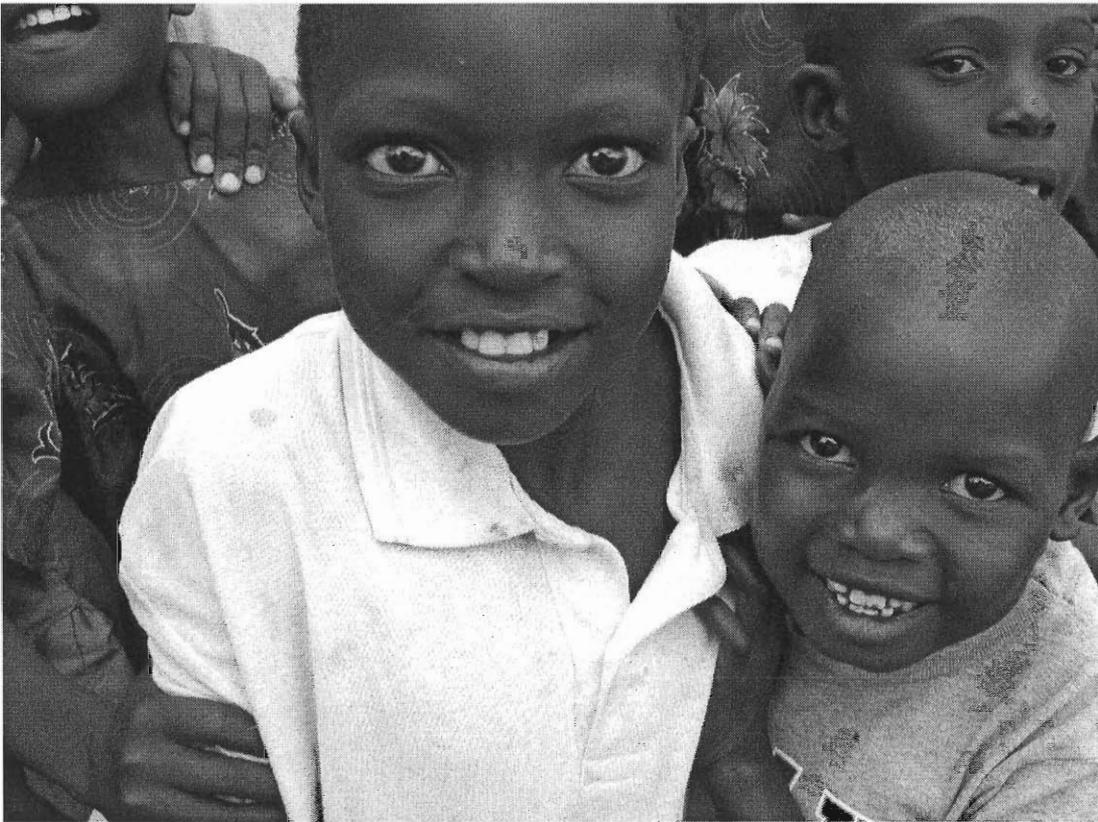


# **Microfinance: A Solution to Global Poverty**



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## 1.0 Executive Summary

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Poverty is defined as scarcity and lack. Poverty has global impact with almost half of the world's population living on less than US \$1 per day.

Poverty fuels instability and an insecure society. With the World becoming an ever smaller community, instability and insecurity in one nation affects the stability and cost of doing business in another. Global society benefits from peace and economic stability.

More than half a billion people in poverty could create jobs and increase their incomes if they had access to financial services.

Microfinance is the provision of financial services – loans, savings and insurance, to those excluded from the formal financial system. Typically the loans are small (as little as US \$25), for short terms (3 months) and unsecured. They benefit the poor by enabling them to increase incomes, smooth income streams, reduce vulnerability to economic shocks and improve quality of life. The provision of Microfinance is a hand up not a hand out.

Microfinance benefits community's by enabling the development of micro-enterprise, creating more jobs, increasing the supply of goods and services to the poor, improving access to education and health and improving stability.

This report provides a concise summary of Microfinance in theory and practice and is aimed at motivating and inspiring others to get involved and make a difference.

## 2.0 Introduction

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Over one third of the world's population live in extreme poverty— less than one USD per day. Over half the world's population live in poverty – less than two USD per day.

