

# Microfinance in less developed countries: history, progress, present – charity or business?

## *Mikrofinance v rozvojových zemích: historie, rozvoj, současnost – charita nebo business?*

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**Abstract:** This paper describes the development of micro-financial activities in less developed countries in the world. The history of this development is divided into four periods with their short characteristics. Currently, the main questions in each period are highlighted and discussed by experts in microfinance. In the past, these problems were published in many scientific periodicals. It concerns mainly opinions, as for example, if the influence of microfinance on poverty reduction is overestimated, or on the other hand, the analysis related to the position of informal and formal micro-financial institutions, their development and acceleration of transformation, the influence of non-governmental organizations etc. At present, there is discussed the question of the preference – the model of 'charity' or 'business,' which is mainly related to the fourth, current development period. For these reasons, this question is intensively focused and analysed. The conclusion of this paper concerns just this area which is fundamentally related to the future development of microfinance as a factor of poverty reduction in the less economically developed regions in the world.

**Key words:** microfinance, financial dualism, transformation, business or charity

**Abstrakt:** Článek popisuje vývoj mikrofinančních aktivit v méně rozvinutých zemích světa. Historie rozvoje je rozdělena do čtyř period, které jsou krátce charakterizovány. Současně jsou zvýrazněny jejich charakteristiky a hlavní otázky daného období, které řešili odborníci na finance. Tato problematika byla ve své době publikována v mnoha vědeckých periodikách. Jedná se především o názorové pohledy, např. zda vliv mikrofinancí na snižování chudoby se nepřeceňuje, nebo naopak, analýzy týkající se postavení neformálních a formálních mikrofinančních institucí a jejich vývoje, akcelerace transformace, vliv nevládních organizací apod. V současném období – zda upřednostnit model „charita“ nebo model „business“. Tato problematika se týká především čtvrté – současné periodě vývoje. Z uvedeného důvodu je této otázce věnována zvýšená pozornost a je dále analyzována. Závěr článku se týká právě této oblasti, která se v zásadě týká budoucího vývoje mikrofinancí jako faktoru snižování chudoby v málo ekonomicky rozvinutém světě.

**Klíčová slova:** mikrofinance, finanční dualismus, transformace, business nebo charita

Micro-financial activities in the poor countries in the world, especially in the tropics and subtropics, have a relatively short history. Their importance (beginning) developed in the 70s of the last century. The complexion of microfinance consists in providing micro-financial services in very small amounts mainly to the poor who are often without any belongings (Jeníček 2008).

Microfinance is not anything new; it follows humankind since the ancient era. It markedly appeared already in the 18<sup>th</sup> century (e.g. Jonathan Swift inspired the Irish Loan Funds) and especially in the first half

of the 19<sup>th</sup> century in the middle Europe. Several credit union systems and cooperative banks have been named after Raffeisen, Kampelik etc. Robert Owen, William King, G.D.H. Cole, Charles Gide and others were very well known theorists in this period.

### Development stages of micro-financing in LDCs

Micro-financial activities in the less developed countries (LDCs) in the world have a slightly different character:

- (1) Strong social feeling appearing by the expressive 'bottom-up' activity. The active attitude of the poor smallholders, fishermen, craftsmen, businessmen and other population of the very poor countryside in these countries.
- (2) Poverty in rural areas where all these people housekeep.
- (3) Period in which micro- financial activities of the micro financial institutions (MFIs) become evident decidedly (decolonization, ending of the period of the 'Green Revolution').

It concerns the 70s of the last century. The development of the MFIs accelerated right in the period of decolonization when new states originated. Great banks of the metropolitan countries created environment for the MFIs in this period and gave rise to the relative vacancy in providing basic micro financial services to the rural poor in developing countries. Simultaneously, the influence of the 'Green Revolution' on the agricultural production disappeared. This "revolution" contributed by new technologies to the higher level of the agricultural basic industry, but not to the higher income for the poor. Financial income reinforced mainly the tertiary sphere; especially middlemen, usurers etc. The poor rural areas in developing countries were not reinforced, it was rather the opposite.

