Finance and Growth: Entrepreneurship and Microfinance

CONVEGNO

“Il microcredito come fattore di sviluppo”

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Università Europea di Roma

Aula Master I piano

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Outline

1. Entrepreneurship, Finance and Growth: the Process of Development
   - Schumpeter, entrepreneurship, economic growth

2. Role of Financial Markets

3. Responses to Overcome Market Failure

   Public Sector Banks MDBs (Multilateral Development Banks)
   - MDBs, National Development Banks, European Investment Bank

4. Microfinance
   - Concept, Scope and Limitations

5. Going Forward
   - Micro Insurance
   - Commercialization
   - Performance Audit
   - Training
   - Spatial Analysis

Thanks

For the material provided by

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1. Entrepreneurship, Finance and Growth: the Process of Development

The Process of Development

- The entrepreneur of Schumpeter
  - According to Schumpeter (1934), the entrepreneur is the innovator who implements change by initiating new combinations, which can take several forms:

(1) the introduction of a new good or quality thereof,
(2) the introduction of a new method of production,
(3) the opening of a new market,
(4) the conquest of a new source of supply of new materials or parts, or
(5) carrying out the new organization of any industry.

- Role of Financial Markets:

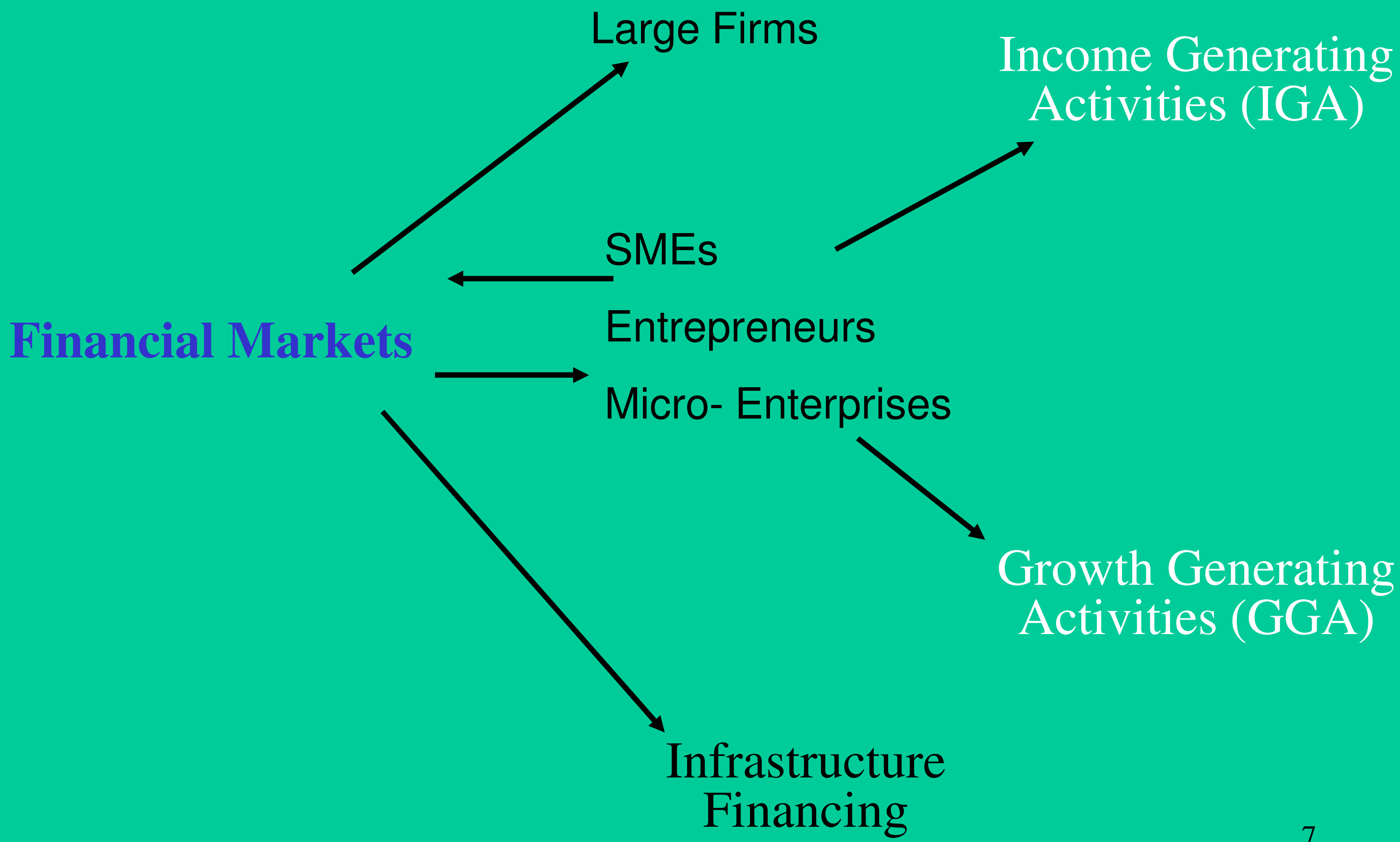
  - Allocation of credit according to efficiency criteria, rewarding the "creative destruction" of the Schumpeterian entrepreneur, and therefore creating opportunities to prompt growth.

Theory

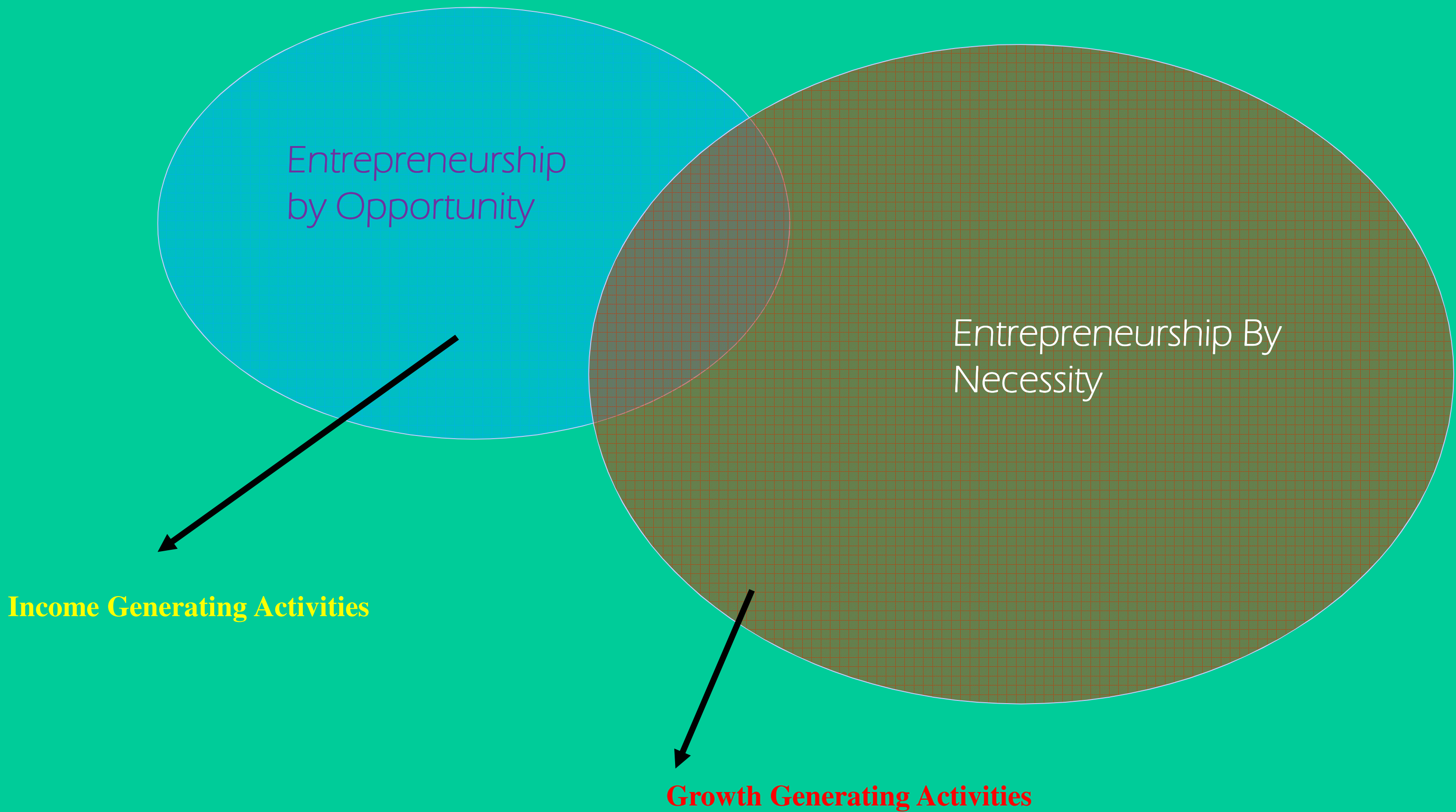
- The central contention is that small firms - home of the independent entrepreneur and the independent inventor- has been the primary source of the technical ideas and innovations that serve as the foundation for the unprecedented growth performance of the world's industrial economies
  - Baumol W., The Free-Market Innovation Machine: Analyzing the Growth Miracle of Capitalism, Princeton: Princeton University Press, 2002

- A functioning financial system allows access to finance for firms and entrepreneurs and promote economic growth
  - King, R. G., and R. Levine. 1993. Finance and Growth: Schumpeter Might be Right. *Quarterly Journal of Economics* 108: 717–37

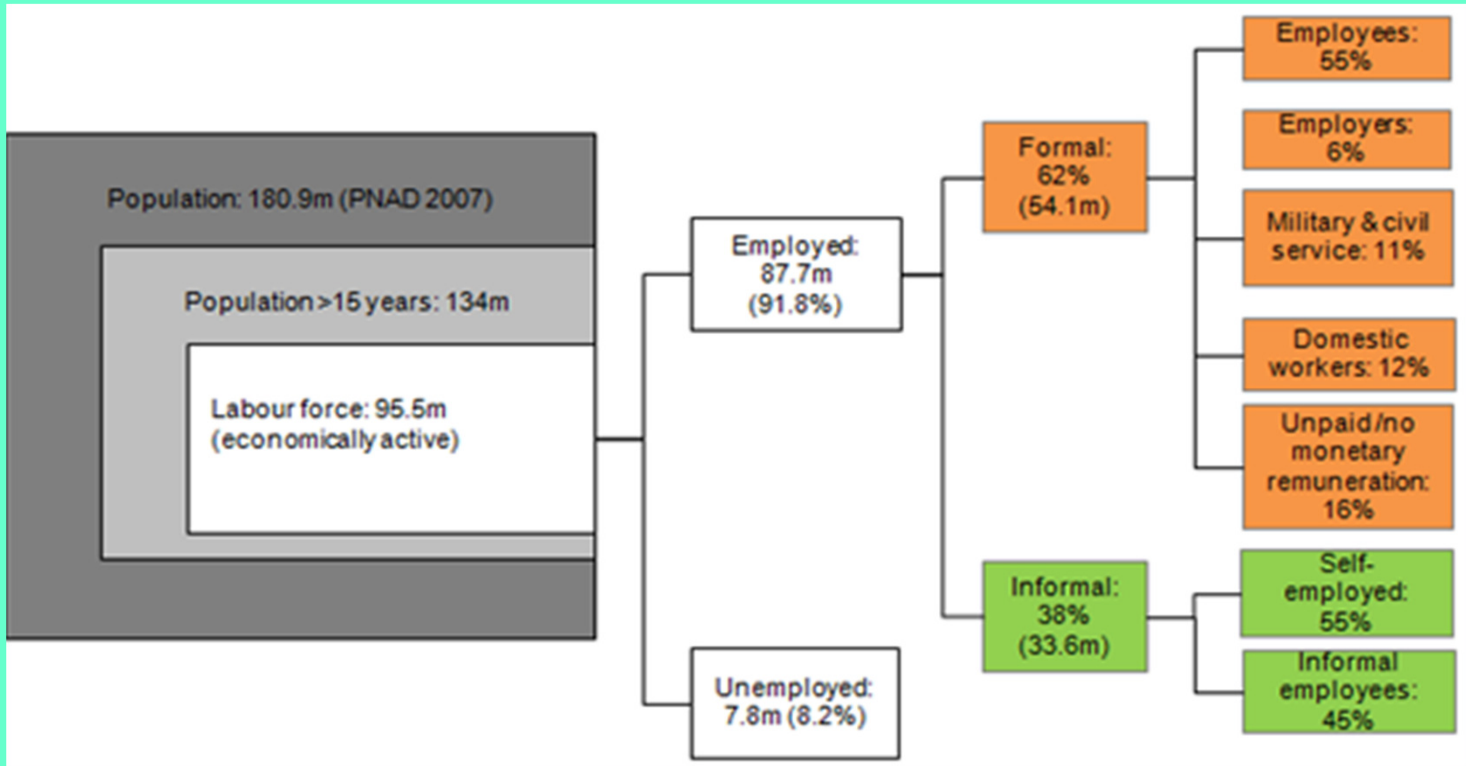
Activities in Need of Financing



Know the Environment!!!!



The Brazilian Economy



Informal Economy

- The level of informality has important implications for two related aspects.

