operational and on-lending purposes. It may come from equity, grants, savings, social investors, apex institutions, whole sale funds, foundations, banks and other sources. The MFIs which are able to enjoy considerable amount of grant financing at this stage to cover both of their operating deficits and on-lending needs are in a better position to rapidly scale up their outreach and leverage greater funds from other sources. The possibility of mobilizing more funds at this stage mostly depends on the quality of performance. If the project is performing well, it can at least make a claim to a slice of the scarce financial resources. This in turn will help it perform better and thereby perhaps have access to commercial sources of funds. But given the legal status of MFIs, this is not as easy as is assumed.

Commercial banks do not consider MFIs their preferred clients. They ask for collateral or guarantee funds. They hesitate to consider funding MFIs because of the nature of legal status most NGO MFIs hold. They distrust MFIs because MFIs in general are not commercial in nature and not subject to regulation. As a result, most of the commercial bankers perceive micro-finance as risky and not fitting with their core business.

Evidence shows that whatever micro-finance lending came from commercial banks in different countries, it came mainly because it was required of them by their governments. Evidence also shows that whatever amount came from commercial banks came after lot of inquiries, conditions and inspections and in amounts smaller than the demand. This situation may be changed and improved if appropriate prudential regulations are made to remove the mismatch between commercial banks and MFIs. MFIs with good track records including capital adequacy ratios, asset quality indicators and less portfolio at risk should have easy access to commercial funds. In this connection the provision of quasi equity as an alternative to traditional equity financing to cover the deficits not financed by grants prior to the break even point and to provide early on-lending funds that can't yet be borrowed from banks may be considered. Commercial funding sources may gain confidence if quasi-equity will remain legally subordinate to any loans it has from the bank. It may be mentioned that while quasi-equity might be advantageous for MFIs, it might prove to be disadvantageous for providers, as it ties up funds for an indefinite period and restricts capacity to support other projects, which might have more potential.

There may be, however, two approaches in connection with having financing from commercial banks for MFIs. One is that MFIs should satisfy all the requirements of commercial banks and live up to the commercial banking standard. The other is setting independent MFI standards and creating a policy and regulatory environment that will require commercial banks to serve the financial requirements of MFIs. The time is ripe to give the second approach serious thought and take immediate appropriate steps for that. MFIs should have their own standards, language and culture, rules and procedures consistent with their special features of credit delivery and recovery, and their unique methods of saving generation and utilization.

Savings as a Source of Finance:

Savings can play a significant role in providing funds for MFIs. Its importance as a means of servicing clientele and as a source of mobilizing funds for on-lending capital is gradually increasing. Saving provides security, convenience, liquidity and returns to the poor savers if this is not locked in. But how far it will solve the problem of capital shortage of MFI will depend on how much saving can be generated by MFIs and at what price.

Savings may be generated both from within and outside. Savings from borrowers do not pose any threat to savers in case the MFI is facing difficulties. It is because their net borrowing is always larger than their total amount of savings. But savings from non-borrowers are always subject to different consideration. It is argued that saving should have a legal cover. Savers cannot afford to lose their money. If the MFI that is mobilizing savings is not doing well, becomes a losing concern or disappears what will happen to the hard-earned savings of the depositors, especially of those who are not borrowers? Hence the question of a regulatory environment becomes dominant while considering whether NGO MFIs, should be allowed to accept deposits and whether saving can play a major role in financing MFIs.

Appropriate Legal Framework

Right or wrong, MFIs in different countries are mobilising both compulsory and voluntary savings. There has not been as yet reported any major misappropriation of saving funds by any MFI. This does not mean that the vacuum in the regulatory regime for MFI savings should continue and the NGOs should remain in suspense. This is not desirable. There should be a clear cut policy decision on a regulatory framework to regularize NGO MFI savings so that they can develop their saving strategy and design campaigns that will allow them to diversify their saving products and maximize their funding from this source. They can even be encouraged to become micro-finance banks within specific legal framework specially designed for their establishment and growth.

Legal Status:

Currently MFIs operate under different institutional identities and structures such as NGOs, cooperatives, credit unions, trusts, foundations, non-bank financial institutions, banks etc. As there is no specific legal framework for MFIs they seek refuge under different forms of legal cover just to avoid the risk of being entangled in legal complications. If allowed or legalised, how can savings become a major source of finance for MFIs is demonstrated by the experiences of Grameen Bank. They now serve 2.4 million borrowers and meet 70% of its demand for on-lending funds from saving sources. Many of its branches have generated more savings than the amount of their loan outstanding!

