Policy Note - January 2013

The Role of Microfinance in Supporting Small Businesses

1. Definition of microfinance[1]

Microfinance can be defined as "banking the unbankable". It refers to bringing financial services such as credit, savings and loans to the poor who are often not served by the formal banking system due to their inability to provide collateral or some form of security and therefore are seen as being a higher risk group for banks.

Microcredit is one aspect of microfinance which provides credit to the unemployed, entrepreneurs, or small farmers who are not "bankable" because they may not have any collateral, are not in steady or permanent employment, do not have a regular income and a verifiable credit history, and thus do not meet the minimum requirements of the formal banking system.

2. Why the focus on microfinance

Microcredit plays an important role because of its ability to assist households and individuals to mitigate the impact of shock and reduce risks through the creation of income generating opportunities. Increasing household income can lead to the accumulation of assets, greater investment in education, and improved food security.

Microcredit has mostly been focused on women, as they represent the poorest sector of their community, have higher unemployment rates, and represent a lower credit risk as they usually repay their loans timeously. There are also advantages in granting loans to women since there is often spill over to the entire household.

Microfinance has a positive impact on the welfare of households by supporting asset and wealth creation, mitigating risks, and smoothing consumption. In addition, improvements in the financial system can lead to improvements in efficiency and reduce costs of delivery in other public programmes. In Brazil, for example, Bolsa Familia (a conditional cash transfer programme) makes payments through an electronic benefit payment card which has reduced transaction costs from 14.7% to 2.1% of the transaction value. For the

[1] http://www.microfinanceinfo.com/the-definition-of-microfinance/

economy as a whole the benefits of deeper financial markets are found in supporting economic growth and reducing inequality.

2.1 Reach of microfinance

The World Bank[2] suggests that 2.7 billion people across the world have no access to formal financial services, thus the poor rely mostly on informal financial services channels, which is more expensive, inefficient, and limits the establishment of a credit history which impacts negatively on future loans being obtained.

The Microcredit Summit Campaign[3] is an initiative which aims to reach 175 million of the poorest families globally through microfinance, ensuring that 100 million families move out of poverty. According to the State of Microcredit Summit Campaign report for 2012, the number of poor families been granted microloans has increased from 7.6 million to 137.5 million over the period 1997 to 2010. If on average there are 5 individuals in a family, the 137.5 million loans affect around 687 million family members. Furthermore, the reach of microcredit in terms of access to capital by female entrepreneurs increased from 10.3 million to 113.1 million between 1999 and 2010.

Despite the rapid growth in the sector over the last number of years, the recent financial crisis has seen the rise of the portfolio at risk (PAR) of many MFIs,[4] placing these institutions' asset quality at risk. Furthermore, many fast-growing MFIs have outgrown their risk management and control systems. Rapid growth has been concentrated in a few geographies which influenced borrower repayment incentives. The inclusion of traditional banks and consumer lenders resulted in unhealthy competition among different lenders. In addition, the risk of over-indebtedness among borrowers increased in several countries, such as Peru and Morocco.

Impact evaluations have focused on the impact of microfinance schemes on the poor and questioned the hypotheses of these programmes in relation to its role in increasing economic activity and creating income generating opportunities which move poor people out of poverty.

3. Models of Microfinance

3.1 Microcredit in Africa

The Hunger Project's (THP)[5] Microfinance Programme provides training, savings and credit that provides support to mostly female food producers at the bottom end of the food chain on the African continent. Since its inception in 1999, the loan portfolio has reached US$2.4 million across 8 African countries;[6] furthermore, 21 rural banks have qualified as independent, community-owned, women-led rural financial institutions. Participants are involved in income

[2] web.worldbank.org/WBSITE/EXTERNAL/NEWS
[3] http://www.microcreditsummit.org
[4] Symbiotics SYM50 index
[5] http://www.thp.org
[6] Benin, Burkina Faso, Ethiopia, Ghana, Malawi, Mozambique, Senegal and Uganda

generating activities, with the increase in income assisting with expansion of their businesses, as well as providing for school fees, health care, and home improvements.