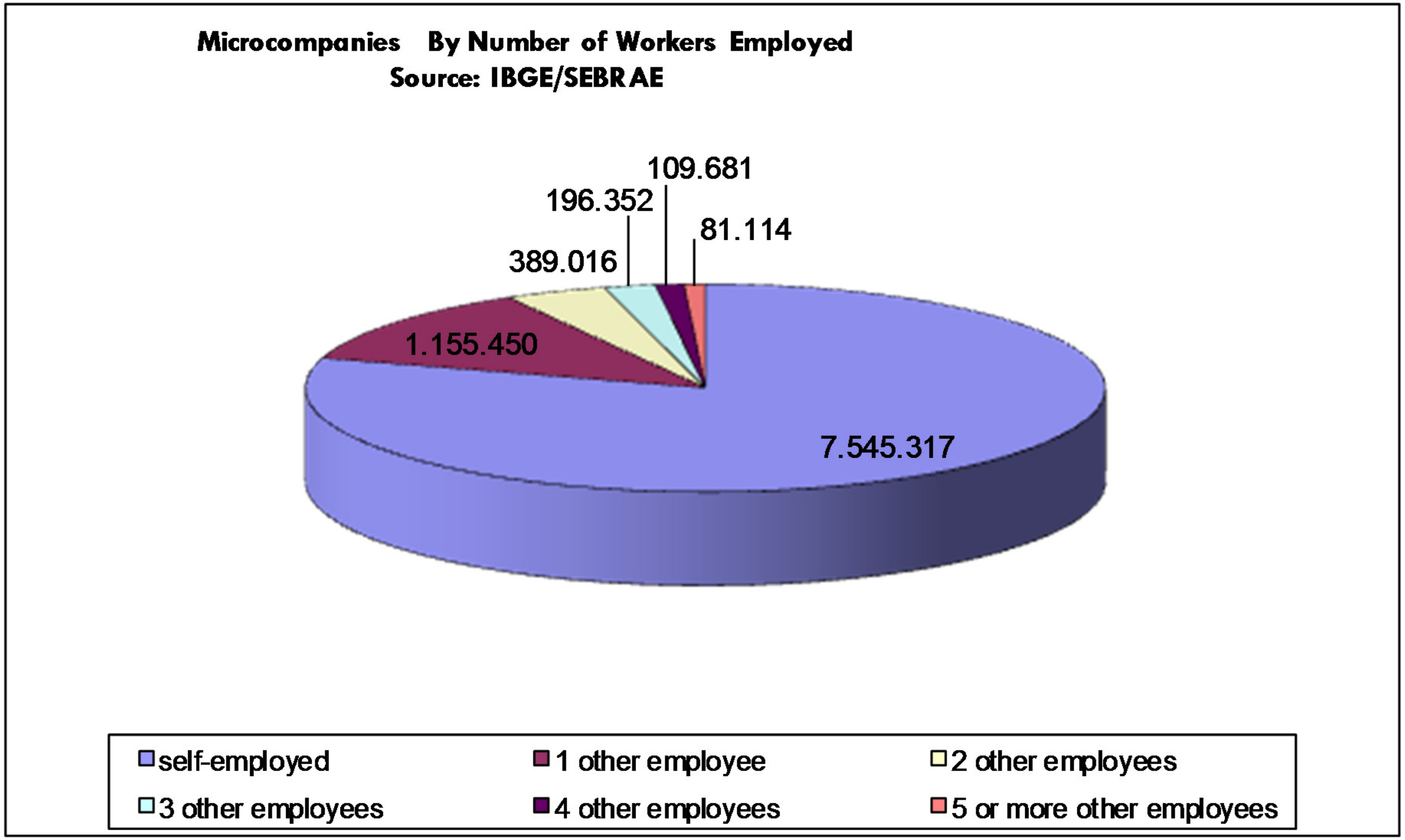
- First, from the point of view of entrepreneurship, high level of informality is related to entrepreneurship with **lower content of innovation**. At the same time, high level of informality implies greater difficulty in measuring entrepreneurship (see Acs and Virgill 2009).

- Second, from the point of view of insurance, Bebster and others (2010) stress not only that the incomes of those in the informal sector are less certain than of those in the formal sector, but they are also **more difficult to reach, presenting distribution challenges**, e.g., formal sector employees can be reached via their unions and employers, the informal sector is more fragmented.

- **In Brazil,** informality is lower than in similar countries**, but at 38%** it remains substantial (compared to the 27.5% informal employment in Mexico as measured by Cardero and Espinosa, 2009; Argentina, with 20% informal employment; and Chile, where 24.4% of those employed are in the informal sector according to the ILO).

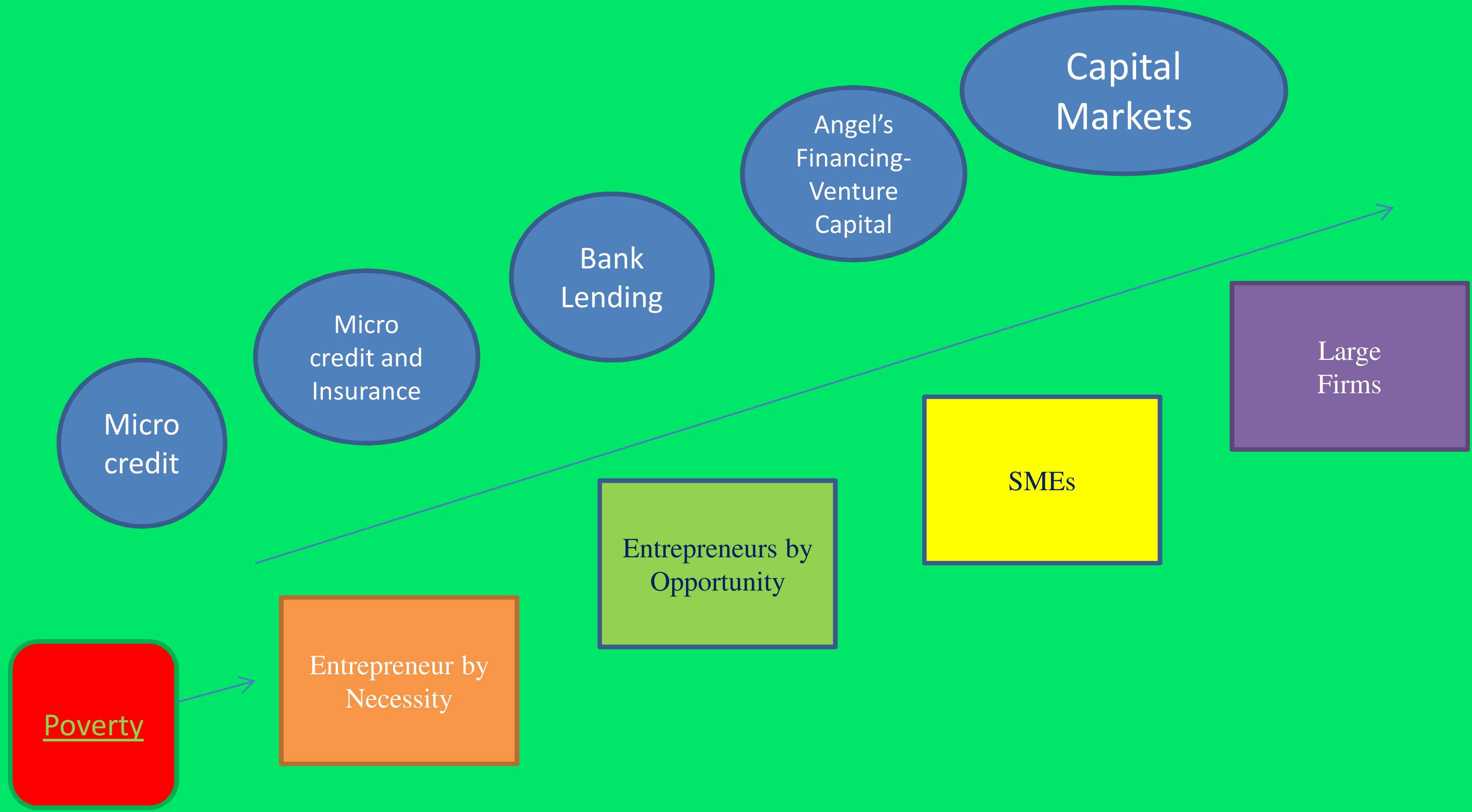
- Though 62% of the labor force is “formally employed”, not all of them are in effect formal if considered from **financial services distribution** point of view. In other words, not all of them can be reached via employee groups. If domestic workers and unremunerated employees are taken out of the formal equation, the share of formal employment in the total employed market reduces to just 44%, placing 56% of the population in the informal market that cannot readily be targeted for insurance via their employers .

Micro-Entrepreneurs in Brazil



2. Role of Financial Markets

Economic activity and Finance



Measures of Financial Sector Development

- Domestic Bank Credit/GDP

  indicator of financial sector development

Geographic Area	M_2/GDP(%)	Domestic Bank Credit/GDP (%)
Latin America	0.49	0.67
Middle East	0.72	0.48
OECD Countries	1.32	**2.3**
Egypt	0.79	0.47
Brazil	0.66	**0.97**

Role of Financial Markets

- The efficient market approach states that Financial Market (FM) allocate efficiently resources to the best projects.

- A functioning Financial Market reduces asymmetries

- The private sector is the engine of growth and public policy should set incentives to be an entrepreneur by establishing a legal and regulatory environment and facilitating innovation.

- Strategy: develop domestic capital markets, in local currency, overcome the so called "the original sin; set a risk-free rate.

Diagnostic

- Difficult access to financing for Micro and SME Enterprise (MSMEs)
  - MSMEs constitute large part of the economy (in some cases roughly 99% of firms) and provide 2/3 of total employment thus creating million of jobs to maintain unemployment rates at present levels

- Need of large amounts of Infrastructure Financing
  - Infrastructure produces economic growth and create jobs

- Reducing Poverty
  - Economic growth reduces poverty and access to finance is relevant for the poor segment of population to exploit an hidden potential.

Diagnostic during the Crisis

- The situation worsens in this time of crisis:
  - Greater Uncertainty
  - Sharp decline in capital inflows
  - Significant reduction in investment including infrastructure
  - Reduction in remittances

- Prior to the current crises, excess of liquidity together with a difficult access to financing for MSMEs → 75% are internal funds
  - Banking finance remains the main source of external finance for MSMEs (12%)

Market Failures

- Financial intermediation is a market function, but does not guarantee financing of MSMEs and Infrastructure and does not allow access to finance

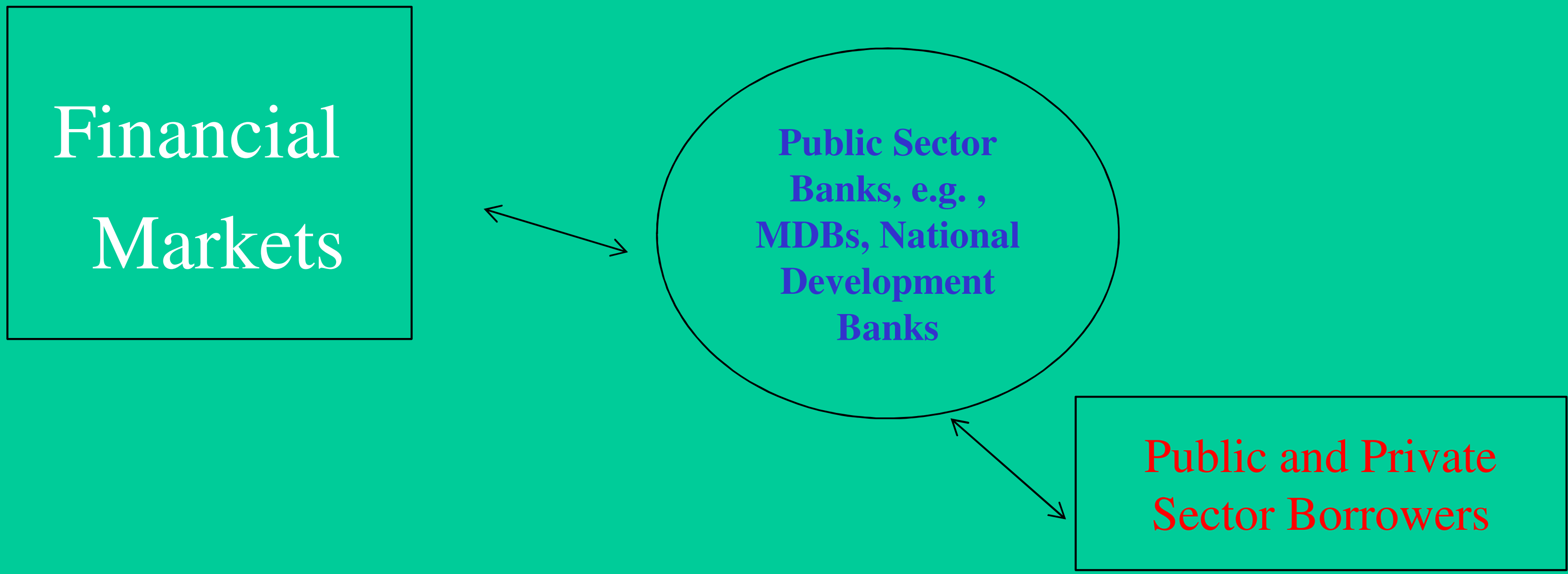
- There is a Market Failure
  - Overcome Uncertainty
  - Limited domestic savings
  - Need of foreign exchange

