PROVIDING OF MICROCREDITS REQUIRES A SPECIFIC APPROACH OF MICROFINANCE INSTITUTIONS

ŠAFRÁNKOVÁ M., SRNEC K.

Institute of Tropics and Subtropics, Czech University of Life Sciences, Prague, Czech Republic

Abstract

Poor people in developing countries face to lack access to financial services from institution, either for credit or savings. There are many reasons cousing this situation of the poor in developing countries such as policy of banks, their location, distrust and fear of low-educated people from complicated process relating to administration of banks etc., and especially collateral required by banks. Microfinance Institutions are providing poor people with effective financial services and delevoping private sector by targeting small enterprises. The frequently discussed issue is the cost of microcredit and interest rate which is very often higher than interest rate of a loan provided by conventional banks despite the fact that the target group of microfinance institutions consists of particularly poor and low-income people. But it should be looking at microfinance in both financial and social perspective and it should reconcile the social impact of microcredit and, cost recovery leading to self-sufficiency and sustainability of microfinance institutions.

Key words: microcredit, microfinance, non-financial services, collateral, interest rate

INTRODUCTION

People living in poverty, like everyone else, need a diverse range of financial instruments to run their businesses, build assets, stabilize consumption, and shield themselves against risks (CGAP, 21.7.2010)

More than half of human population has no access to financial services. Providing the poor with access to financial service is one of the ways to increase their incomes and productivity, therefore reducing poverty from the basic point of view (Robinson, 2001)

Microfinance target primary especially the poor and lower-income clients, including the self-employed. As the basis of microfinance services is generally considered providing small loans – microcredits. However, microfinance has expanded beyond credit to include other services such as savings, insurance etc. Microfinance providers also offer social and technical services such as group formation, development of self-confidence and training in financial literacy and management and other non-financial services related to enterprise development, such as skill training and marketing, and social services, such as literacy training, health care etc.

Thus the definition of microfinance should include both financial intermediation and social intermediation. Microfinance is not simply banking, it is a development tool (Ledgerwood, 1999).

But how microfinance is provided and what products are supplied by microfinance institutions (MFIs) affects besides individual MFIs also the overall political and economic environment of a country.

This paper provides presentation of the qualitative approach of the microfinance impact assessmet made in Jordan.

Jordan is the Arab country where microfinance is widespread and well developed. Poverty remains one of the most prevalent problems in Jordan, government is well aware and therefore has taken numerous steps to combat poverty. Jordan was the first Arab country to develop a National Microfinance Strategy to guide the development of the microfinance sector with the stated objective „to provide access to a wide range of financial services to the majority of the economically active poor households and microenterprises in Jordan. "This is to be achieved in a liberalized and market-oriented economy where the private sector is the implementer, and the government provides the enabling environment for the efficient functioning of markets that encourage the participation of the private sector" (National Strategy for Microfinance, 2005–2010).

Microfinance providers in Jordan do not comply with banking regulations, they are not permitted to mobilize savings from the public; this restriction is strictly enforced (National Strategy for Microfinance, 2005–2010).

Special attention was paid to interest rates. Even if microcredit is intended for the poor, may not be understood as a gift to the poor. It means that the balance must be reached between what clients can afford and what the lending organization needs to earn to cover all of its costs. Clearly the transaction-intense nature of shorter payment period and smaller loans, often in rural areas, is more expensive than running a bank branch that provides large loans to economically secure borrowers in a metropolitan area.

As a result, MFIs must charge interest rates that might seem high, the average global rate is about 35 percent annually, but needed to cover the costs of administering loans (Paris Microfinance Network, 1.6.2010). It must be added that higher interest rates are linked to the unsubsidized loans offering generally by sustainable MFIs.

With the exception of banks and financial institutions in Jordan (all of which may charge interest freely)[1], both the Civil Procedural Law of 1988 and the Usury Regulation of 1926 set an interest rate cap of 9 percent on all civil and commercial transactions. Most MFIs are currently charging interest at a much higher rate, which may constitute a violation of the Civil Procedural Law of 1988 and the Usury Regulation, in case MFIs are not considered and treated as "financial institutions". If challenged in court, MFI interest rates run a risk of being deemed illegal under the Civil Procedural Law and the Usury Regulation. To date however, there have been no known challenges to MFI interest rates (Abbassi et al., 2009).