More than ever before the world is aware of the significant gap between rich and poor, educated and uneducated, political stability and instability. The world is one big neighbourhood and even the fences are being removed or reduced in effect.

Consequently the situation in one back yard is having increased influence on the conditions in another. Extreme poverty goes hand in hand with unrest and can lead to political instability. Instability impacts on global business. It can also impact on personal safety, regardless of where you live.

Whether you are a socialist or capitalist, global society benefits from peace and economic stability. So everyone has a vested interest in reducing instability whether for ethical or moral reasons or purely to improve business.

Poverty is one of the factors that increase instability and greater costs of transacting business. However this report focuses on global poverty and a solution— Microfinance. What is it, how does it work, what are the limitations and what are some examples.

### 2.1 Objective

The planned outcome of this report is two fold:

1. Provide a concise summary of Microfinance in theory and practice.
2. Inspire the reader to consider how they may get involved: "Heck, I could do that!"

## 3.0 The Problem: Global Poverty

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### 3.1 What is poverty?

Poverty is scarcity and lack. A lack of finance to fully feed or educate a family; a lack of access to health; a lack of physical shelter. As a result of poverty, people are more vulnerable to economic shocks, disaster, violence and crime.

The United Nations classify poverty as earning less than \$2 USD/day. Extreme Poverty is measured as earning less than \$1USD/day (United Nations).

Of the World's population (6 billion) there are over 1.1 billion people (18%) that earn less than \$1USD/day. Almost half of the World's population (2.7 billion people) earn less than \$2USD/day. As such, poverty has global impact.

The average income in New Zealand is in excess of \$70USD per day (Statistics NZ).

### 3.2 Who Really Cares?

New Zealand is isolated from the rest of the World by a vast expanse of ocean and life is good here. No one is starving. Everyone has access to basic food, health and education. There is even government support for people who either cannot or choose not to support themselves. So who really cares about poverty?

For some it is all about leaving a legacy....departing this planet knowing that "the world was a better place because of me".

There was a story told of a man who walked onto a beach where hundreds, if not thousands of starfish had washed up in a storm. They were doomed to die but for a little old lady, one by one throwing starfish back into the sea. The man scoffed and queried why she was bothering when there was no way she could make any difference; the task was overwhelming. But her response was "it made a difference to that one!"

For some people no other motivation is necessary than seeing a need and doing what they can to help.

But that is not everyone. Why else would someone do anything about poverty? Another strong reason to get involved is that as long as there is poverty, there are increased costs of doing business. That is a strong motivation for doing something.

The World is rapidly becoming a smaller place. Where it took six weeks to travel from Europe to New Zealand fifty years ago, it now takes 24 hours.

Poverty fuels instability and an insecure society. We see increasing global impact of this with the rise of terrorism not only affecting the country of those disaffected, but throughout the world.

Globally, business benefits from operating in stable and secure societies. One has only to look at the insurance bill to see that an act of terrorism half way around the world affects the costs of doing business in our own country. With more and more businesses having a global scale, the costs are spread throughout, particularly to those who are perceived as being more able to wear the expense.

Global society benefits from peace and economic stability. As seen in the current situations of Iraq and Afghanistan, there is a significant cost to trying to implement peace and stability. The cost is in paid in the lives of civilians and soldiers as well as millions of dollars daily both now and pledged into the future. Governments do not spend and pledge this support with money printed for that purpose but rather from tax received from businesses and individuals.

Whether an individual tax payer, a business or in some other way a user of goods and services in a country, you bear some of the cost of global poverty. As such we all have a vested interest in bringing about a reduction in global poverty.

### 3.3 What could be done?

Poverty is not new. For many years people and organisations have worked with the World's poor, giving aid, providing education, assisting with health care. People like Mother Theresa. Organisations like Red Cross, World Vision, Leprosy Mission...to name but a few.

Individuals throughout the world make financial donations and contributions of goods and services. More recently in 2005 we saw the repeat of an international fundraising event for the poor called Live Aid. This was led by Sir Bob Geldof and supported by the likes of Madonna and Bono (U2). At the same time political leaders were discussing the merits of forgiving Africa's international debt.