- Nationalistic attitudes in emerging countries

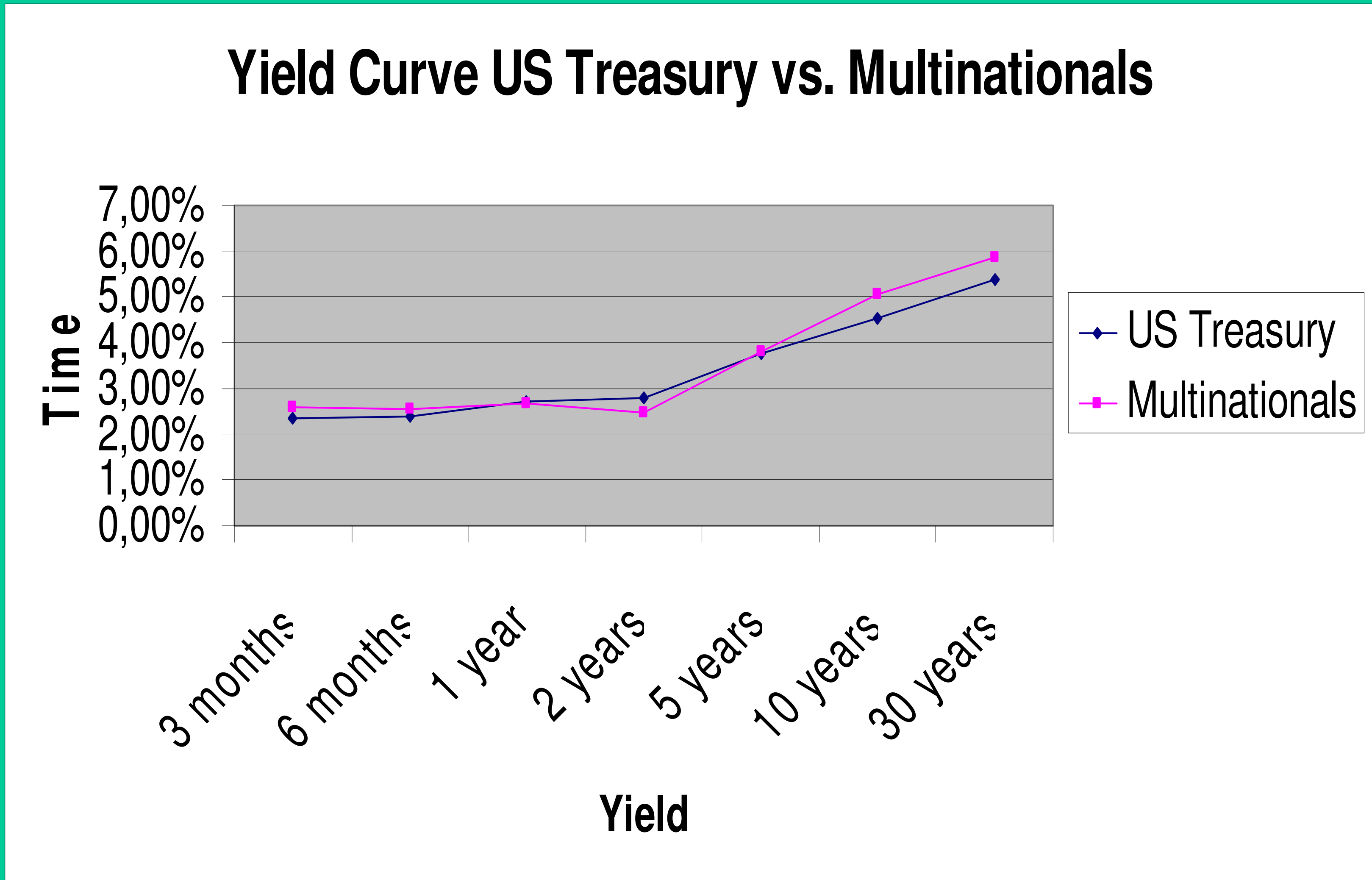
3. Responses:

Multilateral Development Banks (MDBs) and Public Sector Banks

MDBs and Public Sector Banks: How Financial Intermediation Works



AAA Rating of MDBs and IFIs



Multilateral Development Banks a subset of IFIs (International Financial Institutions) and Public Sector Banks

- The "Multinational's" AAA : The strong AAA is mainly a result of:
  1. Strong Membership Support
  2. Sound Financial Policies (e.g., liquidity)
  3. Good Financial Performance
  4. Preferred Creditor Status
  5. Ratio loans outstanding/capital (gearing ratio)
  6. Borrowers are also shareholders

- National MDBs (e.g., BNDES in Brazil): public sector banks constitute an important instrument to overcome supposed market failures (lack of private sector intermediation, low savings, lack of foreign exchange) and to finance long term investments.

The European Investment Bank

European Investment Bank (EIB) was created by the Treaty of Rome in 1958 as the long-term lending bank of the European Union

The task of the Bank is to contribute towards the integration, balanced development and economic and social cohesion of the EU Member States. The EIB also operates outside the EU.

The EIB raises substantial volumes of funds on the capital markets, which it lendson favourable terms to projects furthering EU policy objectives. The EIBcontinuously adapts its activity to developments in EU policies

The EIB is one of the largest non-sovereign borrowers on the EU bond market.

The EIB enjoys its own legal personality and financial autonomy within the EU; it operates in keeping with strict banking practice and in close collaboration with the wider banking community, both when borrowing on the capital markets and when financing capital projects.

In 2008, the European Investment Bank lent a total of EUR 47.8 billion for projects promoting the European Union's policy objectives. Finance for the EU-27 Member States represented 87% of its activities and amounted to EUR 41.4 billion.

Public Sector Banks
Experiences and Research

- Most of the literature on state ownership of banks focuses on development banks – at national and international levels, i.e., Development Finance Corporations (DFCs), MDBs- and their impact on financial development and economic growth.

- Research and experience have shown that public sector banks tend to have low profitability, return on assets lower than that of private banks, inefficiency, various forms of corruption including the so called "related lending", which does not foster entrepreneurship.

- There are also very different types of public sector financial institutions, e.g., commercial banks owned by Government.

- The objective of providing access to finance is not reached.

- Public sector banks are part of government intervention in the economy and lead to financial repression that prevents the development of private financial markets that allocate resources.

- There are various different examples, e.g., KfW, Latin American experience

- Critical Role of IFIs and MDBs in economic and financial crises

Access to Finance

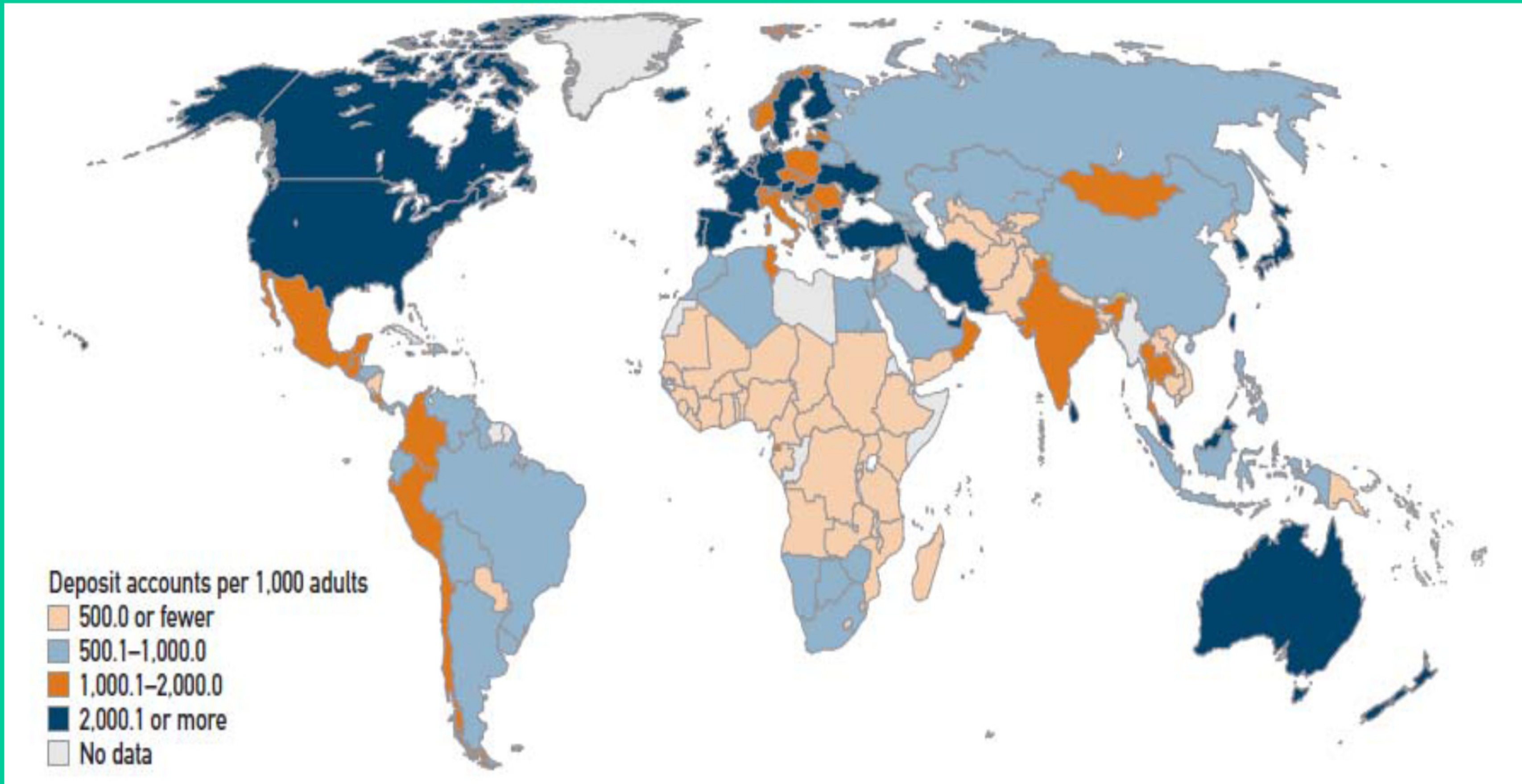
A World Bank- Cgap Publication, Access to Finance 2010 has developed a set of financial access indicators for 139 countries across the globe.

Despite the apparent overabundance of approximately 6.2 billion bank accounts in the world - more than one per adult - a disproportionate amount of the accounts - 3.2 per adult - are located in the developed world economies, while the equivalent figure in the developing world reaches is only approximately 0.9 per adult, inclusive of accounts which are not owned by individuals, such as those owned by government and business entities.

It is estimated that roughly 19% of developed world adults do not have bank accounts (though many may live in households where other members have accounts), **whereas nearer to 72% of adults in the developing world do not have accounts.**

These numbers indicate **a major gap that has not yet even begun to be addressed** by the many policy initiatives currently underway or by the microfinance movement.

Access to Finance:
Number of deposit accounts in banks and regulated non-bank financial institutions per thousand adults

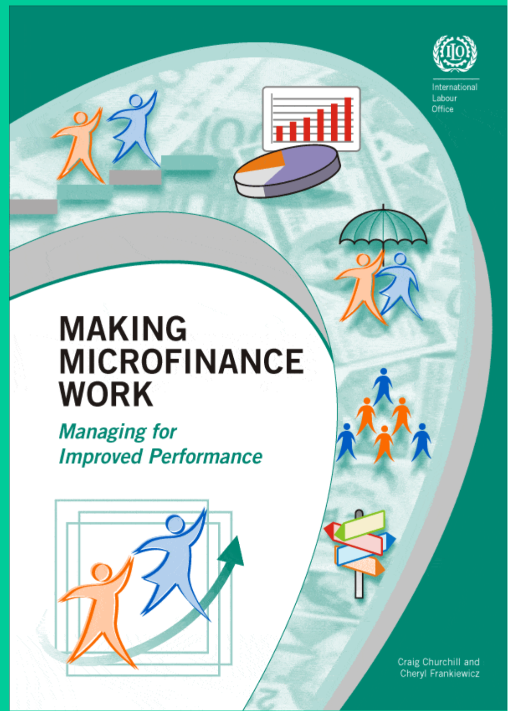


4. MICROFINANCE

Concept, Scope and Limitations

In this discussion we are trying to understand

- Poverty
- What is Microfinance?
- It’s origin
- Poverty and micro-credit
- Process of micro-credit
- Advantages of micro-credit
- IGL and group lending model
- Social Impact of Microfinance
- Scope and Limitations of Microfinance



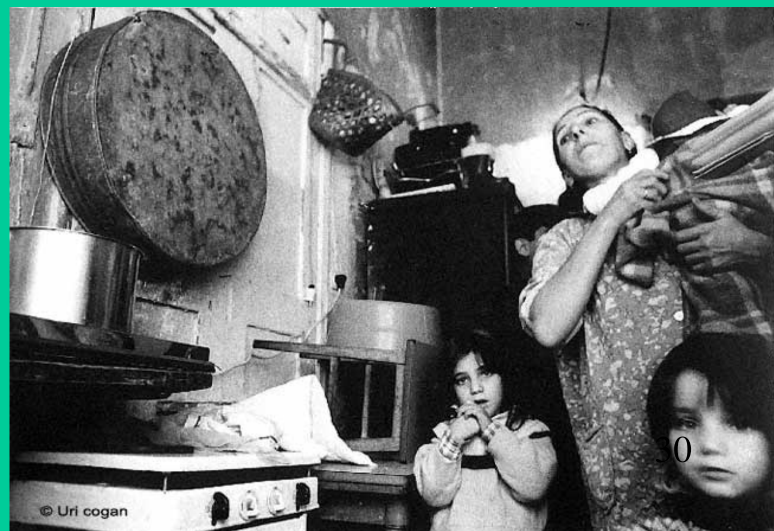
Poverty

- Poverty means being unable to afford basic human needs, such as clean water, nutrition, health care, education, clothing and shelter.