MATERIALS AND METHODS

The study was conducted in Jordan. Research was carried out in the capital of Jordan – Amman and Aqaba (the capital of Aqaba Governorate) in the south.

The focus group

The qualitative part of research focuses on the managers including directors general and credit officers of MFIs operating in areas of research. The objective of this subsection of the research is to assess how the providers of microfinance services perceive the needs of clients and what services they offer.

Using individual interviews based on key open-ended questions there were asked 36 manageres and credit officers from different MFIs. Sample size compared with the sample of quantitative analysis is not that large but must be taken into account that the focus group consists of MFIs staff qualified to answer research questions, namely CEOs, Heads managers and senior staff, in a way which limits the sample (Table 1).

Tab.1: Size of sample according to MFI and area

	DEF	MFW	Tamweelcom	Alwatani	MEMCC	∑
No. of respondents	11	5	7	6	7	36

DEF (Development & Employment Fund)
– Number of active borrowers: 17 515 (2008) (MIXMarket, 3.8.2010)
– financial services: direct and indirect lending programs, non-financial services
MEMCC (Middle East Micro Credit Company)
– Number of active borrowers: 11 885 (2009) (MIXMarket, 3.8.2010)
– Products and services: direct lending – different types of loans
MFW (Microfund for Women)
– Number of active borrowers: 48 160 (2009) (MIXMarket, 3.8.2010)
– Products and services: direct lending – different types of loans, non-financial services
Tamweelcom
– Number of active borrowers: 38 941 (2009) (MIXMarket, 3.8.2010)
– Products and services: direct lending – different types of loans, non-financial services
Alwatani
– Number of active borrowers: 23 687 (2009) (MIXMarket, 3.8.2010)
– Products and services: direct lending – different types of loans, non-financial services

[1]The Central Bank Law No. 23 of 1971 exempted banks and financial institutions from all interest rate caps set by any other legislation unless such caps are set by the CBJ which has the right to set maximum and minimum interest rates on loans granted by institutions subject to the Banking Law. Since 1994, the CBJ has not issued any interest rate caps and interest is currently determined freely by the market.

Interest rate

There are several ways to calculate interest on a loan of which two methods are most common: the declining balance method and the flat method. Selection one of these significantly affect the total interest of the loan for the selected loan term.
(1) Declining Balance Method: monthly payments

$$PMT = LA \times \frac{i}{1-\left(\frac{1}{1+i}\right)^{n}}$$

Where:
PMT = monthly payment
LA = loan amount
i = monthly nominal interest rate
n = number of months

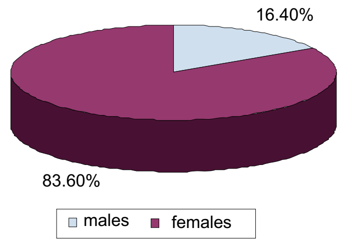
The declining balance method calculates interest as a percentage of the amount outstanding over the loan term which means that interest is charged only on the amount that the borrower still owes.

The flat method calculates interest as a percentage of the initial loan amount rather than the amount outstanding (declining) during the loan term. Using the flat method mens that interest is always calculated on the total amount of the loan initially disbursed, even though periodic payments couse the outstanding principal to decline. Therefore it is clear that the amount of interest charged varies significantly depending on whether the interest is calculated on the declining balance or the flat amount. The flat method results in much higher interest cost than the declining balance method based on the same nominal rate (Ledgerwood, 1999).

RESULTS

In connection with the target groups, most of the loans are targeted to the people developing their business (56% of clients). 39% are targeted to the people starting their business, which is also significant number. This proportion may prove the fact that people who decided for a microcredit once and the project is running then they ask for other loans from MFI in the future to develop the project. But it is the general expression, the percentages of individual MFIs may well change such as percentage according to gender. Most of the clients (83.6%) are females, which was predictably. Generally, worldwide most of the clients are women, especially in Arab world. The main reason is the much more difficult position of women in society and therefore lack of access to financial services because until recent time, although the situation has been in some areas slowly improving, there are still many areas where the females are discriminated in this field. MFIs are aware of this and therefore provide many products aimed at women (Figure 1).