3.2 Microcredit in Bangladesh

The World Bank[7] financed microcredit programmes in Bangladesh to the value of US$ 260 million in the period 1996 to 2007, reaching 6 million poor individuals in the country, of which 99% were female. The finance was used across a spectrum of activities: starting small grocery shops, setting up trading activities, tailoring, rickshaw pulling and agricultural activities including rearing cattle, poultry and farming fish. These programmes have been exceptionally beneficial in supporting the poor and improving their lives. Evaluation of the impact of microcredit on a sample of borrowers carried out in 2001 found that:

- 99% report increase in income, often by more than 15%
- 96% report improved quality of life
- 99% eat more and better food
- 99% are clothed better
- 86% live in better housing
- 88% are now able to send children to school
- 83% have better access to sanitation
- 55% of rural borrowers now own land.

The Financial Services for the Poorest programme introduced by the World Bank in 2001 extended microcredit to the poorest of the poor, those who do not qualify for conventional microcredit programmes (such as beggars or household help). The project was initially piloted in 18 districts covering 20 *Upazilas* (counties) in Bangladesh, reaching 60,000 of the poorest people. Furthermore, around 12,500 borrowers received job skills training to become gainfully employed.

The Bangladeshi government replicated the project across the country with excellent outcomes:

- Around 450,000 of the poorest of the poor have benefited
- Repayment rate has been more than 95%
- Already 20,000 of those who received microcredit 3 years ago can now access regular rural microcredit programmes
- More than half of these borrowers no longer live on less than a dollar a day
- Many borrowers have upgraded their housing conditions from “jhupri” to semi-durable structures within 3 years.

3.3 Microfinance Projects in Brazil

The Northeast Microfinance Development Project

[7] http://web.worldbank.org/WBSITE/EXTERNAL/NEWS

This World Bank-sponsored programme aims to address the lack of access to financial services in the north-eastern region of Brazil where there is a high concentration of poor people. The outcome of the project is the creation of microenterprises through the provision of sustainable and formal financial services. In 2000, the World Bank provided a US$50 million loan to CrediAmigo to extend its operations. The support of the World Bank to CrediAmigo comprises three components:

1. Providing finance to CrediAmigo for funding working capital, investments to solidarity groups and individual solidarity groups who have graduated to this component due to a good record of loan repayments.
2. A capacity development project which hires consultants to assist CrediAmigo to develop promotional and marketing strategies; build risk management capabilities; enhance loan officer productivity; increase cost-effective geographic coverage using projections; improve legal and regulatory requirements; provide training and support needs; identify and design new loan and savings products; conduct evaluations of the environmental management programme; and support loan administration.
3. The final component provides financial resources to design, implement and analyse statistical surveys.

Banco do Nordeste's CrediAmigo Programme

The Bank of Northeast of Brazil (Banco do Nordeste), a state-owned development bank, operates its microcredit operations through the CrediAmigo (Friendly Credit) programme, which was established in 1997, and piloted in 5 branches which extended to 51 branches by 1998. It is one of the largest microlending programmes in Brazil as well as in Latin America.

