Opportunity International AUSTRALIA

What is microfinance?

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Microfinance is the provision of small loans, savings and other financial services to people in developing countries who do not have access to mainstream financial providers. Like everybody else, people living in poverty need a diverse range of financial products to help them build livelihoods: to fund their small businesses, raise their income levels, save and stabilise consumption and shield themselves against risks. Microfinance has revolutionised the world of development by enabling the poor to take their future into their own hands by building their own microenterprises and working their way out of poverty.

Regular paid jobs for the poor in developing countries aren't as common as they are in the developed world. Many earn a living through self-employment, operating their own small businesses. However, to develop and sustain these enterprises, the poor need money to use as capital. But without collateral and formal identification, these microentrepreneurs are often considered 'unbankable' and of no interest to commercial banks. Microfinance organisations fill this gap. Since the microfinance movement began in the 1970s, MFIs have proven that people in poverty are, in fact, a good credit risk – borrowing money (often $100 or $200) to grow a business, earning an income and then using their profit to provide for their families and repay the loan.

The evolution of microfinance: from simple loans to financial systems

The concept of 'microfinance' was pioneered in the 1970s with humble beginnings. Two entrepreneurs, David Bussau (who would later go on to co-found Opportunity International with Al Whittaker) and Muhammad Yunus (now of Grameen Bank), separately lent their own money to people living in poverty in Bali and Bangladesh, realising that what they really needed to turn their lives around were jobs. A loan would help them start a business, earn an income and provide food, shelter and other everyday items for their families.

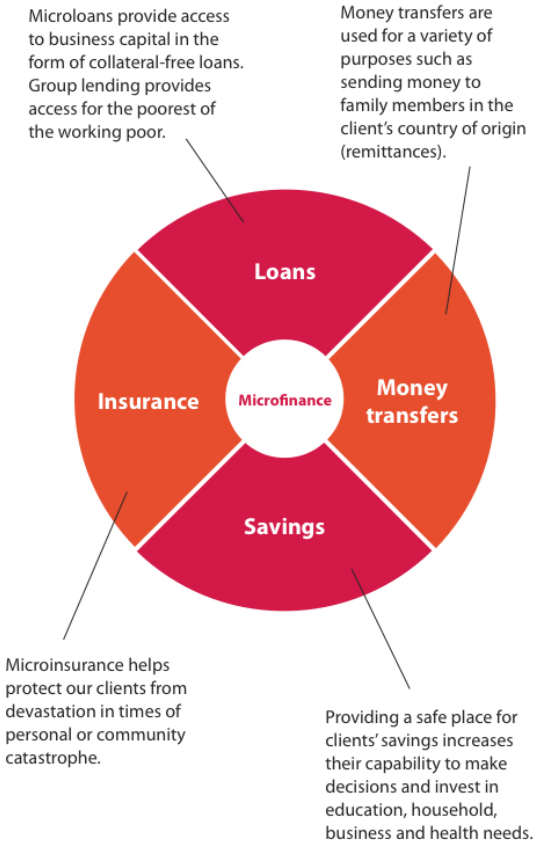
Today, microfinance has evolved past its small-business loan beginnings and now offers people in poverty a range of financial services: broadened loan options, savings, insurance and money transfers. As products have increased, new financial intermediaries have spawned – microfinance institutions (MFIs). Many of these have grown from tiny cooperatives serving a handful of villages to nationwide institutions. There are now over 3,000 MFIs in place throughout the world.[1] It is confidently asserted that microfinance's global impact has helped bring economic independence to some 100 million borrowers and their families over the last 25 years.[2]

Recent years have seen a marked increase in the global profile of microfinance: particularly through the United Nations 2005 International Year of Microcredit, Muhammad Yunus/Grameen Bank's receipt of the 2006 Nobel Peace Prize and the naming of David Bussau as Senior Australian of the Year 2008. Today, microfinance is recognised around the world as an innovative, sustainable solution to poverty.

"I can't think of an economic phenomenon after capitalism that's more important than microfinance..."

Vinod Khosla, founder of Sun Microsystems[3]

Microfinance



Microfinance services – addressing the economic constraints of poverty

Despite microfinance's significant contribution to alleviating poverty, enormous need still exists. According to the Consultative Group to Assist the Poor (CGAP), "nearly three billion poor people lack access to the basic financial services essential for them to manage their precarious lives."[4]

This prevents people living in poverty from making everyday financial decisions and taking advantage of opportunities that most people take for granted. Reasons behind this exclusion include cultural dynamics, lack of mobility, legal restrictions (such as lack of property rights), plus other social factors. Microfinance aims to provide the financial means to overcome these barriers and enable poor people full participation in life.

Microcredit – how working capital provides income improvement

Microcredit is supplied by microfinance institutions to people living in poverty in the form of small, collateral-free loans. This working capital is generally used to start or grow a small business – a mother might use it to buy a sewing machine to work as a tailor, or a father might use it to buy seeds to start a vegetable farm. Whether it is spent on stock, farm animals, or equipment , the capital makes it possible for a person in poverty to move towards an economically sustainable livelihood, and improve their family's quality of life.

Loan terms vary, but loans are usually repaid within six months to a year. Once repaid, the money is recycled and lent out to someone else, multiplying the impact each dollar (or donation) has on poverty around the world. This 'recycling effect' means more small businesses benefit from the initial capital injection and over time it creates self-sustaining income streams that will in turn stimulate local economies.

MFIs do charge interest, recognising the dignity of the poor by enabling them to build themselves sustainable livelihoods in fair-market conditions. Rates vary around the world. Generally, they are higher than mainstream financial providers, in order to cover the cost of the additional services of mentoring, servicing and training clients, who are often in remote locations. That said, rates are considerably less than the other available options for clients. Local moneylenders will often enforce payment of exorbitant rates of interest. Also worth noting is that default on microloans is very rare. The average industry repayment rate is in excess of 97%[5], higher than that of most formal financial institutions.