Figure 1: Groups of clients by gender



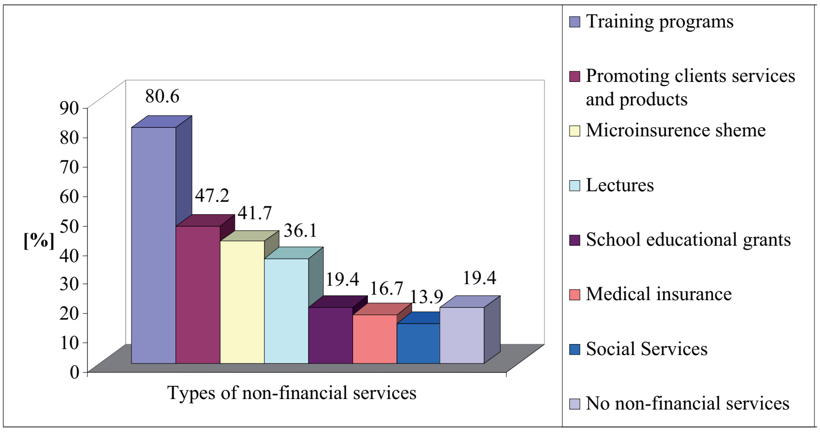
There is no doubt that non-financial services are recently provided by most of the MFIs. MFIs are aware that their clients are mostly poor and less educated people who need help and advice on how to use borrowed money to start business, etc. Therefore most of MFIs provide training programs where clients learn for example how to produce some goods or products relating to their projects etc. Other frequently offered non-financial service is a help with marketing, promoting and selling client´s products and services or emerging microinsurence and others. Most of non-financial services are free of charge for clients. Some MFIs use the principle that clients do not need to pay for non-financial services in case that they take a loan up to the fixed amount of credit.

Figure 2 shows the percentage of the total number of respondents answering different types of non-financial services. Almost all MFIs provide non-financial services, especially in the form of Training programs. The second most frequently mentioned type of services is the category called "Promoting client´s services and products". This category includes for example help with marketing or organizing bazaars for selling client´s products. The category Social services includes for example access to informations about issues such as breast cancer and women's rights provided by MFW. Most of these non-financial services are free of charge for clients.

The respondents were also asked what are the most important reasons for their clients to take a loan from MFI instead of from commercial bank in their opinion? Here are the results.

One of the main reasons for taking a loan from MFI instead of from commercial bank is undoubtedly collateral. Commercial banks mostly require property or salary guarantees which many MFI´s clients simply do not have. Therefore, most of MFIs use alternative types of collateral. Type of collateral used by MFIs depends on

Figure 2: Non-financial services provided by searched MFIs



type and size of loan. The main types of collateral required by MFIs are personal collateral and group guarantees. Salary and property as a collateral were mentioned by employess of MFIs too but it is necessary to add that required property and salary is not as high a priority as is in banks and it is usual required for "bigger" loans (by e.g. DEF, MEMCC) but it is certainly not the dominant approach. Some MFIs use just trust and honest of local people as collateral based on good reputation in the community. Generally this type of collateral seems for Europeans as totally unacceptable and in European terms a failed approach but it works good in local terms in Jordan which shows the repayment rate which is generally 98% and more. The reason could be seen in the mentality of people specially in rural areas and in fact that people are afraid that they would not receive another loan while defaulting. Another type of collateral is based on culture aspects and it is also widespread. This is special "bank checks" called "*Combiaheh*". On this special checks for people they do not have bank account, is written loan amount and interests. There are required 2–3 witnesses, one of which must be a woman in a close family relationship to the person asking a loan (wife, sister etc.) While defaulting they can be arrested and according the culture rules it is unacceptable to see a woman with a police. This type of collateral is used for example by Alwatani or MEMCC.