However, giving more money does not solve the problem of global poverty. Giving more money is actually part of the problem:

- The more given, the greater the dependency on the giver. The hand out results in the hand becoming bigger and asking for more and more. This can eventually become perceived as a 'right' rather than a privilege. In effect the reliance on someone else coming through with the solution or finance all the time leads to a disempowering of the receiver. We see this in New Zealand with some long-term beneficiaries– they no longer have the motivation or willingness to provide for themselves.
- Giving large amounts of money often ends up in the wrong hands, particularly where there is widespread corruption and little accountability. The result is that those in greatest need, who usually have the least influence, end up no better off.
- There is a limit to the amount any person, organisation or country can give.

The United Nations has recognised the need for something to be done. In 2000, members from 189 countries came together and signed the Millennium Declaration that led to the adoption of the Millennium Development Goals. Of the eight goals, the first is to halve the proportion of people living in extreme poverty– and those suffering from hunger – between 1990 and 2015.

Although progress appeared to be made in Asia, Latin America and the Pacific, the continent of Africa saw an increase in poverty levels from 1990 to 2000. As one report stated "There is an urgent need... to scale up action." The Global Monitoring Report 2004 mentioned concern that if current trends continued, most developing countries would fail to meet the 2015 goals.

It is far easier and cheaper making a statement than making a difference.

So what can be done that will make a significant and lasting difference?

More than half a billion poor people could create jobs and increase their incomes if they had access to financial services (World Vision).

## 4.0 The Solution: Microfinance

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### 4.1 What is Microfinance?

Microfinance is the provision of financial services to those excluded from the formal financial system. Microfinance includes loans, savings and insurance.

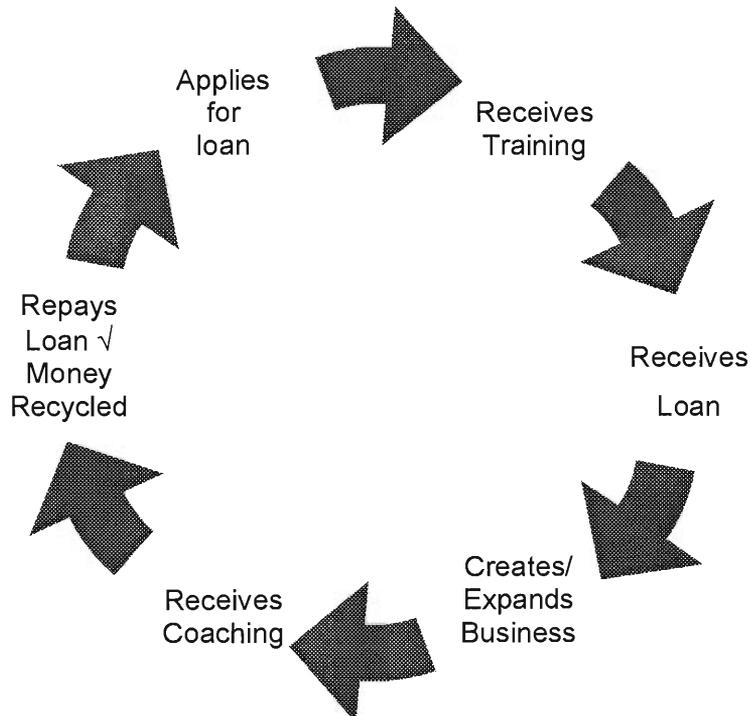
The intention of microfinance is to enable poor people to grow business and increase profit therefore raising themselves up a level and out of the poverty trap. Loans may also be used to smooth income streams, protect against adverse events and increase quality of life. An example of protection against adverse events is when a main income earner from a family falls ill. In order to receive proper treatment the family needs to pay for medication or even surgery. Without microfinance services they would have to sell all or part of their business, home or land, effectively reducing their ability to earn/provide for themselves in the future.

The poverty trap is where an individual or family is living at a subsistence level and do not have access to resources that would help them break out of this. Some of the barriers to these accessing these resources are as follows:

- Poverty barriers – for example where standard financial institutions exclude the poor from their services due to lack of equity, security and/or credit rating. Alternatively there may be access to informal financial services (“loan shark”) where interest rates up to 5% per day are not uncommon.
- Social barriers – for example where certain social groupings (eg. Caste structure in India) are excluded from financial services.
- Cultural barriers – for example where a culture forbids interest being charged on a loan hence no viable financial services can be provided.
- Gender barriers – for example where women are excluded from financial services.