Important personalities, who have merited in the highlighting and next development of the microfinance in LDCs in the 70s of the last century, were above all Muhammad Yunus (Grameen Bank), John Kaith Hatch (FINCA system), Akhtar Hameed Khan (Tameer

Bank), Ela Blatt (SEWA – Self-Employed Women's Association), Michaela Walsh (WWB – Women's World Banking) and others. Development of MFIs could be divided into some important periods – stages, which overlap each other (Figure 1).

The development of micro-financial activities depends on many factors. Firstly, a stable economic environment has to be guaranteed, a permanently functional liberal programme incumbent on support of the private sector as well as on the cooperation with the developed countries in the world and a stable exchange rate (e.g. open international trade, know-how, mutual understanding, toleration etc.). The United Nations are aware of this fact and therefore the UN's Millennium Development Goals concern mainly the poverty and economic recovery in the LDCs. That is why the year 2005 was declared the International Year of Microcredit and for this reason, professor Muhammad Yunus was awarded the Nobel Peace Prize in 2006 (as one the first, he established and successfully developed a micro- financial system in LDCs, concretely in Bangladesh for the so- called Grameen Banks). The importance of microfinance in LDCs lays in the influence on poverty reduction and indirectly in the disproportionate indebtedness reduction in these countries (Srnc, Gebriánová 2005).

### First period

The first period is characterised mainly by (Book Review 2008):

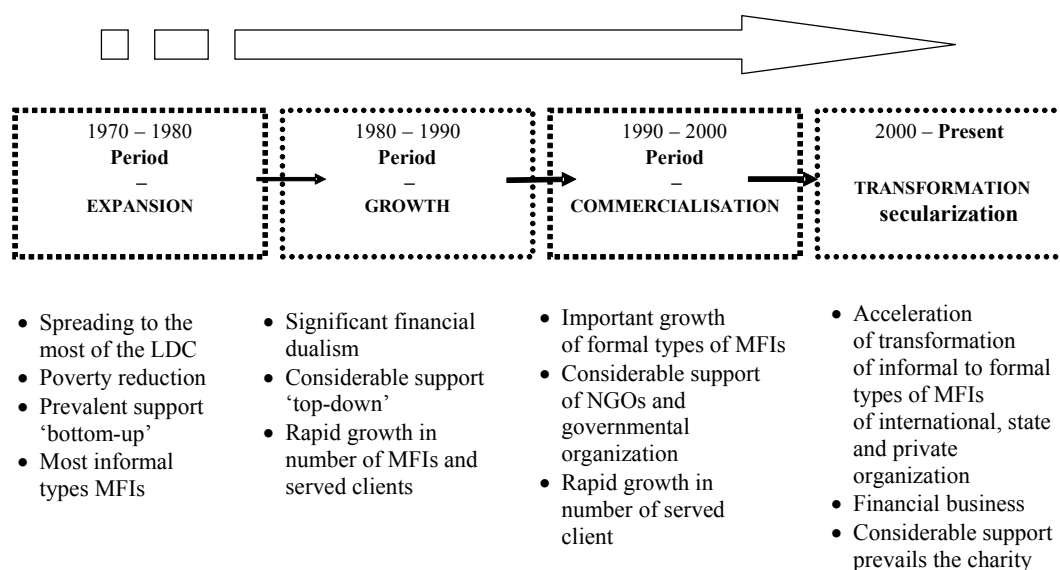


Figure 1. Development of MFIs' activities

Source: Srnc (2007)

- Providing social benefits and taking priority over the raising of the MFIs' profitability;
- Loaned (start-up) money is paid back, but without dividends (interest, profit);
- The principle of mutual guarantee in terms of Peer-ing Groups, Self-Help Groups or in the initiative informal micro- financial activities;
- Micro- financial activities are characterised as: self-sustaining, self-expanding and self-perpetuating;
- Different voluntary groupings are established (e.g. Grameen Groups, ROSCA, ASCRA);
- High level of enthusiasm among persons who were at the beginning of this movement (e.g. Muhammad Yunus);
- Appeal on poverty reduction.