The other often mentioned reason was simple procedure and outreach. Especially low educated people are afraid of "difficult" procedure linking with taking a loan from commercial banks. Therefore many MFIs simplify the application as much as possible and credit officers complete applications together with clients. Then MFIs are aware of the difficult access to the banks, which are located mainly in cities, for people from rural areas. Therefore MFIs locate their branches closer to the rural areas or use also mobile office to reach those people. Also in non-financial services the employees of MFI see another reason for taking a loan from MFI becouse if commercial banks offer some non-financial services than

Figure 3: Reasons for taking a loan from MFI instead of commercial bank

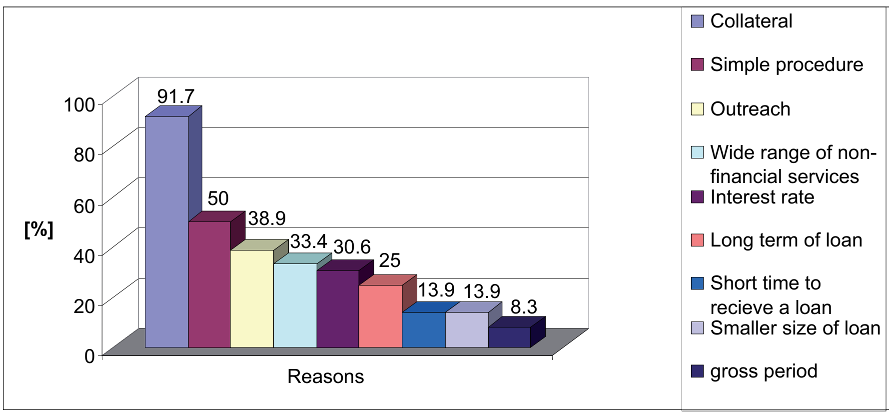
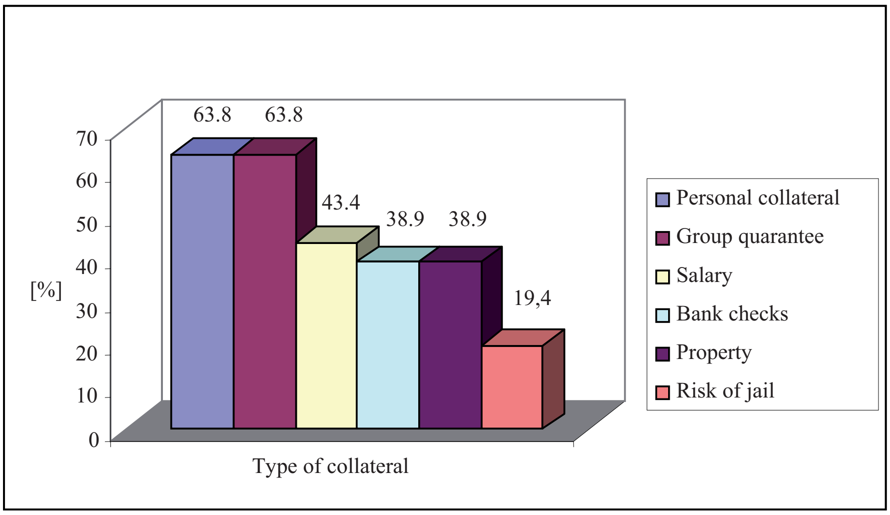


Figure 4: Type of collateral used by MFIs



the clients are usually charged for it. Interest rate was also mentioned by respondents but here is necessary to add that this reason was answered almost exclusively by employees of DEF. DEF is the only MFI which has an interest rate of all products lower than the standard commercial bank´s interest rate.

According to mentioned reasons above, it could be said that the main motives for taking a loan from MFI instead of commercial bank are not of financial nature but rather a starting point for an otherwise intractable situation related to lack of financial services.

As mentioned above most of MFIs, except DEF, use higher or comparable nominal loan interest rates with banks as shown in Table 2. Of course, the difference between interest rates varies depending on product and other characteristics of the loan. Therefore, the percentages of interest rates is only relative and have only a general informative nature. Final amount of interest paid by the client also depends on the method of interest calculation used by institutions. Most of MFI, except few products of DEF, use the flat method. Unlike commercial banks, which are used in the vast majority the declining balance method, which ultimately leads to the lower final interest paid by the client of the bank at the same interest rate as the MFI.