Poverty: 2 Types

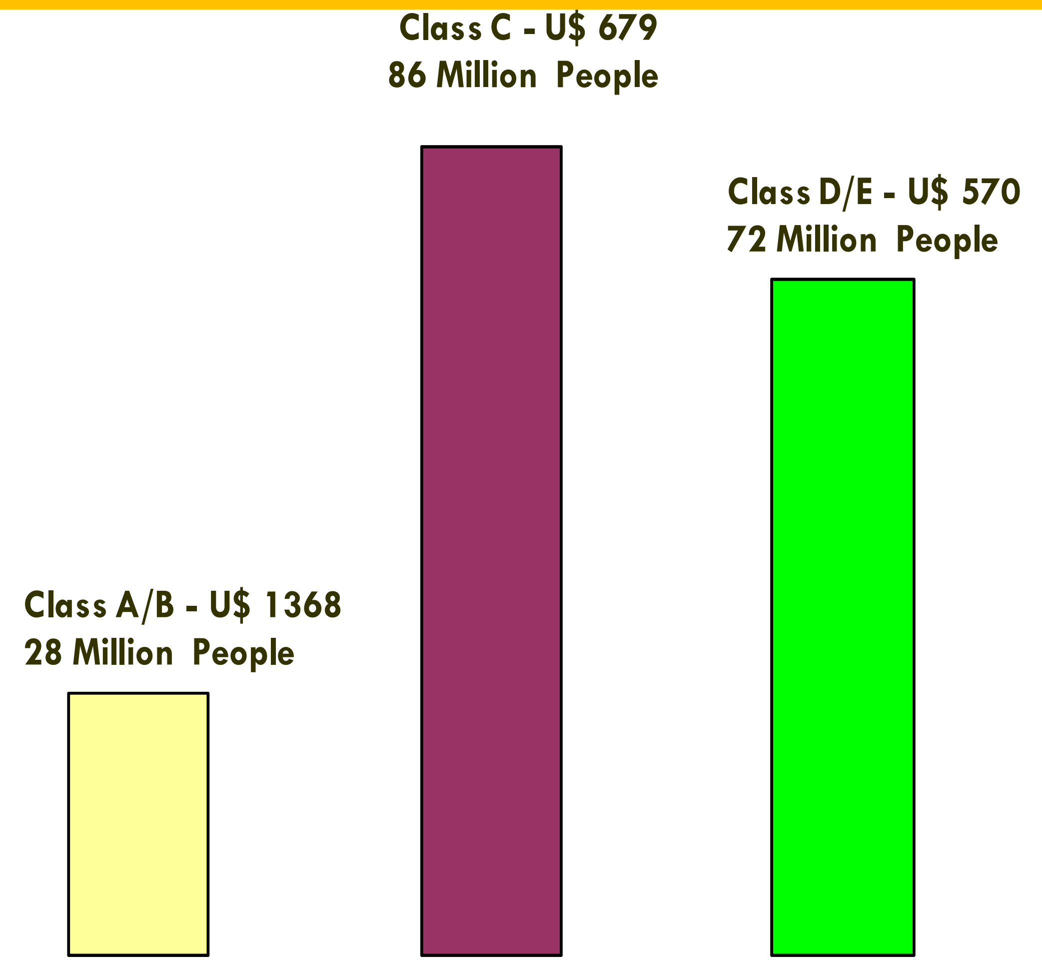
- Absolute Poverty or destitution.

- Relative Poverty
  is the condition of having fewer resources or less income than others within a society or country, or compared to worldwide averages

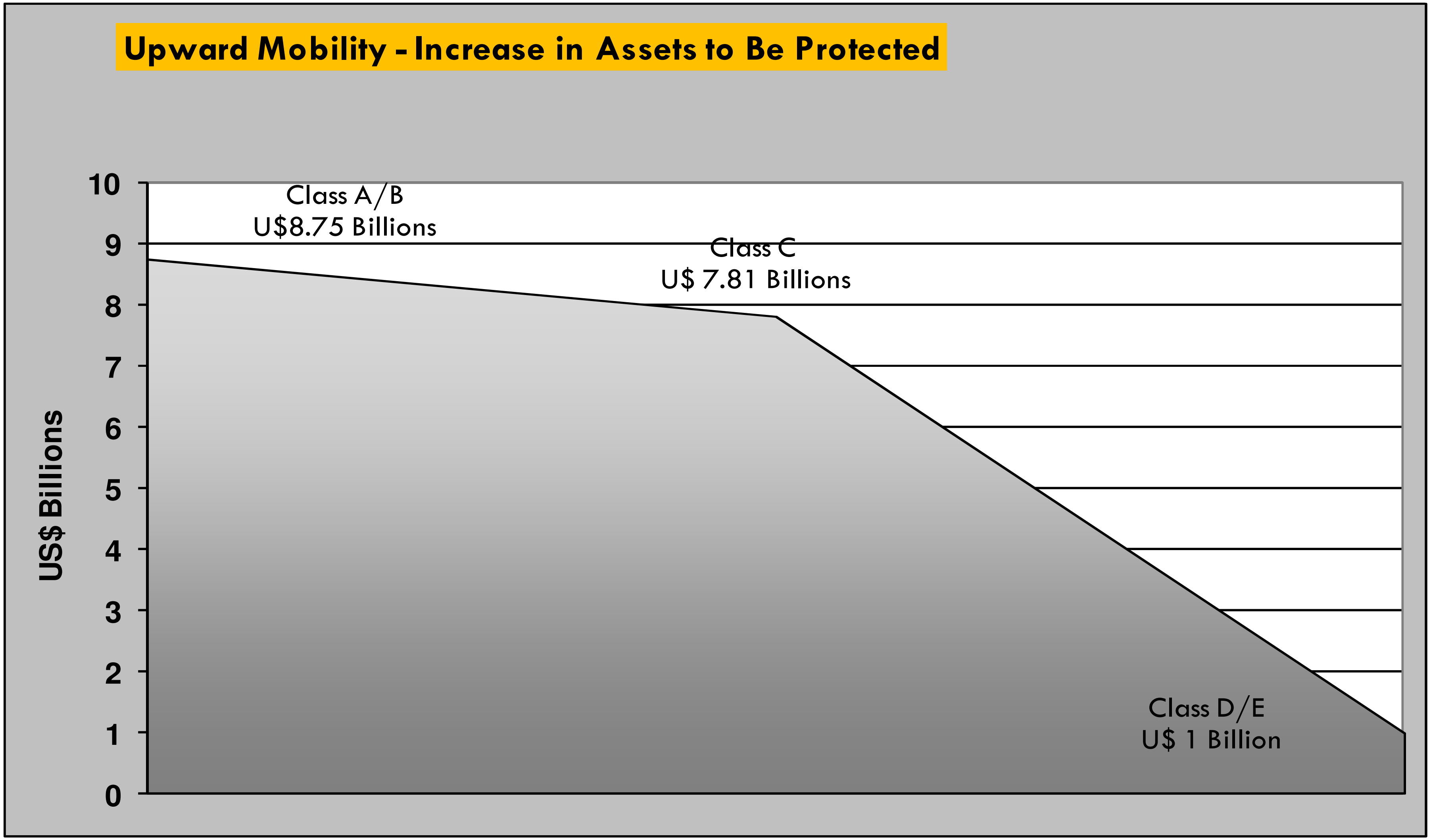


Poverty Overview - Brazil

In the last four years, 35 million people moved from classes D and E, to class C



Market Overview – Brazil
Disposable Income by Class (US$ Billions)



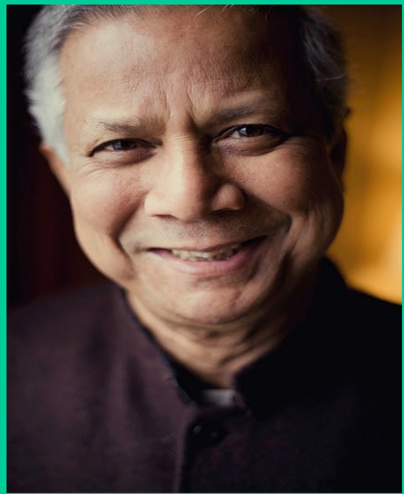
What is Microfinance ?

- Micro finance (MF) is the provision of financial services to those who are excluded from conventional commercial financial services. Because they are too poor to offer much - or anything - in the way of collateral

What is Microfinance ?

- MF includes a series of financial services - micro loans, deposits, savings, insurance- for poor individuals, or group of poor
- It presents a series of exciting possibilities for:
  - o Extending markets,
  - o Prompting Entrepreneurship
  - o Reducing poverty, and
  - o Fostering social change and mobility.

Origins of Microfinance



- The concept of micro finance originated in the mid-1970s in Bangladesh through a pioneering experiment by Dr Muhammad Yunus, then a Professor of Economics.

Origin of Microfinance

- Dr. Mohammad Yunus Established Bangladesh Grameen Bank, a Micro Finance Institution (MFI) to:
  - Provide financial services and entrepreneurship opportunities to poor
  - So they could produce, manage and maintain their own finances
  - It was an end to mistreatment by money lenders, i.e., usury and financial exclusion.

Origin of Microfinance

- The Grameen Bank -a synonym for Microfinance- makes small loans to the impoverished without requiring collateral. Established in 1976, the Grameen Bank (GB) has over 1000 branches (a branch covers 25-30 villages, around 240 groups and 1200 borrowers) in every province of Bangladesh, borrowing groups in 28,000 villages, with over 90% of borrowers are women.

- It has an annual growth rate of 20% in terms of its borrowers. The most important feature is the recovery rate of loans, which is as high as 98%.

- A still more interesting feature is the ingenious manner of advancing credit without any "collateral security". The Grameen Bank lending system is simple but effective. The system is based on the idea that the poor have skills that are under-utilized. A group-based credit approach is applied, which utilizes the peer-pressure within the group to ensure the borrowers follow through and use caution in conducting their financial affairs with strict discipline, ensuring repayment eventually and allowing the borrowers to develop good credit standing.

- The Business Model on which most of the Microfinance works is solidarity lending, a lending practice where small groups borrow collectively and group members encourage one another to repay. It is an important building block of microfinance. Solidarity lending lowers the costs to a financial institution related to assessing, managing and collecting loans, and can eliminate the need for collateral.

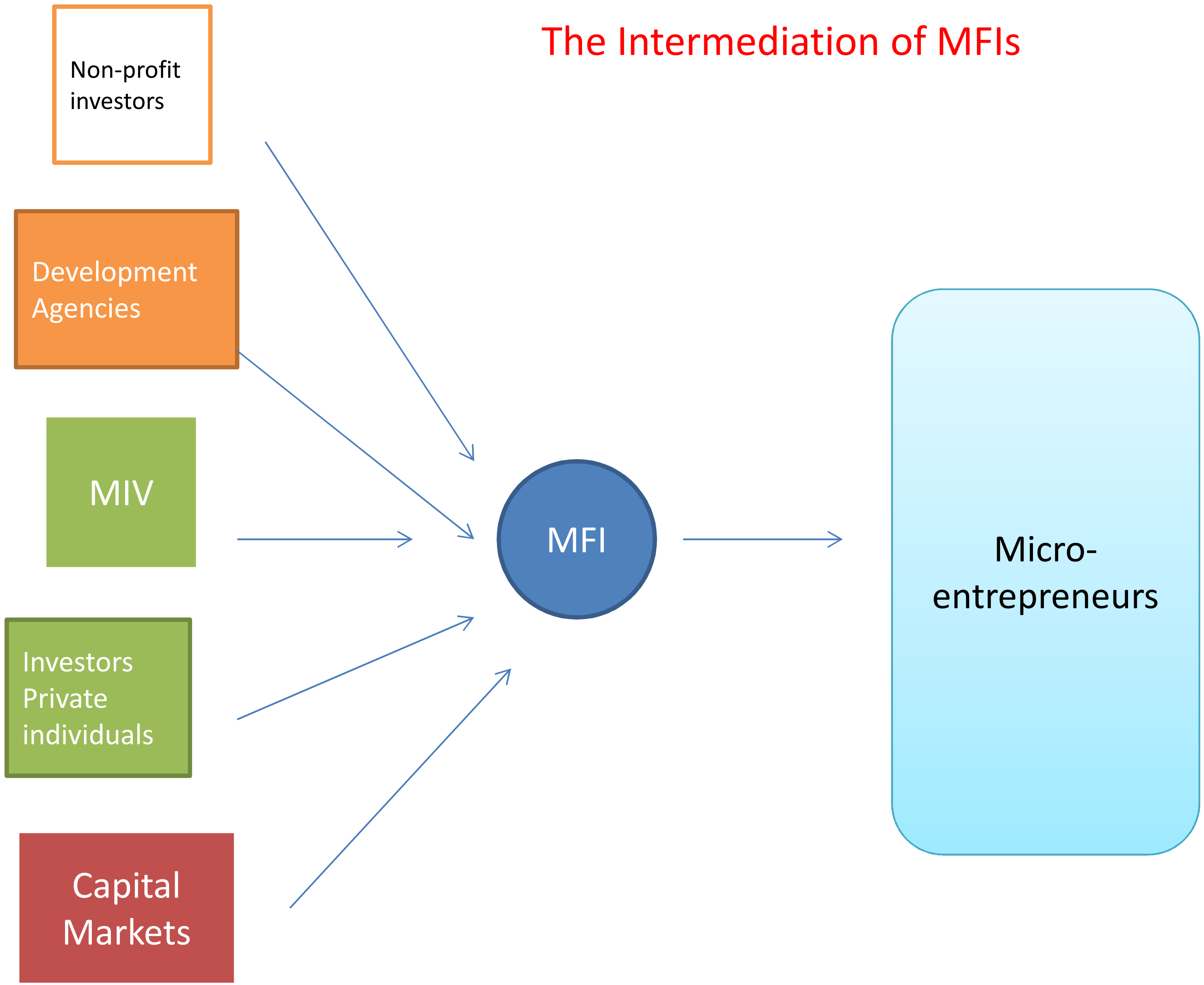
Origin of Microfinance

- Dr. Muhammad Yunus of Grameen Bank in Bangladesh describes the dynamics of lending through solidarity groups this way:

- "... Group membership not only creates support and protection but also smooths out the erratic behavior patterns of individual members, making each borrower more reliable in the process. Subtle and at times not-so-subtle peer pressure keeps each group member in line with the broader objectives of the credit program.... Because the group approves the loan request of each member, the group assumes moral responsibility for the loan. If any member of the group gets into trouble, the group usually comes forward to help."