In the scientific and research area, this question prevailed: 'Does microfinance influence really so strongly the poverty reduction in LDCs?' Poor countryside in LDCs is an entrepreneur environment for the MFIs. These institutions influence not only poverty reduction and debt relief of the heavily indebted countries but currently they are one of the decisive factors to maintain or completely change the living environment in the regions where MFIs appeal. Formal MFIs can very easily come under the endeavour to make profit at the expense of the mainly sustainable environment and poverty reduction (Sherr 2002). Besides, the proof that microfinance influence poverty reduction is Professor Muhammad Yunus who was awarded the Nobel Peace Prize, and the fact that the year 2005 was declared the Year of Microcredit (in terms of the UN's Millennium Development Goals). Definitely, microfinance is not the only factor influencing poverty reduction in LDCs. There are more factors, as for example developing the area of research, science, technology, etc. (Havrland 2006).

## Second period

The second period is characterised by a rapid development of the formal MFIs. Different types of formal MFIs began to evolve in the second half of 80s of the last century. It concerns especially the South-East Asia and Latin America. The development in India reflects the qualitative change (Figure 2).

The coexistence of formal and informal microfinance system commonly used in LDCs is the so-called 'financial dualism'. The modern and transparent formal system dominates in the municipal environment, but it is less accessible to the poor clients. The informal system is more spread in rural areas where it is accessible to the very poor clients and it is cheap but not quite transparent. The formal system is commonly much more known than the informal one in which the understanding is obvious from the financial relations between creditors and debtors. These relations are mostly based on historical, tribal, familiar and traditional relationships. The principle of these relations is honour and promise which is stronger than a written agreement or pledge. Table 1 describes the development of informal and formal MFIs in Guanajuato, Mexico.

In the financial markets, formal and informal MFIs work parallel but just formal MFIs are distinguished by a larger scope of activities and are governed and controlled by the given public institutions.

Poverty in these countries is solved from the point of view of financing in two basic directions:

- (1) the initiative 'bottom-up'; informal self-help groups, profit and non-profit MFIs
- (2) the initiative 'top-down'; profit organizations (formal MFIs or middle- and large-scale financial organizations)

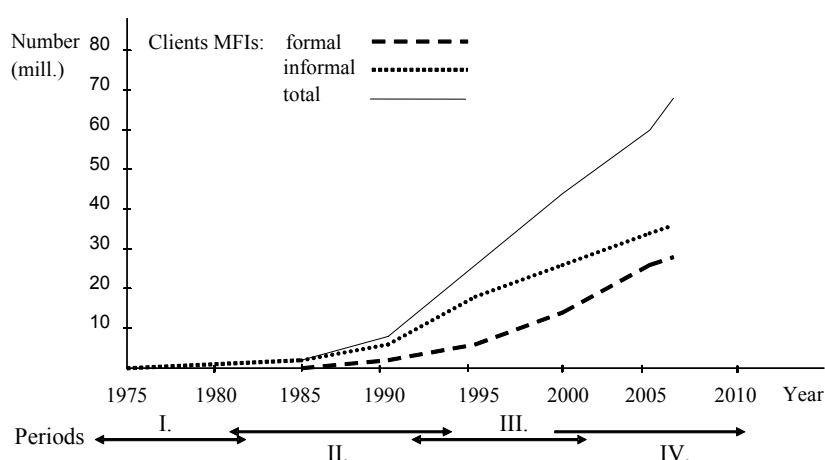


Figure 2. Comparison of formal and informal MFIs in India

Source: Srnec (2007)