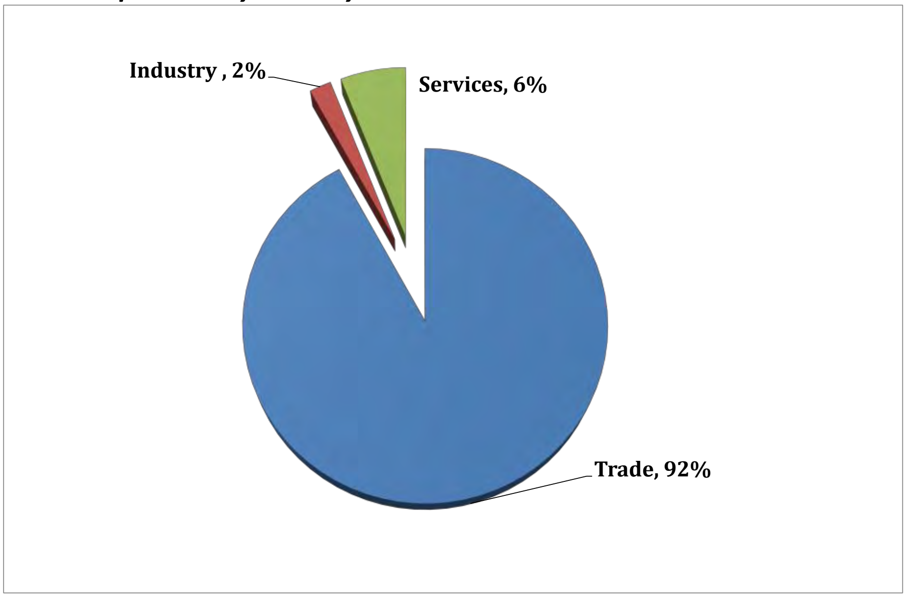
Details of the CrediAmigo programme in Brazil (2002-2010) are the following:

CrediAmigo (Banco do Nordeste)	2002	2010
Gross loan portfolio (US$)	24.6 million	464.2 million
Number of active borrowers	118 995	737 826
Average loan balance per active borrower (US$)	206	629.2
Default rates (1-90 days in arrears) as % of active portfolio	1.81%	0.72%

Source: http://www.accion.org/page.aspx?pid=675

The programme offers financial and business advisory services, with a focus on access and timely provision. Loans are offered to established microenterprises for both working capital and fixed asset needs. Initially loans were limited to a value of between US$130-300 but for repeat loans these increased to US$ 1,700. The interest rate was initially set as a 5% flat rate but was amended over time to be variable and dependent on loan value. The interest rate charged is higher than on larger loans offered by Banco do Nordeste but are significantly lower than those charged by informal money lenders. The Programme offers a discount of 15% on interest payments if all instalments are paid on time. There is a progression aspect to the programme; once the borrower has successfully paid back a loan under the Solidarity scheme, they are eligible for individual credit, with a loan maturity of 5 months. With regard to the sectors in which the programme operates, the trade sector dominates as can be seen from the graph below.

Loan composition by industry



Annual Report CrediAmigo Banco do Nordeste, 2010.

The profile of the borrowers is presented below, and reflects the effectiveness of the programme in targeting the poor.

Profile of CrediAmigo programme in 2010

Profile of beneficiaries	% of Beneficiaries
Gender	
Male	35%
Female	65%
Highest level of education	
University	4%
From 9 to 11 years old	32%
From 5 to 8 years old	28%
4 years old	31%
Illiterate	4%
Age	
18- 24 years	13%
25-35 years	32%
36-50 years	37%
> 50 years	18%
Annual household income	
<US$ 357.40	37%
>US$357.40 less than US$595.66	24%
>US$595.67 less than US$893.50	15%
>US$893.5 less than US$2978.32	20%
>US$ 2978.32	3%

Source: Annual Report CrediAmigo Banco do Nordeste, 2010, Website: http://www.bnb.gov.br/content/aplicacao/produtos_e_servicos/crediamigo/docs/relatorio_2010_bilingue.pdf

In the field of credit provision the programme incorporates aspects such as the provision of loan access through Solidarity Groups[8] as opposed to traditional guarantees or collateral, focusing on personalized customer care which includes a loan officer in the client job location and the efficient provision of loans, the maximum waiting period being 7 days. Value-added products include bank accounts and life insurance policies. The CrediAmigo programme also serves as a complementary programme to other government policies in Brazil, such as the Bolsa Familia programme; 40% of the clients of the CrediAmigo programme are also beneficiaries of the Bolsa Famila programme.