Microfinance Institutions (MFI)

- MFI are the core of Micro finance activity
- There are about more than 2000 MFIs that report data to the MIX Market system, with a coverage of more than 90 million borrowers
- The gross loan portfolio is more than US$20 billions in more than 110 countries
- MFIs support income generating micro-enterprises for the poor
- Trusted channel for delivery of insurance products in mature micro-insurance markets (e.g. India and Africa)
- MFIs in Latin America – (Source: Marulanda, Otero, 2006)
    - NGO’s - Average loan amount $406
    - Commercial banks – Average loan amount - $1,100


The Intermediation of MFIs
Non-profit investors
Development Agencies
MIV
Investors Private individuals
Capital Markets
MFI
Micro-entrepreneurs

Microfinance Institutions (MFI)

- A microfinance institution (MFI) is an organization that provides financial services to the poor. This very broad definition includes a wide range of providers that vary in their legal structure, mission, and methodology. However, all share the common characteristic of providing financial services to clients who are poorer and more vulnerable than traditional bank clients. During the 1970s and 1980s, the microenterprise movement led to the emergence of nongovernmental organizations (NGOs) that provided small loans for the poor. In the 1990s, a number of these institutions transformed themselves into formal financial institutions in order to access and on-lend client savings, thus enhancing their outreach.

- Microfinance institutions have proven that the poor are "bankable". Today, formal institutions are rapidly absorbing the lessons learned about how to do small-transaction banking. Many of the newer players in microfinance, such as commercial banks, have large existing branch networks, vast distribution outlets like automatic teller machines, and the ability to make significant investments in technology that could bring financial services closer to poor clients. Increasingly, links among different types of service providers are emerging to offer considerable scope for extending access.

- Formal providers are sometimes defined as those that are subject not only to general laws but also to specific banking regulation and supervision (development banks, savings and postal banks, commercial banks, and non-bank financial intermediaries). Formal providers may also be any registered legal organizations offering any kind of financial services.
- Semiformal providers are registered entities subject to general and commercial laws but are not usually under bank regulation and supervision (financial NGOs, credit unions and cooperatives). Informal providers are non-registered groups such as rotating savings and credit associations (ROSCAs) and self-help groups.

- Ownership structures: MFIs can be government-owned, like the rural credit cooperatives in China; member-owned, like the credit unions in West Africa; socially minded shareholders, like many transformed NGOs in Latin America; and profit-maximizing shareholders, like the microfinance banks in Eastern Europe. The types of services offered are limited by what is allowed by the legal structure of the provider: non-regulated institutions are not generally allowed to provide savings or insurance.

Microcredit

- Is the most common form of Microfinance

- It means the provision of small loans to entrepreneurs who are too poor to qualify for conventional bank loans.

Process of Micro Loan Distribution

- A micro credit program gives small loans to the poor so that they can procure whatever they need to start or continue a small local business of their choice

Process of Micro Loan Distribution

- A micro loan of an equivalent of US$100 to US$2000 at 1 or 1.5% interest per month, can empower people to start their own business

Process of Micro Loan Distribution

- With that money they can start business of:

- A Kirana Shop: handicrafts, beach mats, clocks, beach bags, children clothing, beach hats, leather goods, picture frames, tea-pots, ceramics and more.

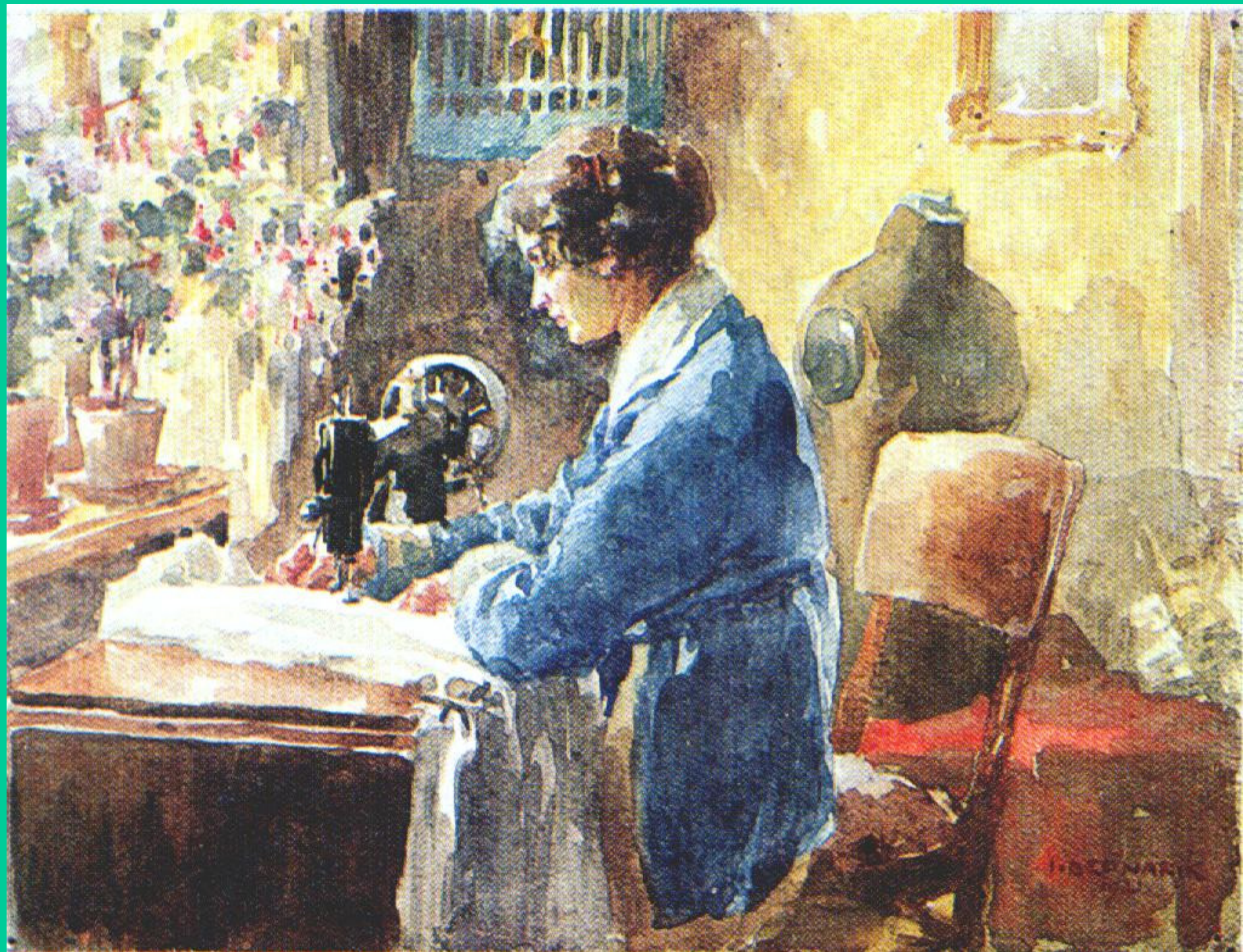
A Bangles Shop

Often you will see Indian women wearing huge armfuls of glass bangles, even while doing day-to-day chores. It is said that bangles bring safety and luck to husband.

Buy a cow or buffalo to sell milk

Making Candles

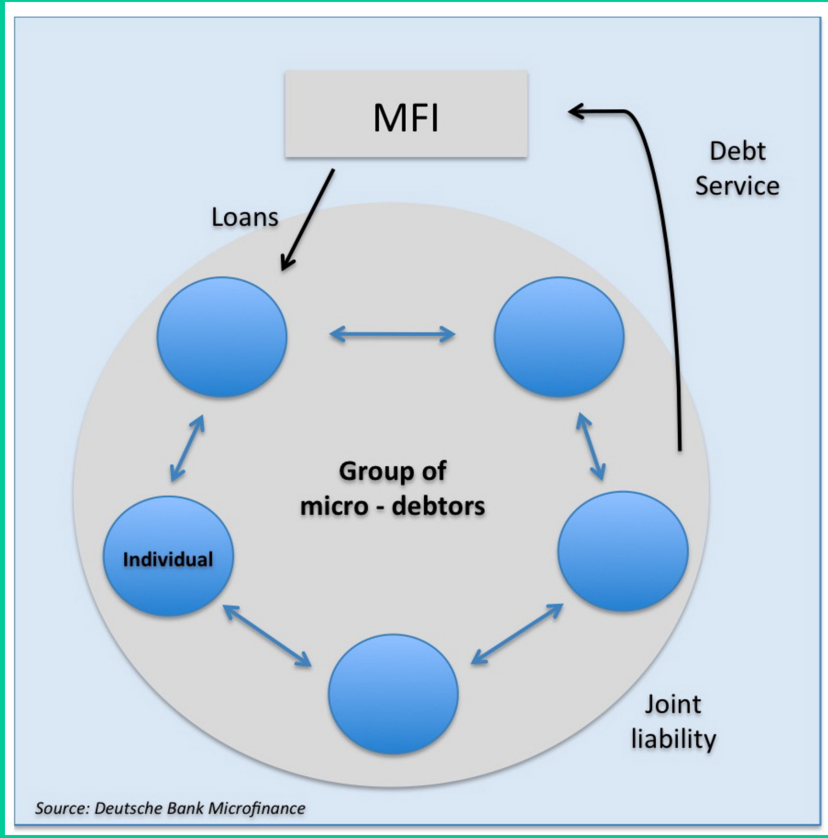
Small Garments Manufacturing Unit



Fruit and Vegetable Shop

Process of Micro Loan Distribution

- In the absence of collateral, the loans are made to groups of five, mostly women, who guarantee each others' loans: Joint Liability Group (JLG)



Process of Micro Loan Distribution

- If a woman wants to receive a loan and if her idea for a business is accepted, she is encouraged to find four other women and form a group.

Process of Micro Loan Distribution

- Then, the first two women are given loans and the others are encouraged to help them make their enterprise a success. After about 6 weeks, if the first two are making their payments on time, the next two women get their loans and six weeks later the last one.

Process of Micro Loan Distribution

- All persons who have paid back a first loan, are automatically eligible for a second loan and eventually a third so their businesses can grow

Process of Micro Loan Distribution

- At the same time from the interest, the loan fund is growing, though slowly, and loans are available to more persons.

Process of Micro Loan Distribution

- If one does not pay back one's loan, no one in the group will receive a second loan

Process of Micro Loan Distribution

- To guard against emergencies, such as one's cow dying or the entrepreneur dying and not being able to repay the loan, an emergency fund is set up at the time of the first loan.
- This simply means that a few coins, perhaps an additional loan can solve the emergency
- Role of insurance

Group Lending Model

- It simply means borrowers take each other's guarantee for the repayment of loan.
- The most successful micro-credit concept.
- A very disciplined and systematic model.

Group Lending Model

- First, all potential borrowers undergo financial literacy training and must pass a test before they are allowed to take out loans.

Group Lending Model

- Weekly meetings with borrowers follow a highly disciplined approach.
- Re-payment rates on these collateral-free loans are as high as 99% because of this systematic process

Social Impact of Microfinance

- The empowerment of poor, entrepreneurs, women;
- As microfinance services are to large extent offered to women; they become more financially literate and confident.

Social Impact of Microfinance

Building Economic Citizenship

- Financial services foster Independence.
- Microfinance can help clients to grow more confident, gain economic citizenship so that they can step out and become a part of main stream of society and have upward mobility.

Social Impact of Microfinance

- Financial services give clients to access to education, healthcare, and other necessities that improves their quality of life. e.g., school fee loan, health insurance and home improvement loan.

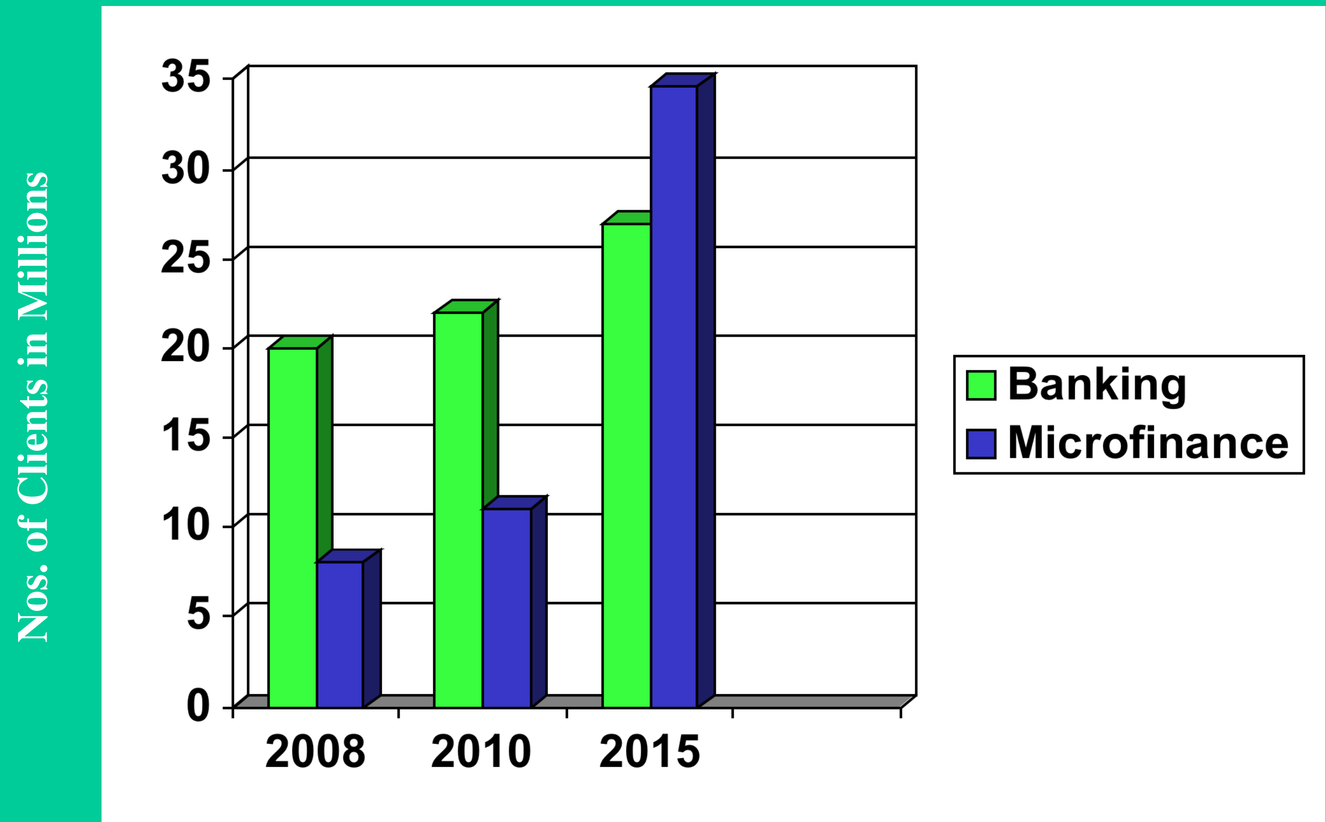
- Thus microfinance is a tool to fight poverty.