Table 1. Number of clients of formal and informal MFIs during the last decades in Guanajuato, Mexico

Clients (mill.)	1975	1980	1985	1990	1995	2000	2005	2008 f.
Informal MFIs	0	0.2	2.9	7.5	19	26.5	34	36
Formal MFIs	0	0	0.1	2	7	14	26	30
Total	0	0.2	3	9.5	26	40.5	60	66

Source: Crespo (2008)

From the point of view of the poor people, all categories are beneficial. On the other hand, it is not so from the standpoint of the needs of the middle- and large-scale investors, especially in the implementation of the developing programmes. In this case, the partner of investors is a formal financial segment. According to the increasing economic level of these countries, the situation in microfinance will be changed.

### Third period

This period is characterised not only by the ongoing growth of microfinance activities, but mainly by the acceleration of transformation of the informal types of MFIs to formal ones.

There exist many organizations dealing with MFIs' acceleration of transformation. One of the biggest and most influential organizations is the UNITUS with its headquarters in Redmond (USA). The UNITUS is a global accelerator working with a venture capital obtained from investors in LDCs. It deals entirely with:

- monitoring the MFIs and their clients,
- advisory services related to microfinance activities in the LDCs,
- management of the training of MFIs,
- acceleration of the MFIs transformation.

The scope of this organization's activities is unusually large. Their research and advisory activities completely cover India, Kenya and Mexico. It concerns three target model countries. Each of these countries has a different micro-financial structure which is characteristic for the given world region. The UNITUS monitored already in September 2005 more than 475 million of the poor clients. The core of its philosophy lays in the opinion that the MFIs have to be in principle profit organizations. This vision can be only agreed with provided that in the given country, there is an appropriate economic environment, living standard and living style of the inhabitants.

There cannot be underestimated traditions, history and other fundamental differences which exist in

different approaches of the life goals – the American versus the Indian approach. The world is various and in that lays its beauty; for sure, its value does not lie just in the GDP or other economic indicators etc. (Unitus 2005).

The main scientific question in this period was an assessment of the objective framework: 'When is the informal MFI suitable for a transformation?'

The conditions and suitability for transformation of informal MFIs to formal ones are highlighted in the scheme of the three triangles – the institution has to meet three requirements:

- (1) stability maintenance in the environment in which the MFIs operate; the critical triangle
- (2) outside sustainable development of the MFI – outside institution's stability; the triangle of outside economic stability (Zeller, Meyer 2002)
- (3) inside economic sustainability of MFI – inside institution's stability; the triangle of inside economic stability

**Critical triangle (stability of the region)** characterizes a space in which it is rational for formal MFIs to develop their activities. Actually, it concerns a balance keeping in solution of the most serious needs in the given regions: sustainable environment development, the necessity to remove hunger and the need of poverty reduction in the region.

**Triangle of professor Zeller (outside economic stability of MFI)** describes the outside stability results from the scope and quality of the provided financial and other services. These services have to fulfil three following requirements: financial stability which ensures sustainable development of the institution, sufficient scope and quality (to hold out with the competition, to be able to spread its provided services) and the necessity of an effective impact on the clients' rising economic stability and prosperity.

The inside economic stability of MFI (**Triangle of MFI's inside economic stability**) concerns the coincidence of three factors which are expressed in bigger financial institutions on the base of business Cash-flow. The factors are the following: profitability of MFI, i.e. its management in the way in which

the yield is higher than costs and the MFI reaches profit; liquidity – the ability of MFI to transform its financial deposits into the liquid assets (the ability to pay off to the clients their deposits when required – from their own reserves, property converted into money or deconsecrating of its actives) and solvency – the ability to reimburse from their usual income, eventually by releasing their common reserves, the costs and obligations even in the cases when losses happen (this enables continuing activities and does not transfer the negative economic results to the clients).

