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Evolution of Microfinance as an Important Part of Global Financial System

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Abstract

Microfinance, as an important part of global financial system, has been a subject of great attention especially in the recent decades. This article examines the process of origin and development of modern microfinance industry, its historical context and evolution to the present stage, its impact on the socio-economic life of developing and emerging countries. The paper tries to answer the question: can today's microfinance be a real and affordable alternative of classical banking system for poor and low-income groups?

Keywords: Microfinance; Financial inclusion; Grameen bank; Group solidarity; Social responsibility; Commercialization; Low-income; Developing countries

Introduction

Modern microfinance, as provision of affordable financial services for the poor, has been successfully piloted and developed in emerging markets over the past 4 decades. It gained a vast experience of implementing efficient, competitive and long-term financial programs for poor communities with a positive socio-economic effect.

Microfinance is provision of financial services to low income and poor households, especially those who lack an adequate access to formal banking and related services. Its main mandate is to enhance financial inclusion at affordable conditions to the disadvantaged and low-income individuals or groups.

According to the Basel Committee on Banking Supervision, Microfinance is "provision of financial services in limited amounts to low-income persons and small, informal businesses. It is increasingly being offered by a variety of formal financial institutions, including banks and non-banks, either as their core business or part of a diversified portfolio"

Distinctive features of the microfinance business model can be described as follows: Microfinance Institution usually caters to low-income clients, both the underemployed and the entrepreneur with an often informal family business. Borrowers are typically concentrated in a limited geographic area, social segment or entrepreneurial undertaking. Loans are usually very small, short term and unsecured with more frequent repayments and higher interest rates than those of conventional banks [1].

The majority of microfinance consumers are poor, low-income and rural residents, most of which are self-employed in informal sector. This category of costumers are naturally characterized by high degree of vulnerability and dependence to external factors which can very easily lead to a sharp decline in the yield and productivity of their micro businesses, resulting in significant problems of creditworthiness and bankruptcy.

Thus, microfinance institutions are largely affected by specific internal or external risks, and proceeding from this, they constantly need to be more innovative, creative and flexible in the market in order to adequately and effectively respond to global or local challenges and offer competitive financial services, ensure stable income-generating activities for their customers and sustainability of their businesses.

Unlike traditional approaches of managing private business, where the primary goal is profit maximization and satisfying the owners' material interests, classical microfinance has the "Double Bottom Line" approach implying that it must have both - financial as well as social objectives [2].

From early XXI we already have a number of "Triple Bottom Line" Microfinance Institutions integrating financial, social and environmental objectives in their long-term business strategies.

Emergence of Microfinance

Microfinance, as part of the financial intermediation, has paved a long way from its initial stage to the modern business model. Its primary forms have been existed in many countries as an effective and reliable alternative of other existing lending practices.

Formal or semi-formal credit and saving groups that effectively collected small funds and then lend it to other members have been around since ancient times across the world (ROSCAs, ASCAs, Self-Help Groups).

From the oldest forms of self-organized financial groups worldwide most notable are "Chit funds" in India, "Gui" in China, "Arisan" in Indonesia, "Paluwagan" in the Philippines, "Tontines" in West Africa.In the Middle Ages the number of pawn shops was rapidly increasing in some European Countries (Especially in Italy), which significantly diminish other financial intermediaries and became a viable alternative for small borrowers.

In 1515 Pope Leon X authorized pawn shops to officially charge interest on their loans, which was prohibited before for religious reasons. The Catholic Church supported foundation of pawn shops as an alternative to usurious moneylenders. After this, the pawn shops spread throughout the urban areas in Europe and expanded later in colonial countries.

One of the most well organized forms of oldest formal microfinance institution was the "Irish Loan Fund" system, initiated in XVIII by Jonathan Swift, the dean and author of Gulliver's Travels. Swift believed that poor people who didn't have enough collateral were still worthy to receive a loan [3].

The "Loan Fund" program became a growing trend in Ireland, resulting in the development of up to 300 micro-lending institutions which provided small and non-collateral loans to poor and low income small farmers in order to help them sustain and create self-employment and growth potential.

In the beginning of XIX, Europe saw the emergence of larger and more formal savings and credit institutions that focused primarily on the rural and urban poor. The strong and effective financial cooperative system was developed in Germany (Raiffeisen, Volksbanken, Sparkassen). It aimed to help the rural population break from their dependence on moneylenders and to improve their welfare.

The similar movement emerged in France in 1865 and Quebec in 1900. Many modern financial cooperatives in Africa, Latin America and Asia find their roots in this European movement. Another early example is the Indonesian People's Credit Banks (BPRs) that opened in 1895 and became the largest microfinance system in Indonesia [4].

After World War II, many countries initiated development finance programs with subsidized credit resources to specific target groups (smallholders, rural, low-income). But majority of these programs failed. 1976 can be stated as a beginning of "modern" microfinance era, when the "Grameen Banking" approach was developed in Bangladesh. Its basic principle is that poor are also bankable and microfinance is financially viable.

The Grameen model was initiated by a Bangladeshi social entrepreneur and banker - Muhammad Yunus. The model was totally based on group solidarity principles: every member of a group guarantees the repayment of other member.