3.4 Microcredit in India

There are currently 149 Micro Finance Institutions (MFI) in India, having extended a combined US$5.2 billion of loans by 2010.[9] There are 31.7 million active microcredit borrowers in India, with deposits at these institutions amounting to US$299.8 million representing 6.5 million depositors in 2010. Commercial banks are also required to provide a certain percentage of loans to designated sectors, one being microfinance.

The Ministry of Micro, Small and Medium enterprises developed a Scheme of Micro Finance Programme in 2004 to support the poor through self-employment and establishing creditworthiness. The programme was introduced in response to the fact that existing microcredit institutions only catered for around 5-10% of required microcredit in India.

The microcredit programmes are run by the National Bank for Agriculture and Rural Development (NABARD) that is responsible for supervising and inspecting regional rural banks and regulating self-help groups.

The Small Industries Development Bank of India (SIDBI),[10] the other microcredit implementing agent, has been operational since 1992 and aims to be “the principal financial institution for the promotion, financing and development of industry in the small scale sector and to co-ordinate the functions of the institutions engaged in the promotion and financing or developing industry in the small scale sector and for matters connected therewith or incidental thereto.”

The industry in India has seen a number of changes over the years, in particular the legislation governing the operation of the sector. The Micro Financial Sector (Development and Regulations) Bill was introduced in 2007 and proposed a number of changes to the industry but was never passed (CGAP).[11] Recent developments include the Andhra Pradesh government issuing the Microfinance Institutions Ordinance in 2010 (later named the Andhra Pradesh Micro Finance Institutions (Regulation of Money Lending) Act), which requires all MFIs to register as well as adhere to other rules set forth in the ordinance. In response, the Reserve Bank of India (RBI) formed the Malegam Sub-Committee to make recommendations on how RBI ought to regulate the microfinance

[8] The Solidarity group technique of loan provision involves groups of three to five borrowers who cross-guarantee each other’s loans. These Solidarity loans normally have a three-month duration.
[9] http://www.mixmarket.org/mfi/country/India?gclid=CMvsxNjhx60CFYuIfAodu20Big
[10] http://www.sidbi.in/
[11] www.cgap.org

industry. In response to the Malegam Committee report, RBI issued a circular in May 2011 implementing some of the Malegam recommendations through prudential requirements for microfinance loans to qualify for priority sector status. RBI subsequently created a new category of NBFC-MFIs in December 2011 and issued directives aimed at addressing responsible pricing, transparency and over-indebtedness. In June 2011, a revised Micro Finance Institutions (Development and Regulation) Bill was introduced before Parliament, most notably proposing the Reserve Bank of India (RBI) as the sole microfinance regulator in the country.

4. International Case Studies on the Impacts of Microfinance

1. The Woman Empowerment Programme in Nepal found that 68% of its members took over decision-making from their spouses on issues related to buying and selling property. The literacy rate amongst members increased from 21% to 85% over the first 30 months of the programme.
2. A survey of one thousand individuals in Bangladesh revealed that credit empowered individuals through ownership, control over assets such as land, involvement in decision-making and an increase in political and legal awareness when compared to individuals who did not receive credit.
3. The TSPI development organisation[12] in the Philippines, which offers collateral-free loans to individuals, rice farmers and for housing or sanitation construction or renovation, found an increase in the number of women who reported being the primary household fund manager. Microfinance has assisted in empowering women to speak up for themselves; for example, the Self Employed Women's Association (SEWA)[13] in India has lobbied for higher wages and the rights of women in the informal sector.

5. Lessons from Microfinance Programmes[14]

In 2010 the state of Andhra Pradesh experienced a crisis when the district government closed a number of MFI branches. The move was prompted by allegations of exploitation of the poor with regard to unethical collections, illegal practices such as the withholding of savings, poor governance, high interest rates, and profiteering.