An appropriate legal framework should be designed to guide the conversion of larger MFIs into Microfinance Banks. If placed in a well-defined structure and given clear requirements, MFIs can generate enough funds through savings to meet the increasing demand for their loan products. This will make them independent of donors. It will also allow start up and smaller MFIs to have access to more donor funds either directly or through national (like PKSF in Bangladesh, RMDC in Nepal and PCFC in the Philippines) or international (like Grameen Trust) wholesale funds. During the transitional phase, however, MFIs may be allowed to accept deposits on the basis of guarantee funds which may be provided by whole sale funds or others . If this can be made to happen it will work as a big push to the growth of micro-finance industry.

Sustainable stage:

This is the stage that each MFI aims to reach, or should aim at reaching. A sustainable operation is a precondition for maximizing the outreach and optimizing the impact on poverty reduction. And it is possible only when the MFI achieves financial self-sufficiency and the overall capacity to successfully face any unforeseen situation. To operate on a sustainable basis, a minimum scale of operation in terms of outreach, amount of loan outstanding, loan loss reserve, accumulated profits and saving balance is needed. Any MFI at this stage should be able to borrow as much funding as they need from commercial sources, which command vast financial resources. Their dependency on commercial sources at market rate of interest on borrowing may be lower if they are able to generate more savings and use this for on-lending purposes. This will cost them less and give them more spread, freedom and liquidity.

The sustainable stage may also create good will for MFI, attracting investors who prefer social investments to donations.

GT experience:

Grameen Trust is a global wholesale fund. It has a vision of poverty free world. Its mission is to fight poverty with credit as the instrument.

GT provides financial and technical assistance to organizations providing financial services to the poor following the Grameen Bank Approach. GT primarily supports start-up projects so that they can grow in outreach and scale up their operations to serve more poor people on a sustainable basis. Its support comes in the form of soft loans. It absorbs the shock of foreign exchange fluctuations and requires its partners only to be responsible for the amount of fund they receive in local currency.

GT has provided financial support to 115 organisations in 34 countries. GT encourages its partners to start small, establish themselves, and take up the challenges of expansion as they gain in experience and expertise.

GT funds come from bilateral and multilateral donors, private individuals and foundations. GT channels this fund to its partners on the basis of selection criteria it has developed for providing seed and scaling up support. GT performs this job professionally and cost-effectively. More than 89% of the fund it receives from different sources goes for seed and scaling up support including about 10% for capacity building. GT spends around 11% administering its Grameen Bank Replication Program.

GT has committed about 17 million to its partners who in turn have cumulatively disbursed more than US$450 million to its borrowers. The amount of their loan outstanding has grown from US$0.34 million in 1993 to US$ 82 m in February, 2003 as they have been able to efficiently leverage funds received from GT. They have also succeeded in mobilizing a significant amount of savings from their clients. From a small amount of savings in 1993, GT partners have mobilized around US$ 23.5 as savings upto February, 2003. Out of 115 organisations who received financial support from GT, 111 have received funds as seed capital amounting to US$10.50 million.

The number of organisations that have received scaling up funds from GT is now 46 including 4 that have directly received scaling up support and 42 that have received both seed and scaling-up support. The total amount committed by GT as scaling up funding to its partners is US$6.11 million.

There has been a steady increase in the number of members of GT partners. From only 18,000 members in 1993, GT partners now serve more than one million members (95% of them women) with SHARE, India serving about 162,000 members itself. The viability at the branch and institutional levels has given many GT partners access to commercial and other sources of fund.

Conclusion

Given the well-recognized role of micro-finance as a means of poverty alleviation, it is high time to have a clear road map for the development of the micro-finance industry. MFIs have the capacity to increase their outreach and to achieve sustainability. But they are missing this opportunity mainly because they have no guarantee of the availability of funds.

In order to optimally use their capacity, appropriate legal requirements, policies and strategies have to be worked out to support MFIs at different stages of their development. They need a clear-cut legal identity of their own as poverty focused financial institutions. The donor support, directly or indirectly through wholesale funds at the earlier stages of their development is very important for them to survive and to grow. In later stages, access to commercial sources and social investment funds will enable them to maximize their potential.

The MFIs should develop their own performance standards reflecting their efficiency and transparency. Their performance should stand as their guarantee for accessing commercial and other sources of funds, and accepting deposits. Once their legal status is made clear and their financing problem is taken care of at each stage of their development, they may significantly contribute to the achievement of the Millennium Development Goal of halving the number of poor people by the year 2015.