Scope of Microfinance

- In India, Micro finance is growing faster than banking and, if the experience in other developing countries is mirrored here, microfinance "will reach more individuals than the banking sector,"

- Robert Annibale, global director Citigroup Inc. Microfinance

Scope of Microfinance



For 2015 the projection sourced from citigroug microfinance

Considerations on Micro Credit

- Micro Loans should never be extended lends to individuals without first providing them with the expertise and training to build a business plan that is likely to succeed. The utilization of funds depends on the capacity of the poor client to use productively it and thus generating a sustainable social impact. Micro finance is not charity!!!

- The mere flow of funds alone in MF sector cannot bring desired level of social impact unless other infrastructure is in place in the given area/region to absorb the funds

- Social capital available in communities facilitate the task of micro finance of supporting social investment and focus on poverty reduction.

- Micro finance relies significantly on subsidies, but at the same time on viability and profitability

- Moving beyond Micro credit.

5. Micro Insurance

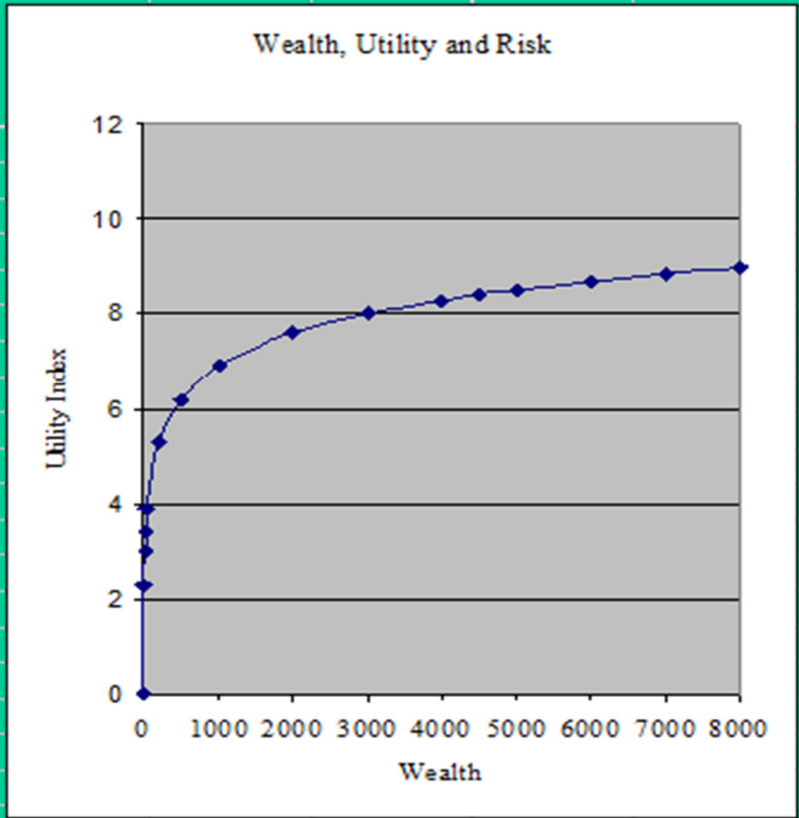
Impact of Events

- Normally, if a poor household loses a source of income, or is subject to an adverse event (e.g., fire), the result is devastating, e.g., a child might be withdrawn from school; valuable assets might be sold.

- This makes the household falls deep into poverty.

Wealth Utility and Risk Aversion

Steeper Curve	Emerging Country	
Wealth	Utility U(W)=ln(W)	Risk Aversion= (U''(W)/U'(W))
1	0	
10	2.3026	0.1000000
20	2.9957	0.0500000
30	3.4012	0.0333333
50	3.9120	0.0200000
200	5.2983	0.0050000
500	6.2146	0.0020000
1000	6.9078	0.0010000
2000	7.6009	0.0005000
3000	8.0064	0.0003333
4000	8.2940	0.0002500
4500	8.4118	0.0002222
5000	8.5172	0.0002000
6000	8.6995	0.0001667
7000	8.8537	0.0001429
8000	8.9872	0.0001250
8250	9.0180	0.0001212
8500	9.0478	0.0001176
9500	9.1590	0.0001053
10000	9.2103	0.0001000



Wealth Utility and Risk Aversion

In an emerging economy there are two factors that make individuals more risk averse:

i) the shape – concavity - of the utility function; and
ii) being in the lower part of any utility function.

The shape of the utility function, more concavity in emerging economies, depends on the uncertainty of the institutional environment and the inefficiencies of the market institutions including insurance. More concave curves of utility imply more risk aversion, i.e., individuals in emerging economies face steeper curves and therefore they resort to be more risk averse.

The second factor is linked with the fact that emerging economies are less wealthy and individuals are more risk averse. Example: a fire destroys home/business with a loss of almost 100% of capital and wealth. There is no safety net and the individual is reduced to poverty for the remainder of his/her life

Adverse Events and Insurance in Emerging Markets

Stochastic and black swan adverse events: death of breadwinner/illness/injury/ loss of property/natural disasters like droughts and floods, earthquakes can overwhelm scarce capital

Poor people are subject to many risks, which are much the same as those faced by the non-poor. However, poor people are highly vulnerable and their ability to cope with these risks is lower. Homemade and self-insurance and forms of risk management are common place among micro entrepreneurs, but are insufficient and inefficient, i.e., micro entrepreneurs do not necessarily misunderstand risks, but they utilize inefficient risk mitigation strategies

Lack of regulation and supervision and mispricing lead to mistrust for insurance policies.

The lack of formal insurance and risk management services, of appropriate products and effective distribution channels undermine economic growth and wealth distribution

Protecting against Vulnerabilities

- Financial services like saving, bank deposits, credits and insurance provide sustainable and low cost coping strategies to deal with disruptive events

- Individuals can re-build their assets or alternate source of income without falling into poverty.

Why is Microinsurance Important?

- Poor use insurance substitutes widely, e.g., in-kind-savings; diversification of income sources. These substitutes are inefficient and have limitations
- Poor also try to avoid certain risks– This tends to reduce their initiative and their welfare
- Ex-post coping can also worsen their position (distress sale of assets)
- Lack of insurance and persistence poverty are intimately related
- Insurance improves the capacity to manage risks

Micro Insurance

- What is micro insurance?–"protection of low-income people against specific perils in exchange for a pre-specified payment determined in proportionate to the likelihood and cost of the risk involved and made in advance". Simply, "*insurance services provided to low-income people"*

- Micro insurance is an integral part of financial services for the poor and low-income people.

- Micro insurance can takes advantage of many features tested in the case of micro credit, e.g., group insurance; community and client based; education.

- Insurance can be made available at reduced transaction costs:
  - simple policies and simple claims settlement;
  - group insurance;
  - efficient MIS systems;
  - link with credit and savings;
  - link to technology, e.g., cell phones,

  and facilitates financing by diminishing borrowers' exposure to risks.

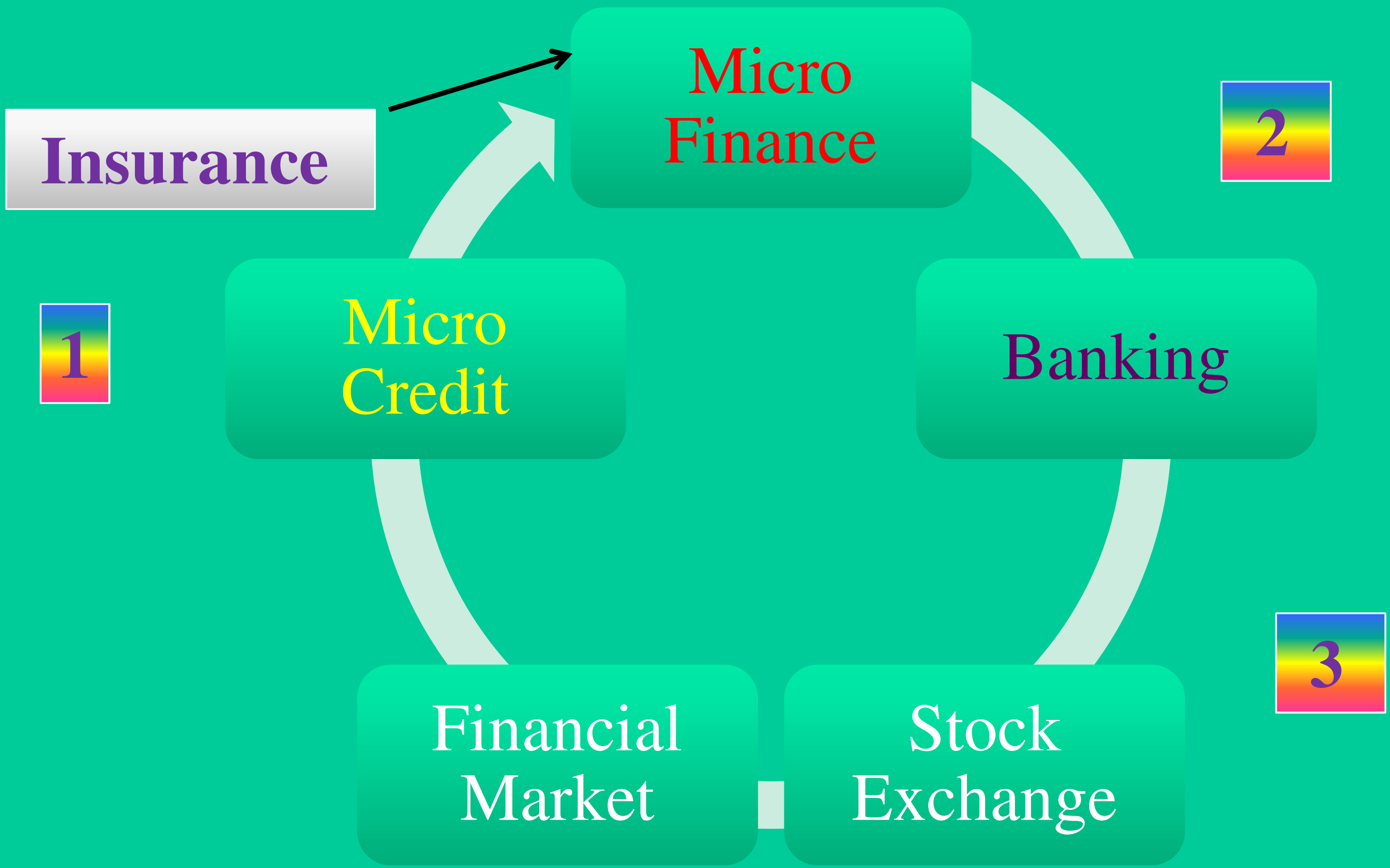
Micro Credit vs. Micro Insurance

However, the main difference between micro credit and micro insurance is that for micro insurance operations **we do not find the equivalent of MFI** in micro credit.