## 4.2 How does MF work?

The loans are generally small, unsecured and with a short repayment period. For example, the first tier in the Vision Fund Programme in Cambodia is US \$25. Typically the loans are repaid over a period of three months to a year. The following diagram is an example of a microfinance loan in practice (Vision Fund).



- An individual hears of microfinance institute and applies for a loan. Typically this is through word of mouth with the loan officers outreaching into the communities to grow a loan portfolio.
- The individual receives assistance in business planning and the loan officer goes through the proposed loan, payments and method of payment. The loan officer also makes judgement on the individuals ability to repay. It is unlikely that the individual will be able to read or write hence the loan officer has to improvise, for example using a thumb print as a signature on loan documents.
- The individual receives loan - cash. Although there may be no formal security, the individual may be part of a group of borrowers (community bank or solidarity group)

who guarantee each other. If one individual fails on a payment then the group is responsible. Other incentives for repayment include reputation in a community and access to future loans.

- The individual uses loan funds to create new business or expand an existing operation. For example funds are used to buy grain in bulk that is then bagged in smaller amounts and sold on the side of the street at a profit.
- The individual meets regularly with the loan officer and/or a group of borrowers who encourage and coach one another. Typically the group will include some new borrowers and those with previous experience hence offering advice.
- The loan is fully repaid and funds are recycled. Once a loan is fully repaid an individual may have the ability to further borrow in larger amounts to a point where formal security may apply.

### 4.3 How does Microfinance benefit the poor?

The following table was reproduced from Finance for the Poor, Asian Development Bank, 2000. This report stated that “Microfinance can be a critical element of an effective poverty reduction strategy.”

As shown, the provision of financial services can result in diversified income sources, increased incomes, reduced household vulnerability to risks and/or external shock, smoothed income and increased quality of life through empowerment – a step up.

#### Microfinance and poverty reduction

Financial Service	Results	Impact on Poverty
Savings facilities of microfinance institutions	<ul style="list-style-type: none"> <li>More financial savings</li> <li>Income from savings</li> <li>Greater capacity for self-investments</li> <li>Capacity to invest in better technology</li> <li>Enable consumption smoothing</li> <li>Enhance ability to face external shocks</li> <li>Reduce need to borrow from money lenders at high interest rates</li> <li>Enable purchase of productive assets</li> <li>Reduce distress of selling assets</li> <li>Improve allocation of resources</li> <li>Increase economic growth</li> </ul>	<ul style="list-style-type: none"> <li>Reduce household vulnerability to risks/external shocks</li> <li>Less volatility in household consumption</li> <li>Greater income</li> <li>Severity of poverty is reduced</li> <li>Empowerment</li> <li>Reduce social exclusion</li> </ul>
Credit Facilities (eg. loans)	<ul style="list-style-type: none"> <li>Enable taking advantage of profitable investment opportunities</li> <li>Lead to adoption of better technology</li> <li>Enable expansion of microenterprises</li> <li>Diversification of economic activities</li> <li>Enable consumption smoothing</li> <li>Promote risk taking</li> <li>Reduce reliance on expensive informal sources</li> <li>Enhance ability to face external shocks</li> <li>Improve profitability of investments</li> <li>Reduce distress of selling assets</li> <li>Increase economic growth</li> </ul>	<ul style="list-style-type: none"> <li>Higher income</li> <li>More diversified income sources</li> <li>Less volatile income</li> <li>Less volatile in household consumption</li> <li>Increase household consumption</li> <li>Better education for children</li> <li>Severity of poverty is reduced</li> <li>Empowerment</li> <li>Reduce social exclusion</li> </ul>
Insurance Services	<ul style="list-style-type: none"> <li>More savings in financial assets</li> <li>Reduce risks and potential losses</li> <li>Reduce distress selling of assets</li> <li>Reduce impact of external shocks</li> <li>Increase investments</li> </ul>	<ul style="list-style-type: none"> <li>Greater income</li> <li>Less volatility in consumption</li> <li>Greater security</li> </ul>
Payments/Money Transfer Services	<ul style="list-style-type: none"> <li>Facilitate trade and investments</li> </ul>	<ul style="list-style-type: none"> <li>Greater income</li> <li>Higher consumption</li> </ul>

