Swedfund

Position Paper – Microfinance

The purpose of this position paper is to present Swedfund's position on microfinance services in developing countries and our framework for work in these types of investments.

Background

Microfinance is the provision of financial services to the low-income segment population and enterprises, which due to poverty typically face challenges in accessing these services. Microfinance include all traditional banking services such as savings accounts, loans, insurances and money transfers. Having access to these conventional services help people improve their lives, establish businesses, secure livelihoods and consequently provides an opportunity to help themselves out of poverty. The outcomes of microfinances thereby contribute to economic as well as social development. Undeniably, growth of the microfinance industry was central to the social progress achieved in South Asia in the past four decades. The microfinance gap in our target market including but not limited to Sub-Sahara Africa, is significant. On a global basis microfinance investment vehicles are directly invested in 96 countries. The top 10 countries account for more than 50% of all microfinance investments and no African country is among the top 10 countries[1].

Widespread lack of access to basic financial services prevents low income entrepreneurs from managing their cash flows or growing their businesses. Women are more likely to be self-employed than men, but 42% of women worldwide, or 1,1 billion, remain outside the formal financial system[2], representing a significant gender gap. Empowering women financially has been shown to have a positive effect on a number of development goals. As a result of poor credit history or lack of collateral, women are, however, more likely to be denied bank loans than men and often pay higher interest rates than men on formal bank loans[3]. Swedfund believes microfinance offers significant opportunities for developing countries to unleash the private sector potential, reaching out to female entrepreneurs and contributes in addressing challenges such as poverty, income inequality, and unemployment.[4] With micro finance we also achieve financial inclusion which in turn is fundamental to reach many of the 2030 Sustainable Development Goals[5].

However, in the recent past some critical matters have emerged regarding the effectiveness of microfinance in combating poverty. Underlying issues that are brought forward are the risks of over-indebtedness and the need for better consumer protection. The high interest rates charged by some microfinance institutions (MFIs) have also been criticized as they have partially shifted from being subsidised into a model where they also strive for positive returns on investments.

We should therefore be aware that Microfinance on its own is not a miracle solution to eradicate extreme poverty. The experience of South Asia and other regions demonstrate that microfinance can deliver positive effects only when combined holistically and integrated effectively with other economic and social programs to meet the diverse needs of the low-income segment and aid in the journey out of poverty. Therefore, providing access to microfinance services comes with the obligation to commit to a number of key elements which secure an integrated adoption of adequate regulatory frameworks, legislations that protects consumers and to certify transparency and accountability of the public sector.

1. Assessment criteria for MFIs

For Swedfund to consider an investment in an MFI its services to low-income clients should substantially adhere to, or undertake to adhere to, the following core principles:

- Avoidance of Over-Indebtedness. Providers should take reasonable steps to ensure that credit will be extended only if borrowers have demonstrated an adequate ability to repay and loans will not put

[1] Symbiotics 2017 MIV Survey)
[2] Global Findex database (World Bank, Demirguc-Kunt et al. 2015)
[3] IFC 2011
[4] UN Microfinance in Africa 2013 Report
[5] https://sustainabledevelopment.un.org/ (SDG1; SDG 2; SDG 3; SDG 8; SDG 9 SDG 10 and SDG 17

borrowers at significant risk of over-indebtedness. Similarly, providers should take adequate care that noncredit, financial products (such as insurance) extended to low-income clients are appropriate

- Transparent Pricing. The pricing, terms, and conditions of financial products (including interest charges, insurance premiums, all fees, etc.) will be transparent and will be adequately disclosed in a form understandable to clients.
- Appropriate Collections Practices. Debt collection practices of providers will not be abusive or coercive.
- Ethical Staff Behavior. Staff of financial service providers will comply with high ethical standards in their interaction with microfinance clients and such providers will ensure that adequate safeguards are in place to detect and correct corruption or mistreatment of clients.
- Mechanisms for Redress of Grievances. Providers will have in place timely and responsive mechanisms for complaints and problem resolution for their clients.
- Privacy of Client Data. The privacy of individual client data will be respected, and such data cannot be used for other purposes without the expressed permission of the client (while recognizing that providers of financial services can play an important role in helping clients achieve the benefits of establishing credit histories).

We therefore investigate whether an MFI is certified by the SMART Campaign[6] or similar initiatives[7] or, in case no certification is in place, negotiate an undertaking by the potential MFI to adhere to such principles within a certain timeframe as part of our ESGAP agreement.

In our review we also assess the potential MFI's own client protection principles which in short describe the minimum protection its clients should expect from the MFI. While the Principles are universal, meaningful and effective implementation always requires careful attention to the diversity within the provider community, conditions in the different markets and of course the country context.

Swedfund also give preference to MFIs whose business activity is not primarily geared to short-term financial returns (for example by focusing on consumer credit), but instead the Swedfund focus is to respond to the needs of our relevant target groups. In practice this mean that we support MFIs that are focusing on MSME loans, housing finance or savings products for small and micro-savers.

Finally, Swedfund always considers the interest levels a potential MFI charges on its loans[8]. The interest rates of MFIs are normally high as MFIs grant a higher number of small loans compared to traditional banks, using a rigorous methodology that results in higher operating and processing costs. Additionally, lack of information on past credit performance and, in many cases, an inadequate legal structure to enforce non-payment increases risk for lending institutions, also contributes to higher rates to cover added risk. As a rule of thumb Swedfund does not invest in an MFI that charge interest rates above the market average for comparable credits. In our evaluation of a potential MFI investment we therefore assess the prevailing interest rates in the market including but not limited MFI rates. To put it in context the Grameen Bank model, suggest setting rates around 15% above the cost of funds. However, this is below the average interest of 27% charged by MFIs globally[9], and in the end Swedfund needs to finance MFIs that "on balance" meets all of our criteria. Although increased MFI penetration in a market does not evidently decrease the interest rate charged, the increased market penetration decreases the propensity to borrow from informal sources in both absolute and relative terms and compared to informal moneylenders, the MFI rate is often significantly lower.[10][11]

Swedfund welcomes activities in the microfinance sector, despite the criticism raised above. With the right incentives and well-grounded ways of incorporating microfinance services, it has proven to be an important tool and enabler for economic and social development that can provide support in a number of the 2030 SDG.

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6 The SMART Campaign is a global effort that aims to bring transparency to the microfinance sector to increase the protection of the clients by providing institutions with an independent, objective seal that ensures that a financial institution is doing everything it can to treat its clients well and protect them from harm.

7 the Responsible Finance Forum, the Social Performance Taskforce, Microfinance Transparency and Principles for Investors in Inclusive Finance

8 Local currency loans as wellas hard currency loans

9 http://www.cgap.org/sites/default/files/Forum-Microcredit%20Interest%20Rates%20and%20Their%20Determinants-June-2013.pdf

10 Berg, Claudia N. and Shahe Emran, M. and Shilpi, Forhad, Microfinance and Moneylenders. 2015. Long-Run Effects of MFIs on Informal credit Market in Bangladesh

11 Informal market rates can range from 40-200% a year. See The World Bank Economic Review, Volume 4, Issue 3, 1 September 1990, Pages 329–349 for a more in-depth review