In the micro insurance business there is a multiplicity of entities that provide or could private insurance policies:

- MFIs themselves;
- Insurance companies;
- ad hoc companies like those that we find in Brazil:
  - dental cooperatives; Odontologia de Grupo, a HMO (health maintenance organization) for the dental market;
  - Self-management entities ("Medicina de Grupo");
  - Philanthropic societies;
  - Self insurance companies

Micro credit and Micro insurance



Key Factors to Introduce Micro Insurance in Emerging Markets

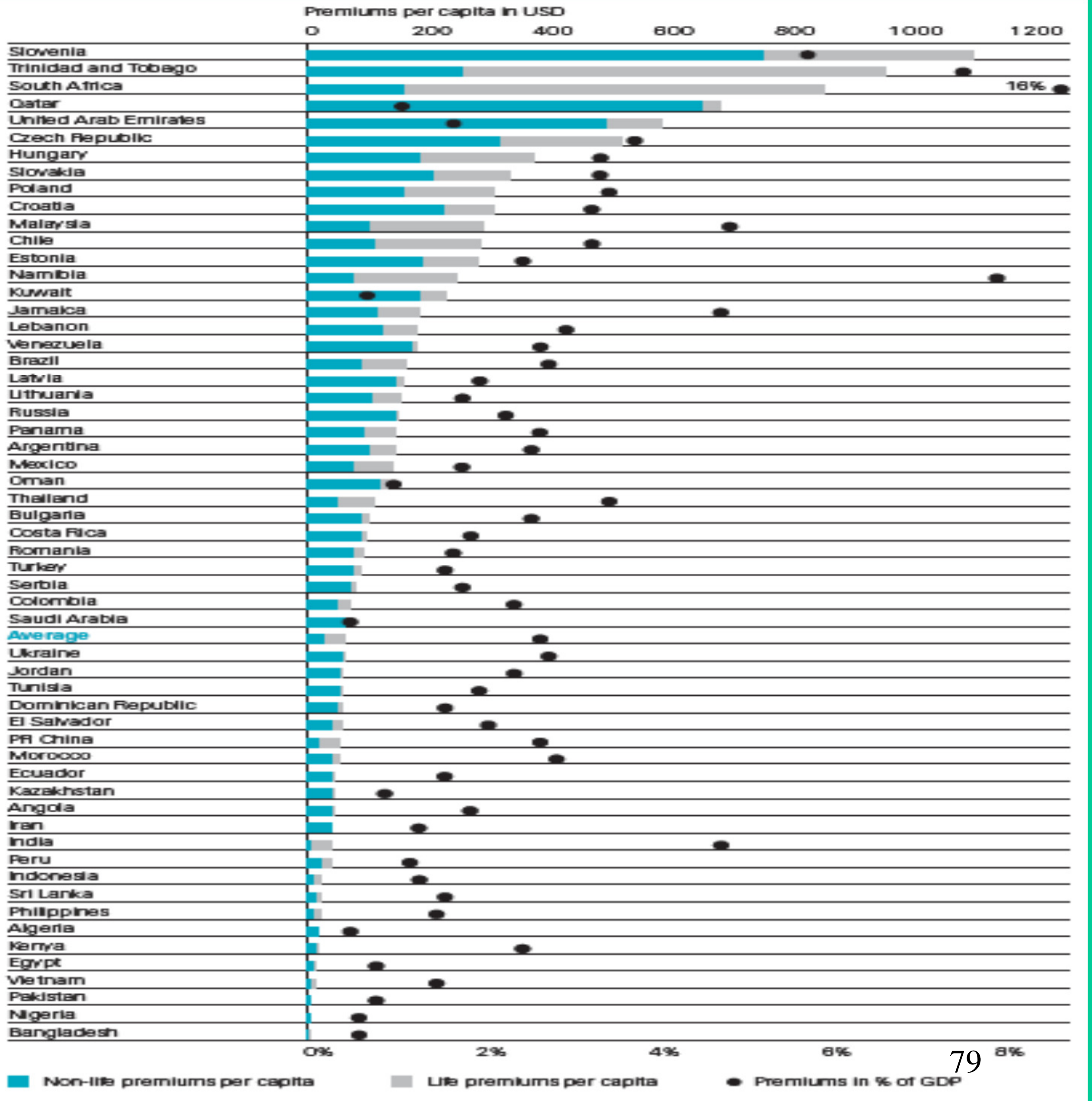
- Know the local culture
- Work on trust and Instill trust
- Educate and simplify to overcome negative attitudes towards insurance
- Utilize distribution channels that have already gained client acceptance
- Provide products that matter to clients

Examples of Insurance Programs

- Turkey earthquake insurance for homeowners
- Cat Bonds (e.g., Mexico)
- Caribbean insurance facility
- Weather derivatives in Asian and African markets
- Private health insurance in Venezuela
- Large scale health insurance programs in Uganda bundled with savings and micro credit

Indicators of Insurance Market Development

Although insurance products are progressively spreading in emerging countries, there is still much room for improvement.



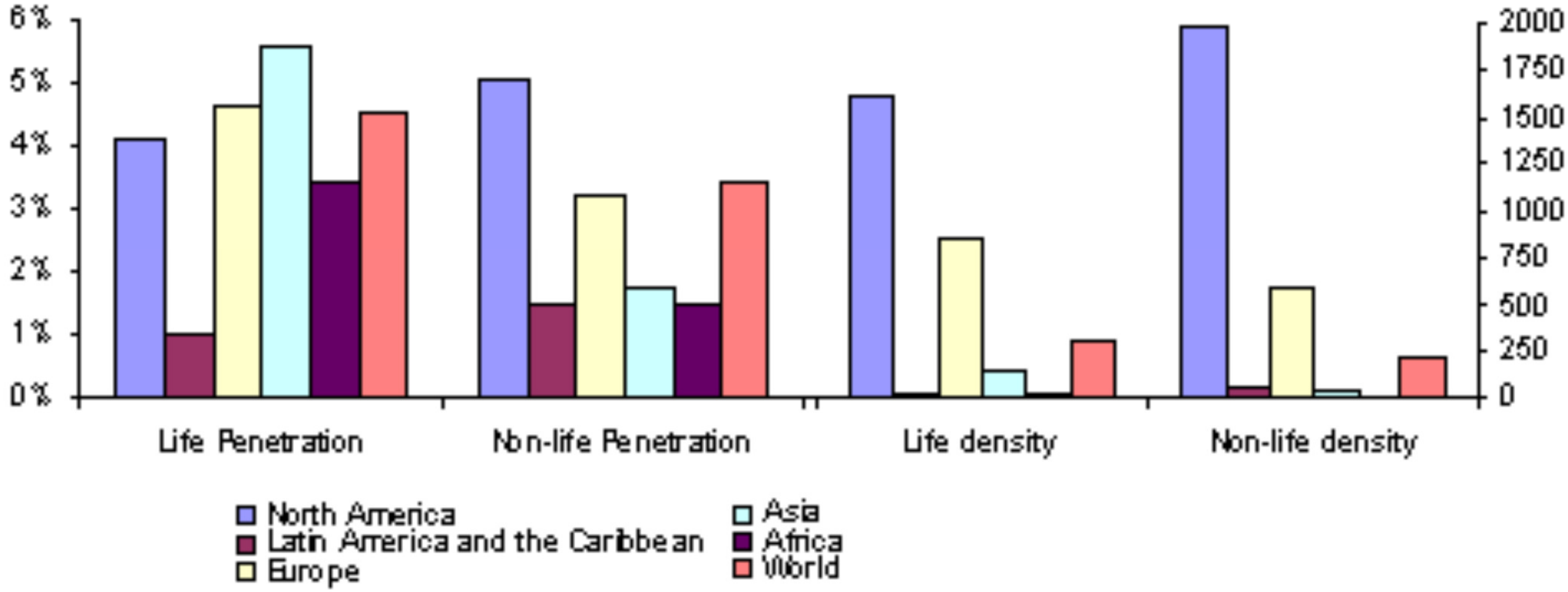
Source: Swiss Re Economic Research & Consulting

Insurance Markets at an Early Stage

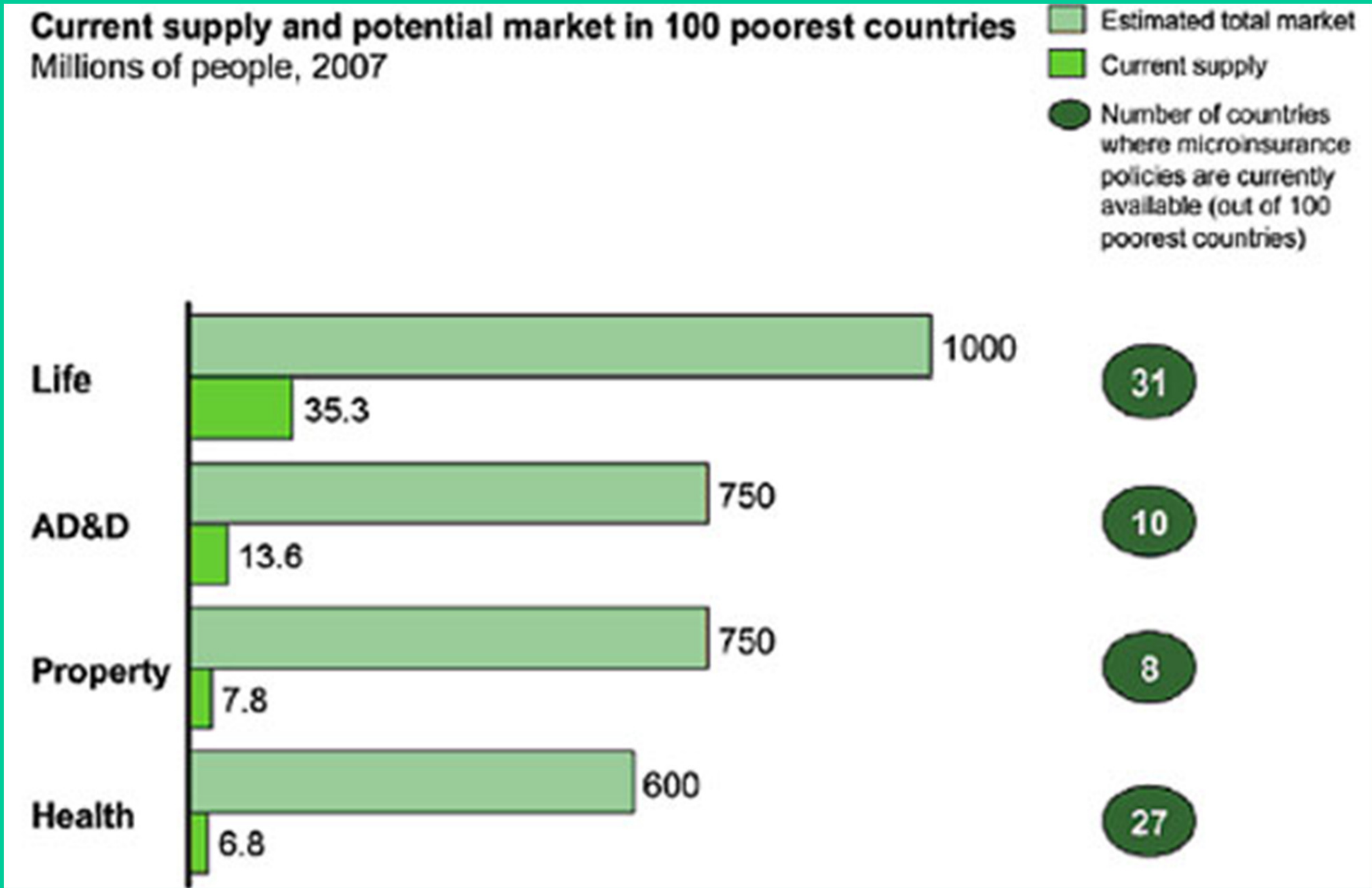
- In most developing countries, insurance markets (let alone, micro insurance) are at an infant stage.
  - Low Insurance penetration (measured as ratio (in per cent) of premium (in US Dollars) to GDP (in US Dollars)
  - Low Insurance density (measured as ratio of premium (in US Dollar) to total population)
- Insurance improves the stability and profitability of finance institutions.

Market Overview/Insurance Potential

Insurance Market Penetration in Latin America as a whole is less than 2%- Brazil has reached 3.2% in 2009, but trails Argentina and Chile.



Insurance Market Potential



Checking List to Strengthen Insurance and Micro Insurance in Emerging Markets

- Regulation oversight is lacking
- Effective supervision
- Development of appropriate distribution systems
- Product development
- Risk analysis
- Data, e.g., actuarial data
- Management Information Systems
- Needs Assessment
- Dealing with clients

Insurance Landscape in Brazil

- Micro-insurance in Brazil is at its infancy
  - Bradesco
    - One of the five largest financial groups in the Americas
    - Sold nine thousand policies at R$30 each
    - Priority is more expensive market
  - Sinep
    - Sells funeral insurance at low rates
    - Has little market penetration in low income communities

- There is little <u>community based</u> micro-insurance in Brazil

- Brazilian micro-insurance (in its current form) is basically cheaper traditional insurance, without the social change and income redistribution dimension of community based micro-insurance

- Traditional insurers are focused on the upper middle class market that yields organic growth of over 20% per year. Culture and incentives reward insurance companies for focusing on large policies/more profitable clients

Barriers to Entry

- **Regulatory** – Micro-insurance regulations in Brazil are not yet approved and new companies can operate with permits issued by the government

- **Limited Understanding of Micro-Insurance .**
  - Consumers are not interested in buying insurance - It will demand lots of education.
  - Need of appropriate surveys and implement education programs of clients and professionals

- **Lack of Rivalry** - Lack of interest in tapping into a market that suffers enormous racial, social, economic and cultural discrimination. Traditional insurance companies are not interested in investing in the market and prefer more lucrative upper-end of the market.

- **Financial Markets** -. Interested NGO's cannot tap local capital markets for funding and they have to rely on international funds, grants and subsidized loans.

6. Commercialization

Commercialization

- The topic of commercialization has been hotly debated, largely because it raises fundamental questions about whether the dual social and financial missions of microfinance can coexist.

- The experience shows that the two priorities can coexist, and when done right, they are mutually reinforcing, creating a healthier long-term business model for both clients and investors.

- Many MFIs Grameen Foundation partners with – particularly those that are for-profit entities with strong social missions – work hard at maintaining a strong focus on both social and financial goals.

- Some publicly-traded U.S. companies appear more committed to and more convinced of the need for mission-focused business.

- Take the U.S. company Whole Foods, with a market capitalization of US$12 billion. In a recent presentation to the Asian Institute of Management in Manila, Whole Foods director Dr. Ralph Sorenson, discussed the company's "conscious capitalism" model, in which businesses are "primarily driven by their mission and their sense of purpose." This requires optimizing returns for all stakeholders, with customers as the most important stakeholder, and leads to an ultimate vision that "in the long run, it is better to be mission-driven than profit-driven…profits [are] an end result, not a goal in and of themselves."

