Microfinance

An Aid to Nepal's Post-Earthquake Recovery

Overview

One month after a series of earthquakes ravaged the Kathmandu valley and surrounding areas, efforts are turning to formulating a plan for recovery. With the onset of monsoons and poor sanitation increasing endemic disease incidences, initial efforts have been focused on temporary shelter, clean water sources, maintaining food supplies, and continuing medical support. While this white paper is not a political commentary, it is difficult to ignore the remarks of independent observers who have called attention to the dichotomy of massive international aid offset by the complete absence of government visibility and support. The people of Nepal are left largely to their own devices to ensure their economic and physical recovery.

Assuming, for the moment, that emergency aid will begin to address the immediate humanitarian crisis, we are left with the issue of how to ignite longer-term sustainable development. Specifically, the questions that loom large are: How to facilitate economic growth and development in a post-crisis context? What can be done to mitigate long-term dependency on humanitarian aid? What will have a transformational impact on people's lives?

It is a well-established that the majority of net new jobs are created by small businesses. Globally, small businesses provide between 65 and 80 percent of all jobs. Yet these small businesses suffer from lack of access to capital. Providing credit through microfinance offers an important and viable mechanism to strengthen and grow micro as well as small and medium enterprises (SMEs). Small business credit, in turn leads to the building of businesses, increased productivity, job creation, and asset accumulation. Ultimately, this brings about intangible benefits, such as economic self-sufficiency, empowerment of women, and improved standards of living including better nutrition and education of children. , Therefore, we believe that one of the primary areas of emphasis to support Nepal's economic recovery needs to be strategies, policies, and infrastructural investments that encourage the growth of small business.

Microfinance

Microfinance has had a long and varied history beginning with the first pawnshops founded by Franciscan monks in the 15th century to today's use of crowd funding and peer to peer lending. In the mid-1800s, Lysander Spooner wrote about the benefits of small loans to small businesses as an aid to exiting poverty and Friedrich Wilhelm Raiffeisen founded the first cooperative lending bank to support farmers in rural Germany. More recently, Muhammad Yunus, Nobel Prize Winner, introduced the concept of microfinance through Grameen Bank. Grameen Bank now serves over 7 million poor Bangladeshi women.

How do we define microfinance? Essentially, microfinance is the availability of financial services including savings and current accounts, insurance funds and microcredit (very small loans) to micro and small businesses that are typically owned and run by people from poor and low income households. Families living in poverty are generally unserved (do not have access to loans but need them) or underserved (have a loan and/or overdraft but have financing constraints). The small businesses may be formal (registered) or informal (non-registered) entities. Formal businesses contribute, on average, 50 percent of GDP in high income countries and 65-80 percent of GDP in developing economies. East Asia and the Pacific have the highest number of formal SMEs (11.2-13.7 million).

The 10 microfinance principles established in 2004 by CGAP and endorsed by the Group of Eight include:

1. Poor people need loans, savings, insurance and money transfer services
2. Microfinance must be useful, helping raise income, build assets, cushion against external shocks
3. Microfinance must pay for itself and not rely on donors or government
4. Financing must be offered through permanent institutions
5. Microfinance institutions (MFIs) must help integrate the poor into the mainstream financial system
6. The job of government is to enable financial services not provide them
7. Donor funds complement and build private capital, not compete with it
8. Bottleneck is shortage of strong MFIs and managers
9. Interest rate ceilings hurt poor people by preventing MFIs from covering their costs, which reduces access to credit
10. MFIs must measure and disclose performance

Small Businesses (SMEs)

SMEs employ the largest number of people in aggregate (~2/3 of OECD countries) and create the most net new jobs across regions, particularly in low-income countries. Small firms have the highest growth rates but the most limited access to capital, even though access to capital is also positively correlated with higher job growth rates. The size of the micro and SME sector and economic growth of a country are positively correlated. Our conclusion is that, for Nepal, the road to economic recovery will be paved through job creation as an outgrowth of financial support for micro and small businesses. Four channels lead to job creation within the micro and SME sector: financial help for entrepreneurs, larger business investments, increased liquidity in the marketplace, and indirect job creation through supply and distribution chains and spillover effects.

Currently, SMEs face challenges to grow, particularly access to finance, a current finance gap of $2.1-$2.6 trillion. Globally there are 200-245M formal and informal enterprises that to not have a loan or overdraft but need one (unserved sector) or do have a loan but still find access to finance a constraint (underserved sector), 90% of these are micro businesses (formal and informal). The financial gap is more pronounced for women owned businesses.