Tab. 2: Interest rates

Name of MFI	Interest rate (p.a.)	Calculation method
Alwatani	8–18%	flat
MFW	10–21%	flat
DEF	5–11%	flat and declining
MEMCC	11–20%	flat
Tamweelcom	13–20.5%	flat
Commercial banks	11% and up	mostly declining

Let's explain this issue on a particular simplified case. Let's have a client who has taken a 12-month loan for 1000 JD (Jordanian Dinar) with interest rate 15% p.a. and monthly payments.

(1) Our client is a client of the commercial bank using declining balance method of interest calculation. Monthly payment PMT was calculated at 90.26[2] (Table 3).

(2) Our client is a client of the MFI using flat method of interest calculation. Monthly payment is 95.833 JD (Table 4).

According to the Tables 3 and 4 the total interest paid by client of commercial bank using declining method is approximately 83 JD. Client of MFI using flat method pays at the same nominal interest rate of 15% p.a. almost double the interest amounting 150 JD. According Ledgerwood, method selection may be related to higher costs of MFIs in comparison to commercial banks and way of revenue increase. MFIs prefer to use flat method rather than increase their nominal interest rate. Commercial banks calculating interest on the declining balance would have to increase their nominal interest rate substaintially to earn the same revenue as an MFI calculating interest on a flat basis.

[2]Interest rate of 15% p.a. was choosed as aproximatelly the average of MFI's interest rates.

Tab. 3: Declining Balance Method (JD)

Month	Payments	Principal	Interest	Outstanding balance
0	–	–	–	1000
1	90.2584	77.7584	12.5	922.2416
2	90.2584	78.73038	11.52802	843.5112
3	90.2584	79.71451	10.54389	763.7967
4	90.2584	80.71094	9.547459	683.0858
5	90.2584	81.71983	8.538572	601.3659
6	90.2584	82.74133	7.517074	518.6246
7	90.2584	83.77559	6.482808	434.849
8	90.2584	84.82279	5.435613	350.0262
9	90.2584	85.88307	4.375328	264.1432
10	90.2584	86.95661	3.30179	177.1866
11	90.2584	88.04357	2.214832	89.14299
12	90.2584	89.14411	1.114287	–0.00113[1)]
Total	1083.101[2]	1000.001[1]	83.09967[2]	

[1]Data was calculated in Excel. Total principal is 0.001 higher because of rounding off a PMT which affects also outstanding balance value in 12 month
[2]Difference of 0.00133 is due to rounding

Tab. 4: Flat Method (JD)

Month	Payments	Principal	Interest	Outstanding balance
0	–	–	–	1000
1	95.833	83.333	12.5	916.667
2	95.833	83.333	12.5	833.334
3	95.833	83.333	12.5	750.001
4	95.833	83.333	12.5	666.668
5	95.833	83.333	12.5	583.335
6	95.833	83.333	12.5	500.002
7	95.833	83.333	12.5	416.669
8	95.833	83.333	12.5	333.336
9	95.833	83.333	12.5	250.003
10	95.833	83.333	12.5	166.67
11	95.833	83.333	12.5	83.337
12	95.833	83.333	12.5	0.004[1)]
Total	1149.996[2]	999.996[1]	150[2]	

[1]Data was calculated in Excel. Total principal is different from 1,000 and outstanding balance in 12 month is different from 0 because of rounding off
[2] Difference of 0.004 is due to rounding

DISCUSSION AND CONCLUSION

Basic microfinance objective is to provide financial services to the people with lack access to financial services from traditional financial institutions. Those implies that MFIs provide services suitable to this people. Becouse of the target group of microfinance, it is important to provide products and services to be accessible to clients, which requires special approaches of MFIs differing from traditional banks. This applies in particular to collateral, outreach, additional non-financial services supporting clients etc.

The surveyed MFIs offer products and services suitable to the target group differing from traditional bank products and services in favour of this target group, which means the poor and lower income people, small businesses and many women. Therefore, becouse of the environment of Jordan supporting sustainability of MFIs in long term, it may be a way for poverty reduction.

But it should be noted, that although microfinance can play an important role in poverty reduction, it is only a partial tool for poverty reduction.