#### **Fourth period: business or charity**

Microfinance creates financial markets and builds up civilization structures in isolated and remote regions: that is why some banks buy at present the whole portfolios or even the whole institutions. Initially, microfinance had the character of self-help and charity. In the 21<sup>st</sup> century, microfinance more and more attract the attention of small- and middle-sized investors.

The number of small and poor businessmen without a standard access to the financial sources but with a possibility to use microfinance services was estimated in the year 2007 at about 500–750 million in the world. Nevertheless, the potential and the needs of the developing world are still relatively neglected. The interest rate in informal and mostly self-help MFIs is about 5% p.a. In terms of financial dualism in micro financial markets, MFIs assert more significantly. Their business is mainly of the investment character. The capital costs mean for the investor fulfilling of the target goal – the achievement of the presumed financial returns.

The rapid rising entry of financial investors into the financial markets in the poor countryside led to increasing of interest rates of the microcredit to the range of 30–100% p.a.; e.g. Mexico – Banco Compartamos, Bolivia – Banco Sol etc. (MyElen 2008).

The price of the initial capital is then markedly high. The new situation brings about many questions. For the answers, the author chose Mexico. It is so because in Mexico, there act the Czech MFI Myelen, the important and successful Mexican Banco Compartamos and there are also available results from the research of the students of the Czech University of Life Sciences Prague.

Small informal MFIs are mostly of the self-help character with the charity support ('Charity Model') and the formal MFIs with a significant support of

NGOs (as a financial intermediary), middle- and large-scale banks as well as other large organizations ('Business Model'). Both informal and formal MFIs work side by side.

'What change brings a strong entry of financial capital to microfinance activities in the poor regions?', 'Charity or business?', these are the often asked questions. Both ways have their own advantages.

Opinions and facts supporting the development of microfinance activities in the 'Business model':

- The clientship of the Banco Compartamos increased during the years 2000–2007 from 60 thousands to 900 thousands of Mexicans;
- On 19<sup>th</sup> April 2007, the Banco Compartamos became the first Latin American MFI to offer equity through an Initial Public Offering (IPO);
- Financial capital is transferred from other regions to the poor and remote rural areas in Mexico;
- There occurs a rapid acceleration of the poverty reduction in the Mexican countryside;
- Charity is not able neither sustainable nor it significantly increases a cash inflow to the poor countryside;
- Banks have a special incentive system for the clients at a low risk;
- Interest yield and profits of investors from the micro-financial systems are very high – it is close to the usury;
- The bank is able to satisfy investors, to currently develop it and so to satisfy more and more clients and their business activities, etc.

The IPO is a transparent system, a new phenomenon in microfinance cooperating with other MFIs in the country. It concerns a commercial model increasing the impact, scope and quality of the provided services (Acción 2007).

Opinions supporting the way of the 'Charity model':

- It appeals to the extreme poverty reduction in the regions where there is a very complicated access to the financial sources.
- In the micro-financial market, there functions a high level of information asymmetry which is close to moral hazard.
- This model is less stable and in many cases charity organizations change the region of their sphere of activity.
- Informal MFIs are supported by the mutual guarantee of their members/clients and in that way they decrease a risk level.
- In the case of rapid economic growth of the region as a whole, the charity model can hinder this development.

Table 2. Characteristics of the clients in the state Guanajuato

Questions and answers of the most clients (after the third loan cycle):	Informal MFIs 'charity'	Formal MFIs 'business'
Credit is repaid from the own business	yes	yes
Initiated a new business activity	yes	extended
Own business	yes	yes
Employ other family members	no	yes and even employees
Invest to own business	yes	yes
Increasing financial reserves	no	yes
Yields are used for	foodstuff	investments, education
Willing to continue in relation to MFIs	yes	yes
'Charity model' intends to change to 'Business model' in the future	yes	x
Clients are satisfied with the level of interest rates	yes	partially
Client was in the household before the loan cycles	yes	no
Improving living standard	yes	yes
Continue in cooperation with MFIs	yes	yes

Source: Crespo (2008)

As the base for a model situation, there was used a choice of some basic information obtained from the questionnaires and from the personal research realized by Crespo (Table 2). The results were published in her PhD thesis (Crespo2008).