Demand from investors for high growth rates has created incentives for fast growth which in return distorted good banking practices and contributed to vulnerabilities in the system (GCAP, 2010).[15]

1. The rapid expansion of credit provision in a highly concentrated market and the loss of credit discipline can lead to greater risk if combined with higher levels of indebtedness. This is because incentives in microfinance are often built on disbursement and collection volumes without taking into account the

[12] http://tspi.org/
[13] http://www.sewa.org/
[14] Note: Please see the table in the appendix for papers detailing results of impact evaluations using randomised experiments in the field of microcredit.
[15] CGAP "Andra Pradesh 2010: Global implications of the crisis in Indian Microfinance ", Focus Note Number 67, November 2010.

corresponding incentives for excessive credit supply or the need for effective underwriting of the risk.

2. If growth of the loan provision outpaces internal controls, coupled with poor technology and high staff turnover, the risk will increase.
3. The fact that Indian MFIs focus on the provision of credit only results in a heavy reliance on asset quality, since borrowers have no deposit relationship to the MFIs.

A recent study entitled, "Latest findings from randomised evaluations of Microfinance"[16] by Bauchet *et al* (2010) attempted to investigate studies which used randomised experiments to evaluate microfinance schemes in a number of countries, in particular the work of Banerjee *et al*[17] (2010) and Karlan and Zinman (2011).[18]

Bauchet *et al* (2011) suggests that the results from the randomised experiments confirm the results from other studies which show that the model for microcredit works for populations which can successfully expand and grow their businesses. The authors correctly emphasise that not every borrower is a micro-entrepreneur and not all economic activity that poor people engage in yields high returns. This has implications for a country such as South Africa with its low levels of entrepreneurial activity and the complementary interventions required to support survivalist and micro-entrepreneurs in starting, establishing and expanding their business. Bauchet *et al* (2011) highlights that "microcredit has not transformed informal markets" nor has it resulted in "significantly high incomes on average for enterprises" but rather that the important impact of credit provision on increased consumption, risk mitigation and the ability to invest in human and physical capital for households should receive more attention.

While randomised experiments are useful in impact evaluation of microfinance they do have some limitations. Most microfinance programmes evaluated by randomised experiments evaluate the programmes after 2 or less years, when in fact the actual observable impact of credit provision would occur over a longer time period and thus researchers may need to return to the households and conduct further surveys to determine the long term effects.

Bauchet *et al* (2011) provides for a number of design features which have been evaluated to determine their effectiveness in the field of microcredit. Firstly, the traditionally held view is that group liability that incorporates women and weekly repayments represents the hallmark of a good model of microfinance. However, studies show that individual liability may not negatively affect repayments by borrowers and could attract more individuals; it could also be a way to encourage greater demand for formal channels of microcredit.

[16] Bauchet, J. Marshall, C. Starita, L. Thomas, J. Youris, A. "Latest findings from randomised evaluations of Microfinance", Access to Finance Forum, Reports by CGAP, JPAL, IPA, FAI, Number 2, December 2011.
[17] Banerjee, A., Duflo, E., Glennerster, R., Kinnan, C. "The Miracle of Microfinance? Evidence from a Randomised Evaluation", Cambridge, JPAL and MIT, June 2010
[18] Karlan, D., Zinman, J. "Microcredit in Theory and Practice; Using Randomised Credit Scoring for Impact Evaluations", Science, 332 (6035, pp 1278-84, 2011.

As mentioned, woman have been targeted for MFIs due to high loan repayment rates as well as their reinvestment of income into the well-being of the household. However, research has found that granting access to capital through credit has not led to an increase in the profits of female-owned enterprises. Cash grants provided to female entrepreneurs in Ghana and Sri Lanka provided no return on capital since the cash was often used for household expenses rather than investment in the enterprise. In Ghana, however, the provision of in-kind transfers of inventory or capital did yield a large return for female entrepreneurs relative to males. Another important outcome for female-run enterprises is that the impact of an in-kind grant was higher for female entrepreneurs who had existing businesses with high profit at the outset of the intervention. The implication for MFIs is therefore to conduct screening of applicants to identify high performance that will result in a greater impact, while also allowing for the ability to provide flexible products, since potential return can be gauged, adjusting risk profile and interest rate offered. For those female entrepreneurs who may be more difficult to assist, such a screening process could place them outside the reach of microcredit.