As in other developing countries, in Nepal, there are many challenges that need to be addressed before the necessary infrastructure can exist to support microfinance. These include;

1. Inappropriate donor subsidies
2. Poor regulation and supervision of deposit taking MFIs
3. Few MFIs that meet the needs for savings, remittances or insurance
4. Limited management capability in MFIs
5. Institutional inefficiencies (identity verification, design appropriate products, grow business, reduce risk)

6. Inability to fund microloans through savings and with sufficient margins (high transaction cost relative to loan size leads to high interest rates, upwards of 70%, average is well over 30%)
7. Need for broader distribution of services for rural and agricultural entities
8. MFIs need to increase in number, strengthen capacity, expand diversity to serve different needs

Fortunately, many of the above issues have been addressed in other developing countries and these efforts point to the four pillars of success outlined below.

Four Pillars the Support and Grow Small Business, Jobs and the Economy

Focus on women

On average, over 31 percent of SMEs in developing countries are owned by women. More women owned businesses cite access to capital as a constraint to business growth, 5.3-6.6M (63-69%) are under or unserved and there is a significant credit gap of $260-$320B. Women business owners are further constrained by the legal/regulatory environment in which they operate and at the mercy of firm growth limitations derived from societal-specific characteristics like education, training, size of firm, and cultural barriers. Women business owners need access to the same financial products as their male counterparts plus non-financial services such as support for capacity building, networking and market information. Past experience has shown that women business owners are less likely to default on fiscal obligations, women can support themselves independent of men and their businesses can reach sustainable growth and economic self-sufficiency. Historically, the likelihood of a MFI lending to a women business owner is 38% higher than lending to a male business owner. There is some suggestion that MFIs want to see characteristics such as emphasis on family, education, health, community. These characteristics are seen as positive indications of financial responsibility and are viewed as highly represented in women. Men are often seen as highly risky. The Global Partnership for Financial Inclusion (GPFI) launched the Women's Finance Hub in 2013. The Hub, managed by the International Finance Corporation (IFC), is an online platform to help advance access to finance for women owned businesses by disseminating research and information on critical issues related to the women's market. It helps identify gaps in data, promote collaboration and innovation in improving women's access to finance. We believe that the HUB could be an excellent resource for Nepal's MFIs.

Recommendation: Create government supported incentive programs to strengthen MFI financial outreach to women and women small business owners.

Embrace the future

Nepal has historically relied on tradition to guide development efforts. Unfortunately, this limits innovation and weakens support for economic recovery. By evaluating and embracing new technologies and infrastructures seen to be effective in other developing countries with similar issues, Nepal can leap-frog into the 21st century. For example, reducing MFI bricks and mortar presence by leveraging existing mobile phone networks eliminates substantial cost from the financial system.

Efforts must move from providing more capital to providing capital that is affordable. There must be a balance between outreach to the poorest unserved micro and SMEs, achieving sustainable growth in small businesses while maintaining profitable margins for MFIs.

FIs in developing countries have limited experience with micro and SMEs. FIs often maintain that local presence is a requirement for all business financial relationships, increasing bricks and mortar costs and adding to the expense side of the profit equation. In addition, they often resort to commercial lending practices which are inappropriate and costly when applied to micro and SMEs. They have difficulty determining creditworthiness efficiently and effectively and may not be able to articulate sound lending principles within their established risk appetite. To keep margins healthy, FIs often charge micro and SMEs higher interest and fees to compensate for the low revenue yield produced by small loans. Banks are reluctant to develop additional financial products for this audience because of low interest margins.

Recommendation: Invest in cost reduction tools, such as automated decision making to streamline the decision making process and alternative scoring techniques (i.e., application driven models, Entrepreneur Capability Assessment) and embracing infrastructures already in existence such as internet and mobile phone banking. Combine products across micro and SME customer accounts (business and business owner and employees of the business) to capture market share and strengthen margins.

Infrastructure support

McKinsey estimates that bank revenues could reach $367B by 2015 for the MSME segment with 20 percent growth. However, this type of growth is achievable only through the use of new techniques and technologies. These technologies can, for example, improve capital provisioning through the use of optimization analytics or can use psychometric evaluations for targeted entrepreneur learning activities.