The research in the Mexican state Guanajuato proved that during the years 2006–2007, there increased the total volume of micro credit, business profit, quality of living, household facilities etc. Similar results are confirmed by the comparison with other regions in the world. It concerns for example the study in the Peruvian region Puno (Ramos 2006), in Chile (Romani 2002), Uganda (Morris, Barnes 2002) and elsewhere.

## RESULTS AND DISCUSSION

It is important that both the Charity and Business model work side by side. Charity appeals in the micro financial market as a factor which influences decreasing of the interest rate load of the clients and it serves especially in the extremely poor regions. It supports mainly self-help groups (Self-Help Groups) which act in the informal economic environment.

'Business' is above all a segment of the financial market. It is an indivisible part of the financial industry. A high interest rate load is given mainly by the tax burden of the yield (Mexico 15%), by the caused investments and the necessity to satisfy the investor. In the case that

the investor does not get the expected financial yield, he/she would invest somewhere else. The 'Business model' is related to the overall economic development in the given region. The following figure shows the micro financial system, the scope of its functioning and the impact on the clients (Tichá 2009).

## CONCLUSION

The Figure 3 shows especially the scope of the activities of the main participators in micro-financial activities in LDCs.

- Poverty is not natural for the humans and therefore its reduction in all groups of the population is necessary as illustrated in the Figure 3.
- The required development will aspire to strengthening of the formal segment into the micro financial industry. That means to minimize the groups 'destination' and 'extreme poor' and so to strengthen the functioning of the 'Business model'.
- The 'Charity model' will remain an essential complementary activity.
- Investors are the essential factor of the overall poverty solution, for the standardization and transparency of the micro-financial sector.
- The ethical attitude will be very important and the balance between the contribution to the poor businessmen and investors. The investor does not provide financial sources as long as he/she does not

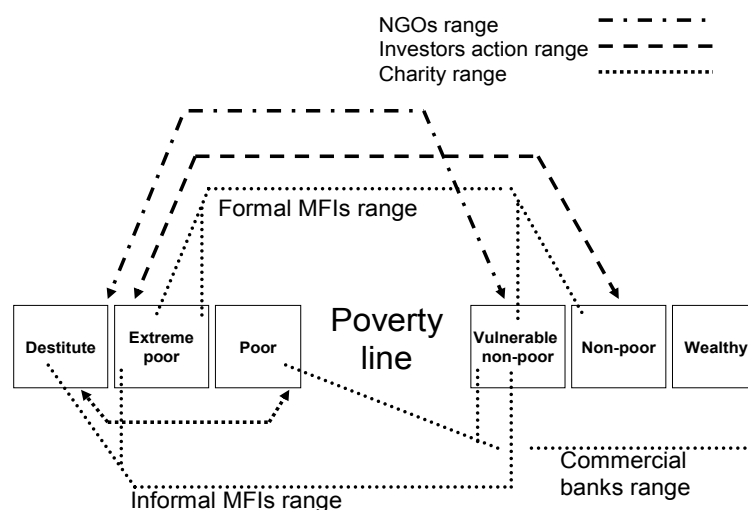


Figure 3. Poverty line of the poor

Source: The Microfinance Gateway, 2006

obtain the expected yield; on the other hand, the poor businessman will not use financial sources as long as the investor does not support significantly the growing of his/her future activities.

- NGOs are an essential accelerator of the change of informal to formal type of micro-financing. It is an important interlink between providers of financial sources and the poor countryside.
- It is obvious that one of the main factors to reach a balance between investors and final clients is the maintenance of the voluntary initiative 'bottom-up' and 'top-down' and above all – the interest of the investors.

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