Return on investment for entrepreneurs occurs only with a lag after the investment has been made. Most microcredit loan repayments are inflexible and require payments within the first week or month of the loan issuance, followed by weekly and monthly repayments. This does not allow sufficient time for the investment to yield a return and forces borrowers to set aside a portion of the initial loan to make repayments. The design implication of this could be for banks to offer a 2 month grace period, for example, for those clients who require it, while also increasing the interest rates applicable on these loans to compensate for potential losses due to default.

While research suggests that the poor save, they often do not use savings to finance business investment. A survey done in India of vegetable market sellers by Anath *et al* (2007)[19] found that it would be possible for these sellers to save the small amount required to buy daily inventories instead of financing these daily purchases from informal money lenders. In order to change this behaviour the authors tried to provide a top-up grant that enabled vendors to restore savings after an emergency. Based on the hypothesis that the vendors did not understand how much borrowing from money lenders actually cost, financial literacy training was offered focusing on the compound effect of increased savings and decreased interest payments. There was, however, no change in behaviour of the vendors, who continued to borrow from the money lenders on a daily basis. There may be a number of reasons underlying this behaviour including the belief that the present is more important as the future is unknown and the fact that when there are additional resources available these must be shared amongst relatives or to cover emergencies.

6. Conclusion

Microcredit can play an important role in supporting small businesses. However, the research emanating from randomised control trials indicates that it is particularly beneficial for entrepreneurs who are able to expand their businesses and for those that have a

[19] B. Anath, Karlan, D., & Mullainathan, S., “Micro entrepreneurs and their money: Three Anomalies”, 2007. Draft available at http://karlan.yale.edu/p/AnomaliesDraft.v7.pdf

relatively high level of profit prior to receipt of the loan. The design of a microcredit programme will differ according to the circumstances, but it is important to take into account cultural aspects and institutional capacity in the delivery of the programmes. Testing interventions to determine the behaviour change of borrowers before a national roll-out of a programme is important in order to ensure that an intervention does indeed result in more and sustainable enterprises that can lift the poor out of poverty.