Microfinance is not a magic sky-hook that reaches down to pluck the poor out of poverty. It can, however, be a strategically vital platform that the poor can use to raise their own prospects for an escape from poverty. (Matin, 1999) The effectiveness of microfinance programs as tools of poverty reductions depends, among other things, on whether and how successfully they address the real constraints faced by the poor (Gulli, 1998).

An important point is that microcredits provide access to finaces for the poor, without which they would be hardly able to operate their little businesses or they would be forced to obtain money under unfavorable conditions, such as through loan sharks. This site is a financial matter. But moreover, there are also important social aspects of microfinance helping really the poor to improve their life situation. To this aspects belong, besides possible requirements for clients in the social sphere conditioning loan drawdowning, also undoubtedly non-financial services provided by MFIs. The conditions related to microcredit are adapted to the poor, which generally means small size of loan, shorter repayments periods etc. All this facts couse increasing the cost of MFIs in comparison with traditional banks. For a financial institution to scale and remain sustainable, at a bar minimum, it has to cover its costs. Therefore, the interest rates of microcredit may be often higher. It should be noted that although MFIs may charge a higher interest rates to cover their costs, these interest rates are still significantly lower than the interest rates that many borrowers were previously paying to money lenders in the local area. This is a type of sustainable, by the market abiding MFIs, that are not subsidized or another way supported by donors. In case of supported MFIs, they generally provide loans with smaller interest rates than the commercial banks.

According to Ledgerwood, subsidized lending programs provide a limited volume of cheap loans. When these are scare and desirable, the loans tend to be allocated predominantly to a local elite with the influence to obtain them, bypassing those who need smaller loans (which can ussually be obtained commercially only from informal lenders at far higher interest rates).

This happend for example in Costa Rica in 1974, where 80 percent of the US $56 million in subsidies provided to Costa Rica's largest bank went to larg-scale wealthy farmers (Lont and Hospes, 2004).

Jordan, as mentioned above, provides conditions for the development of microfinance sector.

Thus the country enviroment supports development of microfinance sector and especially self sufficiency of MFIs, which implies that there is a big support of private sector in microfinance and market-oriented financial and credit policies, e.g. market-oriented interest rates charged on microcredits. Therefore government agencies will not participate in the implementation of credit and/or quarantee programs anymore. Which means that subsidized lending programs will gradually withdraw from the market (National Strategy for Microfinance, 2005–2010). All this facts have obviously impact on the interest rate charged on microcredit by MFIs.

Therefore, there are operating a relatively large number of microfinance providers. On the other hand, more providers of microfinance services means bigger supply in the microfinance market and, in particular in the private sector, may couse it some competitive pressures. Becouse self sustained MFIs operate in competitive environment, it can be assumed that MFIs seek to gain a competitive advantage, especially through developing the range and terms of financial services available to the target group, which means many who are poor and lower-income, lower educated and many women. But is the range and terms of microfinance services really suitable to this target group? Generally, it can be said that yes. According results of quantitative part of Micofinance Impact Assessment made in Jordan, almost 60% of client sample (186 from 311 clients) never even asked for a loan in the commercial banks and it can be assumed, that the rest of clients did not receive financial products from commercial banks too for various reasons or were just not satisfied with. What is the most important reason?

The most important reason seems to be the collateral. Commercial banks require traditional collateral such as property, salary, land, machinery, and other capital assets. The poor people have no such collateral. Therefore many MFIs use collateral substitutes such as personal collateral, group quarantee or bank checks.

Here is a concencus to the case study from Mexico, where the results on the demand side shows, that 75% of the households interwied had never requested a loan from the formal financial sector. Rural enterpreneurs felt this would be too risky, given the excessive amount of collateral required. Many enterpreneurs also addmited that they were afraid of formal institutions (Chaves and Sanchez, 1997).

Combating poverty through microfinance in Jordan seems to be successful way in the long term due to political and economic environment of a country, where the government provides the enabling environment for the efficient functioning of microfinance market, which allows self sufficiency of MFIs.

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Corresponding author:

Ing. Miroslava Šafránková, Ph.D.
University of South Bohemia
Faculty of Economics
Ćeské Budějovice
Czech Republic
e-mail: m.safrankova@email.cz