#### **4.4 How does MF benefit a community?**

The provision of microfinance services can result in many flow-on effects that benefit the community as a whole. Some of these are as follows:

- Development of micro-enterprises. As an individual obtains access to greater financial resource, grows own business, diversifies and may even start additional micro enterprises.
- Micro-enterprises create jobs. As a business grows so does the requirement for more labour. A United Nations report indicates that for each microfinance loan, 1.5 jobs are created.
- As micro enterprises expand, the supply of goods and services are increased to a community. For example, as the corner store expands it brings in a wider range of products and eventually other services such as internet access (seen in Uganda).
- As household income increases there is a greater demand and ability to pay for improved education, health, infrastructure....
- Improved stability in community.

#### **4.5 What are the limitations to MF?**

Microfinance is not a cure-all. It is a vehicle that can help individuals get to a goal but of itself it is nothing. There are a number of other factors that need to be incorporated for a fully effective strategy in reducing poverty. These include such things as greater education, improved governance and better health services.

Microfinance on its own has some specific limitations even when incorporated in an overall potentially effective poverty alleviation strategy. These limitations include the following.

- Requirement for economic opportunity. If an individual exists in a situation where there is no opportunity to grow a business then microfinance has little use. For example in a disaster situation such as immediately following the Asian tsunami or refugees camped on the Sudanese (desert) border. There must be some business opportunity to start with in order for microfinance to provide some benefit.

- Individual ability to repay the loan. No matter how much you help some people they struggle to help themselves. Some individuals, even if few, do not have the ability—physical, mental or emotional, to borrow and repay a loan. They may benefit more through the provision of microfinance services in a community where more jobs are created.
- Environmental conditions eg. Regulation, inflation. Some conditions in a country can be prohibitive or restrictive to a Microfinance Institute getting established and being viable. A measure of regulation is beneficial in the financial sector. For example, it ensures that if you put your savings in an institution, you can get it back again. However over-regulation, where access to credit funds is restricted or significant legal restrictions are imposed on financial institutions, can limit the effectiveness of a Microfinance Institute. Another example is where interest rates may be capped possibly resulting in negative real interest where inflation exceeds the nominal interest rate. This results in the 'shrinking' of a loan portfolio over time even with full repayment.
- Viability/Sustainability of Microfinance Institute. Ninety percent of microfinance institutes rely on donor funding (UNCDF, 2002). Few progress to Operational Self Sufficiency where all the cash costs (eg. Administration, interest, loan loss) of the institute are covered; let alone Financial Self Sufficiency where the cash and non cash costs (eg. Depreciation, inflation, capitalisation – growth) are fully covered. Less than two percent qualify as sustainable institutions. Without sustainability of the institute providing the means for a hand up how can poverty reduction be sustainable?

## 5.0 The Application: MF in Practice

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### 5.1 World Vision: Vision Fund

World Vision is one of many international organisations involved in aid and development. In New Zealand they account for over half of the privately funded overseas aid. The organisation was founded in 1950 and has built up a strong reputation to be leaders in their field.

World Vision did not initially start out providing microfinance services to the poor. They have evolved from providing emergency relief to Basic Area Development (Child Focus) to Microenterprise Development and Microfinance. Now they are involved with the full range of aid and development.

Vision Fund is now the separate arm of World Vision that encompasses all the Microfinance development. Vision Fund is only currently involved where there has already been a strong World Vision presence. Hence there is already some basic infrastructure, a strong local network and most importantly, trust.

The first World Vision microfinance services were provided in Latin America in 1993. Now Vision Fund is serving in 44 countries with 258,000 clients. The total loan portfolio is currently \$76m (2005).

The short-term goal of Vision Fund is to help lift 550,000 clients out of poverty by 2008, with a loan portfolio in excess of \$150m.