APPENDIX: Overview of Financial Services and their Impact

Study	Location	Financial services	Evaluatio	Intervention	Impact	Lessons
Banerjee et al (2010) "The Miracle of Microfinance? Evidence from a Randomised Evaluation"	India	Microcredi	Evaluated the impact of access to credit by randomising the placement of new Spandana MFI branches in Hyderabad, India.	MFI branches offered loans to self-formed groups of 6 to 10 woman in 52 randomly selected communities. averaged about US$ 200.	•Demand for the credit was low at only 18.6% for the treatment (8.3% higher than the control •The prob of starting a business increased by 1.7% for the treatment group. •No significant effect on business profits , revenue, spending or number employees. •No change on hh expenditure but effect on composition of spending, with existing business spent more on durable goods and cut back on "temptation" goods such as tobacco, alcohol and food consumed outside the hh, while hh which did not start a business consumed more non-goods. •No impact on female empowerment as measured by increase in female control over hh •No increased of expenditure on education and	Microfinance was working as should be; the new businesses and the shift toward productive investment allowed hh to make decisions about reprioritising, invest and make use of new opportunities
Cr épon et al (2011) "Impact of microcredit in rural areas of Morocco: Evidence from a Randomised Evaluation"	Morocco	Microcredit	Evaluated the impact of Al Amana a MFI opening 60 new branches, offering group loans in a rural area where no formal financial service were previously available	Loan of value between US$124-1855 were provided to a randomly selected Village, while the control group village would only receive the service after a 2 year period.	•Following a 2 year period, this programme also experienced low take up rates at 16%. •Many of the borrowers used the loans to pay off existing debt. •No significant improvement in welfare or consumption. •The increase in income did not assist in mitigating income, health or business shocks. • The number of new businesses did not increase despite a number businesses starting and closing increasing. •Micro credit had no impact on non-agricultural businesses, existing businesses increased savings and reduced consumption, while those with no prior business activity consumption increased •For existing farming loans did assist in increasing the volume of activities such as the hiring of employees outside the hh, while sales, profits and expenses increased. •Livestock activities saw higher savings in the form of livestock accumulation with no effect on profits and a small impact on sales. •Animal husbandry activities increased and income from loans was used to diversify livestock	The opportunities presented by microcredit are used by individuals in different ways. This evidence assists researchers to better understand the individual factors which play a role in a person's ability to use a loan effectively.
Karlan & Zinman (2011) "Microcredit in Theory and Practice: Using Randomised Credit Scoring for Impact Evaluation"	Philippines	Microcredit	Evaluated access to individual microcredit loans where the First Macro Bank offered small, short term and uncollateralized loans with a fixed repayment schedule to micro entrepreneurs on the outskirts of Manila. On average customers in this study had a higher level of income and education than average microcredit recipient. The Bank uses a credit scoring method based on criteria such as personal financial resources to screen applicants.	Those individuals who only marginally failed the credit scoring criteria of the bank was randomly assigned a loan of US$220 (representing 37% of the average borrower's net monthly income)	•An analysis completed 11 to 22 months later, found no increase in investment in the enterprise for those who received the credit, while the overall number of business activities and employees declined. In addition subjective wellbeing declined. •The loan did assist in coping with risk, strengthen community ties and open up the door to informal credit.	The channels through which microcredit works is often different to those expected. These channels may often start with the hh rather than the business. It also lowers the need for other risk mitigating tool.
Karlan & Zinman (2010) "Expanding Credit Access; Using Randomised Supply Decisions to Estimate the Impacts	South Africa	Microcredit	Evaluated a programme of a Consumer finance company who made small loans to low income workers at high interest rate with no collateral requirements. Payments are made according to a fixed schedule.	Those who narrowly failed to qualify under the normal underwriting criteria was offered a loan of US$127 (representing 40% of the average borrower's net monthly income) at an annualised interest rate for a period of a year of 200%	•6 to 12 months after receipt of the loan, income was higher and those receiving the treatment i.e. the loan had a higher probability of remaining in employment. •26% of hh in the treatment group reported an increase in food consumption. •Subjective measures of decision making, community status and feelings of optimism were also higher. •Participants were also able to establish a credit history which increased the probability of a future loan by 19% over a period of 15-17 months.	The evaluation occurred after the loan had been received and repaid, Suggesting the time lag for impacts to be observed.
Dupas & Robinson (2011) "Savings Constraints and Microenterprise Development: Evidence from a Field Experiment in Kenya"	Kenya	Micro savings	Evaluated a programme initiated by the Bumela Village Bank to provide to small business owners access to a savings account. The accounts offered no interest and substantial withdrawal fees were applicable, however demand for the product was still high.	The target population was market vendors, bicycle taxi drivers and self employed artisans who had no existing savings account and was interested in opening one,. Daily logbooks were kept by participants on business investments, expenditures and health shocks.	•Women used the accounts extensively and 25% of woman users saved more than US$14.28 (daily income is US$2). •Four to six months after the opening of the account, women in the treatment group had a 45% higher daily investment in their business, no measurable impact for men was found. •As income increased so food expenditure was 10-20% higher in the treatment group. •The savings account assisted in projecting women against unexpected health shocks. Those women without a savings accounts drew down from their working capital in response to illness. •Saving money in a formal account reduced the risk for women of having to money with family, friends and neighbours.	Women face substantial barriers to savings and these constraints impacted on the running of their businesses.