In 2006 Yunus and the Grameen Bank were jointly awarded the Nobel Peace Prize for their "efforts through microcredit to create economic and social development from below". Many countries and institutions followed Grameen's group solidarity approach and developed similar or different microfinance business models (FINCA, Bank Rakyat, Accion).

Beginning of the 90s is the next hallmark in the history of modern microfinance. For the first time ever, a microfinance NGO has been transformed into a commercial bank and allowed to take deposits from public (Bankosol in Bolivia, 1992).

From late 90th many other microfinance NGOs followed this path of transformation. The same period also characterized by downscaling of commercial banks and their active penetration in microfinance market.

The next important stage in microfinance industry was the year 2007 - the first and very successful initial public offering by Banco Compartamos, Mexico. The IPO of the stock was 13 times oversubscribed and raised $467 million in total.

Similarly successful was another public offering by Indian Microfinance Bank (SKS) in 2010, whose share price increased 4 times and attracted more than $100 million. Along with the commercialization and transformation, some other interesting changes were also developed in microfinance during a recent decade, including technology and product innovation.

One of the good example is emerging of mobile banking system in Kenia (M-PESA) which was totally focused on microfinance clients and rural costumers.

It should also be emphasized that in parallel of such successful growth and attractive financial performance, the direction of social responsibility has been weakened and original fundamental values of microfinance have been significantly diminished.

Microfinance Today

An Innovative and flexible business model; principles of group solidarity to guarantee a loan repayment; effective mechanisms of client selection and simple lending procedures successfully replaced a conservative approach of traditional commercial banks (collateral requirements, formal and bureaucratic procedures, traditional "bank-borrower" distance) and provided microfinance institutions with a strong competitive advantage.

After commercialization from 2000th, today's microfinance sector positioning itself more as an integral part of a profit-oriented financial market rather than effective instrument of combating poverty. According to the World Bank, more than two billion poor and low-income people in developing countries still do not have adequate access to affordable financial services.

In 2004 Key Principles of Microfinance were developed by the Consultative Group to Assist the Poor (CGAP) and endorsed by the G8 at June 2004 Summit in Sea Island, Georgia, USA, as part of their commitment to expanding the access of microfinance [5].

These 11 key Principles listed below address how sustainable microfinance can be a powerful instrument against poverty:

- The poor need a variety of financial services, not just loans.
- Microfinance is a powerful instrument against poverty
- Microfinance means building financial systems that serve the poor
- Financial sustainability is necessary to reach significant numbers of poor people
- Microfinance is about building permanent local financial institutions
- Microcredit is not always the answer
- Interest rate ceilings can damage poor people's access to financial services
- Government's role is as an enabler, not as a direct provider of financial services
- Donor subsidies should complement, not compete with private sector capital
- The lack of institutional and human capacity is the key constraint
- The importance of financial and outreach transparency.

Due to their successful growth and high rates of profitability, microfinance became attractive industry for private financial markets especially from 2000th. More and more investors were interested to invest in MFIs by expecting high returns.

The large amount of easily available funds, in turn, has led to excessive supply of resources in the market, which encouraged the creation of financial pyramids and over indebtedness of borrowers. The first crisis of the microfinance market and the problems of repayment occurred in several countries (India, Pakistan, Nicaragua, Morocco, Bosnia and Herzegovina).

This problem was especially aggravated after 2007-2008 global financial crisis, which caused a sharp increase in aggressive and unethical treatment of borrowers by a number of institutions, including violations of fundamental client rights.

In response to these new types of challenges, global microfinance industry started to work on a new rule and standards to balance its commercial and social objectives, improve client protection mechanisms, and strengthen the sector's reputation.

USSPM and SMART Campaign are the two most important international global initiatives trying to promote the principles of transparency and responsibility in the microfinance industry.

The Social Performance Task Force (SPTF) Universal Standards for Social Performance Management (USSPM) are a set of management standards that apply to all microfinance institutions pursuing a double bottom line [6].

Meeting the standards signifies that an institution has strong social performance management practices. To achieve this, institutions must:

- Define and Monitor Social Goals;
- Ensure Board, Management, and Employee Commitment to Social Goals;
- Treat Clients Responsibly;
- Design Products/Services & delivery channels that meet clients' needs & preferences;
- Treat Employees Responsibly;
- Balance Financial and Social Performance

The SMART Campaign Client Protection Principles articulate the standards of care that clients should expect to receive when doing business with a financial service provider. There is consensus within the financial inclusion industry that providers of microfinance services should adhere to these core principles [7]:

- Appropriate product design and delivery
- Prevention of over-indebtedness
- Transparency
- Responsible pricing
- Fair and respectful treatment of clients
- Privacy of client data
- Mechanisms for complaint resolution

Conclusion

It is a fact that in recent decade's microfinance has accumulated a waste experience in implementing sustainable and viable financial programs in developing and emerging markets. A large number of these programs have a certain positive socio-economic effects.

Today, out of infancy, the microfinance industry faces a new type of challenges including its ability to deal with mobile banking and other technology innovations and concerns that some markets are now over-saturated.

How the industry deals with these and other challenges will greatly determine whether the sector continues to grow, develop and make progress, or it will be subsumed within the larger global financial sector.

By applying a right and effective management systems, keeping flexible and client-oriented business model, being open to changes and innovations, and following responsible finance practices, microfinance can still play an important positive role in developing and emerging markets.

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