The way Vision Fund (Cambodia) works is as follows:

- Sponsorship funds are raised and then leveraged off to gain further commercial funds to reach a far greater number of individuals. Sponsorship funds alone would not be sufficient to meet the need.
- Local loan officers leverage off existing networks and trust in a community to identify individuals who would benefit from and be suitable for microfinance services.

- Individuals borrow money from Vision Fund as part of a community group that meets together fortnightly to receive training, encouragement and make payments as part of guaranteeing one another. The community group is typically 20-60 women (79%) from a similar peer group within the same neighbourhood.
- Businesses grow and repayments are made.
- Once loans are fully repaid individuals may have the opportunity to borrow successive loans in continuing with the group or even progress to larger individual loans secured over a particular asset.

On time repayment for Vision Fund Cambodia is 99.8%. This compares favourably with commercial banks that have tangible securities against loans.

Living Example:

Lim was a rice noodle-maker of 20 years earning less than NZ \$1.50 per day. He was supporting a family of six children. In 2004 he took a loan of NZ \$130 to buy better rice. Subsequently he increased noodle production from 100kg to 700kg per day. Now he earns NZ \$10 per day and employs several family members.

“For the first time in my life... I can build my business as I choose. My children can choose a better future.” (Source: World Vision)

## 5.2 Uganda

Uganda is a country similar to the size of New Zealand but with a population of 24 million. Of this population, 10% have AIDS. This has and will have a significant impact on the social and economic performance of the country.

The country has highly productive soils and food is not lacking. However, where a family may have their own children plus those from deceased brothers or sisters— due to AIDS, there is usually not enough money to fully educate everyone. Lack of education is one contributor to staying in poverty.

Also, a family may have a small business, such as a pharmacy (but not as we know it), but it is only half stocked due to lack of working capital (seasonal finance). This could be borrowed from a moneylender but the interest rates charged make the venture not worthwhile. Hence the family stays at a level where everyone exists 'hand to mouth' and there are no surpluses for education or even health issues that may arise.

So what could be done? Donations have a limit— both in the supply and the benefit as previously discussed. So how can microfinance help?

In 2004 two New Zealanders went to Mbale, a rural area in eastern Uganda near the border with Kenya. They connected with a local Ugandan pastor who leads a network of 20 churches throughout the region. Five years earlier, the Ugandan pastor had completed some training in New Zealand. This first visit to Uganda was to build relationship and assess the integrity of the people— Is what we have heard true? Can these people be trusted? The reports were excellent.

In 2005 a team of 13 business people travelled to the same area in Uganda. They looked at how to work with the local people to empower them to step up a level in providing for themselves and their extended families. Initially it was thought that business ideas would be the best.

However, the team found that business ideas already abound. One of the major limitations is the cost to implement the business ideas. One community bank scheme targeted at women had a cost of finance in excess of 50% pa.

So how could they help?

Steps so far (note that this is very much a smallscale 'pilot' project):

- Identified local church network. In effect this could be the distribution network as it covered the whole region and was strongly connected into an oversight team.
- Identified key individuals to carry responsibility for the project. Obviously these people would need to have high integrity as well as an understanding of finance and

business. The main individual identified actually works as part of a community bank and already understands microfinance in theory and practice.

- Gained agreement on desired outcomes and method. The project needs to be operated by locals without hands on input from New Zealand. The desired outcomes included empowering locals to establish and grow expanding business in order to release finance to fully support their own extended families. A separate trust was to be established and a board set up to govern the project. The agreed method of operation was via community banks where groups of individuals guarantee each other and meet regularly to encourage each other in business and finance.

Steps from here:

- Source initial funding from New Zealand businesses and individuals. This is primarily being sourced from a church network within New Zealand.
- Loan application, training and funding in Uganda. Some training material has been sourced by a contact that provides basic business training in rural India. The principles are the same.
- Planned trip 2006 by some of the New Zealand team to assess progress and assist in some training.
- Business expansion.
- Repayment and recycling of loans.
- Reassess progress.

So far progress has been slow, dealing with a different culture and communication half way around the world. However with the right people (volunteers at this pilot stage) there is no reason why some New Zealand 'donated' funds cannot have a far greater impact for a longer period.

## 6.0 Summary

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Give a man a fish, you feed him for a day;  
Teach a man to fish, you feed him for a lifetime...

**Fund a man to fish, you can change a nations future.**

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