A more conventional version of microcredit involves lending to groups of people. Repayments are typically weekly or monthly and are collected at regular group meetings. More recently, MFIs have also begun to issue loans directly to individuals.

Experience has shown that families benefit more when women handle the household income, as they tend to be more reliable with repayments. In some MFIs, 100 percent of clients are women, although many lend to men, also. The dominance of women in microfinance programs has seen a significant change in their status, both within families and local communities.

Other microfinance services – building financial systems for the poor

Savings help people living in poverty smooth out irregular income streams, as well as provide funds for emergency costs. The demand for microsavings is apparent when looking at the innovative ways the poor save – without access to formal banking services, many invest in assets that can be exchanged to cash in the future (such as jewellery or livestock)[6], while some participate in informal savings groups or pay local cash collectors to keep money safe.

However, these methods of savings are subject to fluctuations in commodity prices or destruction by fire, theft, fraud or mismanagement. The poor remain constrained by a lack of *formal* deposit services – some two-thirds of the world's adults still do not have a basic bank account.[7] Banked funds provide additional security for clients, encourage the discipline of saving and earn interest for the account holder – all of which improves the client's ability to repay a loan and develops their financial management skills.

As well as responding to consumer demand for savings access, MFIs actually benefit from the supply of microsavings accounts. Saved funds provide cheap, available capital for the MFI to mobilise as microcredit loans. There are, however, legislative restrictions in some countries that restrict whether an MFI can take savings. In some regions, commercial banks are also now beginning to offer microsavings accounts, driven by the high demand from poor clients.

Insurance is an important complement to credit, savings and other financial services to reduce the impact of risks on poor households. According to the International Labour Organization, only 20 percent of the world's population has access to adequate social protection, such as health care and pensions: more than half have no cover whatsoever. Microinsurance fills this gap.[8]

The most common forms of microinsurance are *'Credit Life'* and *'Term Life'*. Credit Life covers the lending institution (the MFI) against the inability of the borrower to repay a loan as a result of death or disability. It also ensures that the family of the deceased/disabled person doesn't inherit their debt. Term Life microinsurance also covers death (and sometimes disability), however the policy is owned by the client, and it is usually designed to meet any funeral costs or other immediate expenses of the bereaved family. Other insurance products, such as health microinsurance, are less prevalent – due to the difficulties in overcoming issues such as fraud – but remain very valuable to the poor.

Money transfers may be required at a domestic level (sent from urban family members to rural areas), or at an international, cross-border level – 'remittances' – which are funds sent home each year by developing country migrants working outside their country of origin. The global financial crisis has had a significant impact on international remittances, with 2009 figures expected to total US$304 billion, down from an estimated $328 billion in 2008.[9]

While many countries lack any viable money transfer services, there is a growth in formal transfer mechanisms. Some countries are taking steps to make remittance transfers possible via mobile phone. Yet despite these efforts, substantial volumes of global remittances continue to flow through informal, and sometimes dangerous underground channels, outside government supervision and regulation. MFIs are increasingly trying to seek alliances with banks and money transfer companies to offer safe, convenient and lower-cost transfers to their clients.

Where does microfinance work best?

Often, those countries experiencing desperate poverty because of war or significant unrest are unsuitable for microfinance because these conditions prohibit the operation of such facilities. These countries are often better suited to direct governmental aid and other forms of humanitarian assistance. However, when the right conditions exist in a country, microfinance can be a sustainable, far-reaching solution to poverty.

These conditions include:

- Significant poverty resulting from people's lack of access to opportunities to improve their lives. Constraints are primarily income- or employment-related rather than, for example, medical- or security-based issues.
- National economic growth, political stability (ie not lawless or post-conflict environments) and a conducive regulatory environment should be present – providing a platform for a free market.
- A country's population and market environment must provide sufficient size and accessibility to sustain economically viable businesses.

Opportunity International Australia – how donor funds reach clients

Organisations like Opportunity Australia do not lend directly to people living in poverty. We receive donations, and in turn, partner with indigenous MFIs that offer various financial products *directly* to our clients. This helps us better understand their needs and make sure we serve people effectively.

Our funding helps finance our partner's microfinance programs. The MFI can then 'leverage' our contributions as security to borrow more capital by way of commercial debt to increase funds for the poor. Opportunity Australia also supports its MFIs with technical assistance and strategic expertise.

The future – beyond microfinance

Opportunity Australia believes that microfinance will continue to be an effective method in helping people out of poverty. Microfinance should not, however, be viewed as the *sole instrument* for poverty reduction. Its enormous potential can only be fully realised in combination with other interventions – as part of a broader poverty eradication strategy.

To enhance the impact of our partners' microfinance programs, we are helping integrate microfinance products with non-financial support services. These training and development services improve the ability of microbusinesses to succeed and grow through market access, product quality and similar improvements.

As microfinance expands its services to meet the demands of the poor, it becomes more than just an economic development tool. It is a vital means of income generation, social inclusion and community renewal. Its far-reaching impact can help widen the horizons of opportunity for families, giving them options for dignity, empowerment and hope. It increases people's confidence and changes family attitudes, as well as improves the societal perception of the poor.

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Opportunity International Australia exists to provide opportunities for people living in poverty to transform their lives. With over 35 years' experience in microfinance and support services, we use a business approach to solve poverty. Rather than a hand-out, we provide our clients with a loan as small as $100 to help grow their small business. This enables them to earn an income and afford food, water, shelter and an education for their children. Motivated by Jesus Christ's call to serve the poor, we believe in the potential of people regardless of their gender, ethnicity or religious affiliation.

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