Advanced methodologies and analytics such as those cited above require appropriate, relevant, available data. Such data can best be managed within a central repository of financial information on micro and SMEs. This business bureau or repository provides a framework for development of financial services analytics and best practices. The capture of financial experience and the use of data mining tools creates visibility in to performance and transparency in the support of micro and small businesses creation and job development. These tools, when used in a sound strategy for lending and financial service support, eliminate biases, introduce sound lending practices and reduce costs.

Recommendation: The government should require FIs to contribute micro and SME data to a nationally supported business bureau database or to a database maintained by a third party (e.g., D&B or Experian). Such initiatives have demonstrated success throughout Europe, the US, Russia, China, Latin and South America. The availability of the data for decision making, whether for a credit product or other financial services, creates discipline and consistency. It enables the creation of credit scoring systems for account origination and account monitoring and provides the foundation for FI and government policy development, identification of viable initiatives and documentation of key performance indicators (KPIs) of success or failure.

Development of a repository requires that an infrastructure exists or is purchased/developed to support the capture, retention, merge/purge, product creation and sale to ensure that such a repository can sustain itself and drive value for its contributors. This effort can be funded by FIs, private or third party investment or the government but must be in place to provide the services needed by the FIs to be successful in the micro SME space.

Regulations

Expanding SME financing for formal and informal businesses necessitates adherence with sound financial principles regarding capital allocation, model management, truth in lending and other general best practices. Some of these activities are articulated by international standards. Others must be executed at the local level, taking into consideration local practices and the availability of FIs to perform tracking and monitoring activities around their decision making practice.

80 percent of all businesses in developing countries (280-340M) are informal and encompass 60 percent of the labor force. Informality is related to low economic development, poverty, low productivity, and low quality jobs. Registration of the majority of informal business improves their access to capital. In addition, it supports private sector efforts geared toward the integration of such firms into manufacturing and wholesalers distribution chains; mobile and e-transaction platforms; small business banking; integration into other supply and value chains.

Government support through government guarantee programs can make funds available to businesses not traditionally supported by FIs (e.g., SBA or Spring/CBS). By guaranteeing all or the majority of the requested loan amount, FIs become more comfortable lending to new startups, credit challenged, or non-traditional borrowers. The FIs are able to expand into other financial products, growing their market share. The businesses are able to recover from disasters, purchase real estate, or borrow for expansion purposes retaining and growing jobs.

Recommendation: Creation of an incentive program for the registration of informal businesses to reduce illegality and increase access to capital for appropriate growth and job creation but recognize not all informal businesses have the capacity or willingness. Incentives could include a reduced cost for registration, a simplified process, reduced tax burden, and public outreach to articulate the benefits (e.g., selling to government or other registered businesses; access to new markets, capital, technology, finance, capacity building, judicial system; better business predictability).

Consider development of a government guarantee program in support of non-traditional micro and SME financial service acquisition. Funds from the Prime Ministers Fund could partially support such and effort and the resulting job creation could boost the faltering economy.

The government needs to implement regulatory reforms to support Partial Guarantee Schemes. One example includes movable collateral frameworks that encourage financing against valuable moveable collateral (e.g., in China). The regulatory reforms needed to support such efforts include those addressing property law, creation of electronic registry for pledging assets, business registration, and lender training in the use of moveable assets. Such efforts create viable lending vehicles and eliminated the required use of real estate as collateral—which micro and SME's do not usually have.

To further simplify the micro and SME microfinance structure, different institutions may be licensed to provide financial services based on size of institution. For example, differentiate between supply chain finance and tailored financial services and products for SMEs. Such difference in licensing requires complete understanding of the micro and SME growth lifecycle, the segment economics, market analysis to improve acquisition and reduce costs, activation and retention, risk management, information and database management, analytics (modeling, segmentation, reporting, tracking), and advanced analytics (time to event modeling, optimization, Markov simulation).

Summary

It is incumbent on policy makers and private sector (finance institutions, financial intermediaries) to intervene to encourage better banking services, higher deposit rates, greater access to capital, regulatory reforms, better infrastructure, competition in the financial sector, and support measures (i.e. development of programs that lower costs of financial services for under and unserved micro and SMEs).

The key to economic recovery, whether from a devastating earthquake or a global recession resides in support for microfinance, access to capital for micro and SMEs and the subsequent jobs created. Anything less is simply temporary measures that are not sustainable and that will have to be replaced repeatedly over time.

References

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