Commercialization

- Grameen Koota (GK), a long-time Grameen Foundation partner in India with a deep social mission, has grappled with this balance. GK's ability to scale has been largely funded over the years by local commercial banks, an effort supported through the Growth Guarantee program. However, when it comes to securing strategic equity investors, GK expressed concern that taking on more commercially-minded equity investors might force it to place profits ahead of mission, for example, by pushing it away from the more difficult-to-reach clients who cost more to serve. GK has managed a balanced mix of both social and commercial investors, and being extremely clear about its plans (target segment, mission, how their business will evolve), so that investors know upfront what they are "buying" and do not expect GK to shift course after their investment. This balanced approach has allowed GK to continue to focus on achieving robust social and financial results.

- Grameen Bank offers one of the earliest and longest-standing visions for microfinance as a business that puts mission first and views profits as a means, not an end – and is a strong example of a local, deposit-driven model.

- Grameen Foundation stresses the priority of the social mission with profits acting in service of that mission, and that overall, this approach is a win-win scenario, creating stronger institutions that put the benefit of their clients front and center thus ensuring these institutions generate healthy social and financial returns over the long term.

- –

Commercialization

- Few MFIs follow a vision of microfinance as a truly double bottom line business.
  - (a) maintaining a strong focus on improving clients' lives by, among other things, offering diverse products and services and measuring how those products work through social performance tools;
  - (b) including poverty-fighting principles in their incorporating documents; and
  - (c) managing the allocation of profits such that clients benefit through improved products and services, lower rates, or complementary services such as health or education.

- PT Ruma, a micro franchise-based social enterprise in Indonesia, is an example of a business that has built social goals into its incorporating documents. Ruma's articles of association require that its social goals be met before shareholders receive any financial dividend payouts.

- Kiva of United States operates successfully worldwide as an NGOs with a concern for the bottom line.

- Capital raising presents another challenge for many MFIs, since the way an institution funds itself can drive very different behaviors, priorities, and business models.

  - For example, commercial lenders do not typically seek to influence a borrower's strategy; often they simply want to be repaid on time at a pre-determined rate of interest.
  - Strategic equity investors, on the other hand, expect to have a seat at the table advising on the direction of the institution and, alter the behavior of management and priorities of the institution. If investors' focus on short-term financial returns may conflict with an institution's ability to meet its social goals – in other words, to put clients first.

The Challenge of Financial Inclusion

2.7 billion (72% of adults) in developing countries do not use formal financial services

160 million (19% of adults) in developed countries as of 2009 [CGAP, Financial Access, 2009]

The MIX reports 90 millions Microfinance borrowers worldwide as of 2009.

- **Financial Management is a Basic Human Need**
- *"Money management is, for the poor, a fundamental and well-understood part of everyday life. It is a key factor in determining the level of success that poor households enjoy in improving their own lives" [Collins, Daryl et al., Portfolios of the Poor: How the World's Poor live on $2 a Day]*
- **Financial Inclusion** is widely associated with **economic security and development**
  - Income generation (credit)
  - Increases investment capital (savings)
  - Increases economic security (savings, insurance)
- **Financial Inclusion is now an integral part of the regulatory agenda in developed as well as developing countries.**

Microfinance System

Pillars of Financial Inclusion and their Challenges

"Access for individuals to appropriate financial products and services. This includes people having the skills, knowledge and understanding to make best use of those products and services.

Scottish Executive, Social Inclusion Division, Financial Inclusion Action Plan, 2005

1. UNDERSTANDING FINANCIAL INCLUSION

Reaching underserved population

2. CLIENT EDUCATION

Clients

- Access
- Financial literacy
- Diverse Life and Business Needs
- Engagement / Retention

Products

- **Single /multi-product**
- **Appropriateness**
- **Efficiency and scalability**
- **Tailored to the client**

Distribution

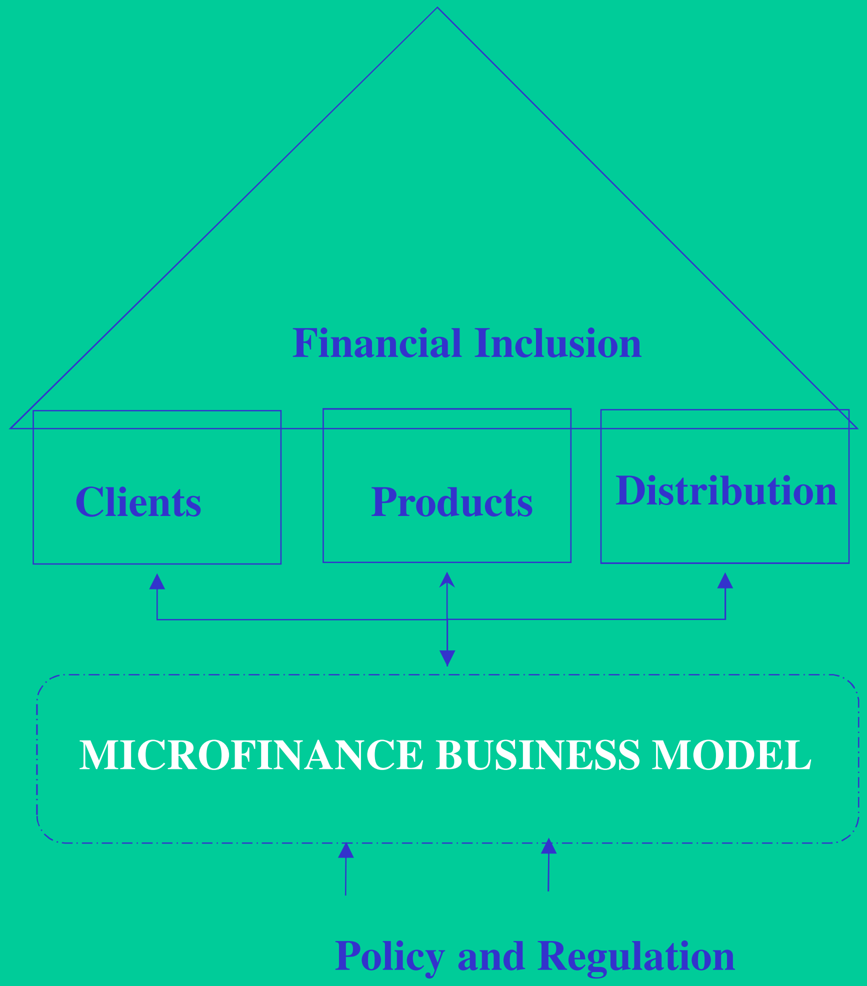
Market context/infrastructure

- **Evolution of distribution channels**
- **Scalability**

3. PRODUCTS AND SERVICES

4. Policy and Regulation

The Microfinance Business model based on the three pillars



Microfinance provides a business model which addresses the pillars of financial inclusion:

- Understanding the client excluded segments
- Creating products which are scalable as well as tailored to clients' needs
- Building channels to deliver these products efficiently

"Microfinance is the provision of segment-specific financial services to low income individuals. MFIs promote microenterprise. They expand access and breadth of financial services to advance financial inclusion" ***Citi Risk Management Manual*****, April 2010**

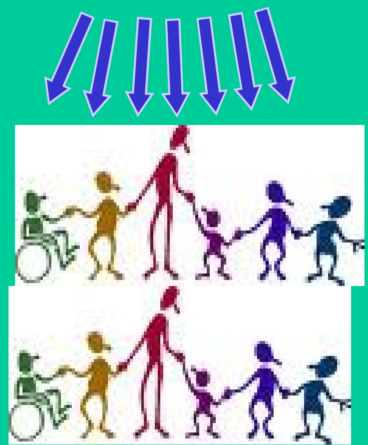
Scale and Outreach vs. Product Tailoring

“ Deliver the broadest range of appropriate products as efficiently as possible to the highest number of people at the lowest possible price.”

Balancing breadth and depth

Depth of financial Inclusion
Reaching underserved population

Production Centric



Breadth of financial Inclusion
Designing appropriate products

Client Centric

- **Credit – Access to finance**
- **Savings – Capacity to accumulate capital**
- **Payment solution: checks, electronic, mobile, etc.**
- **Remittances**
- **Insurance**

7.Performance Audit

Models Financial Ratios and Indicators

Microfinance and particularly Microfinance Institutions (MFIs) need to operate efficiently and transparently to use scarce resources and to be able to fulfill their mandate and attract financing from various sources.

There various models to appraise, evaluate, measure and monitor the performance of MFIs.

There are a multitude of financial ratios and indicators, which provide useful information to help evaluate the performance of the organization in several different aspects of its activity for a number of stakeholders, and most importantly. donors and investors in microfinance institution (MFI) as well as MFIs’ managers and auditors.

Funders of MFI and managers of MFI have an aligned interest in designing, assessing and monitoring the performance of the MFI.

Funders' Perspective

Funders use appraisals of MFI to make informed funding decisions. Funders can be foreign or domestic donors, foundations, development agencies, or NGOs.

Funding can take the form of loans, grants, equity investments, or financing for technical assistance.

Reports generated through the process described in this appraisal guide enable existing and potential funders of MFIs to assess the following:

- How well does the MFI match the funder's strategic priorities?
- Is the MFI efficient, well managed, and profitable (or en route to being so)?
- What is the quality of the MFI's products?
- Do they meet client needs?
- Would funding add value to the MFI?

CGAP Guide to Appraising Micro Finance Institutions (MFIs)

- CGAP Guide represents a tool for those who provide funding to MFIs
- MFIs could have received a rating from a rating agency, or other similar organization, which facilitates the evaluation and appraisal of the founder and make a funding decision.
- The rating information may need to be supplemented by an appraisal. If no rating exists, a funder may want to consider commissioning one, or hiring a rating agency to conduct a confidential, less formal evaluation in place of an appraisal.
- The complete appraisal is completed with a report with a funding recommendation including key factors and any mitigating circumstances.
- The report should provide sufficient supporting information for the funder to make an informed funding decision.

CGAP Report

1. *Overview*	summarizes the MFI's vision and mission, organizational strengths and weaknesses, and macroeconomic, political, and other external factors.
2. *Institution*	describes the MFI's ownership and governance, organizational structure, regulation and supervision, management, external relationships, human resource management, information and communications technology, information availability and quality, internal controls, and external auditing.
3. *Products*	analyzes the MFI's voluntary savings, lending, financial and non-financial products.
4. *Social performance*	assesses how well the MFI translates its social goals into practice, looking at systems, outreach, and potential for achieving impact.
5. *Loan portfolio quality*	reviews how the MFI measures, monitors, and manages its loan portfolio, including delinquency and write-offs.
6. *Financial performance*	analyzes the MFI's financial performance, risk management, and financial ratios.
7. *Business planning*	evaluates the MFI's strategic and business planning processes and financial projections.

UNDP Indicators

UNDP has developed a model, which also takes the perspective of founders.

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1. Outreach — how many clients are being served?

2. Client poverty level — how poor are the clients?

3. Collection performance — how well is the MFI collecting its loans?

4. Financial sustainability — is the MFI profitable enough to maintain and expand its services without continued injections of subsidized donor funds?

5. Efficiency — how well does the MFI control its administrative costs?

Micro Finance Performance Indicators (1)

Micro Finance Performance Indicators	
1. Outreach	
Number of active clients or accounts	Number of active clients or accounts
2. Client Poverty Level	
Average outstanding balance per client or account	Gross amount of loans or savings outstanding/Number of active clients or accounts
3. Collection Performance	
Portfolio at Risk (PAR) or	Outstanding principal balance of all loans past due more than x days/Outstanding principal balance of all loans
Loans at Risk (LAR) or	Number of loans more than x days late/total number of outstanding loans
Current Recovery Rate (CRR) together with	Cash collected during the period from borrowers/cash falling due for the first time during the period under the terms of the original loan contract
Annual Loan-loss Rate (ALR)	1 – CRR/T
4. Financial Sustainability (Profitability)	
for commercial institutions:	
Return on Assets (ROA) or	After-tax profits/Starting (or period-average) assets
Return on Equity (ROE)	After-tax profits/Starting (or period-average) equity
for subsidized institutions:	
Financial Self-Sufficiency (FSS) or	Business revenue (excluding grants)/Total expenses + IA + CFA + ISA
Adjusted Return on Assets (AROA) or	Accounting profit/loss (excluding grants) – IA – CFA – ISA/Period-average total assets
Subsidy Dependence Index (SDI)	S/LP * i
5. Efficiency	
Operating Expense Ratio (OER) or	Personnel and administrative expense/Period-average gross loan portfolio
Cost per client	Personnel and administrative expense/Period-average number of active borrowers [x GNI per capita]
Source:UNDP	

The "SEEP 18"

- The USAID and SEEP take a broader, but similar approach to performance's measurement for MFIs. They developed a framework to provide microfinance practitioners with a means to develop financial statements and reports to be used for assessment and monitoring in accordance International Financial Reporting Standards (IFRS).

- The Framework is also expected to assist MFI managers in developing a consistent performance monitoring system based on international standards and in making decisions, informing boards of directors, and reporting to donors, investors, network organizations and other interested parties.

- The Framework - written by and for practitioners - constitutes a valuable tools for raters and auditors.

- There are 18 indicators to reflect the areas of measurement that are priorities for most MFIs. The "SEEP 18" are divided into the following four groups:

  - Profitability and sustainability,
  - Asset/liability management,
  - Portfolio quality, and
  - Efficiency and productivity.

Micro Finance Performance Indicators (2)

Micro Finance Performance Indicators
PROFITABILITY AND SUSTAINABILITY RATIOS
R1—Operational Self-Sufficiency/Financial Self-Sufficiency
R2—Return on Assets/Adjusted Return on Assets
R3—Return on Equity/Adjusted Return on Equity
4.2 ASSET/LIABILITY MANAGEMENT RATIOS
R4—Yield on Gross Portfolio
R5—Portfolio to Assets
R6—Cost of Funds/Adjusted Cost of Funds
R7—Debt to Equity/Adjusted Debt to Equity
R8—Liquid Ratio
PORTFOLIO QUALITY RATIOS
R9—Portfolio at Risk/Adjusted Portfolio at Risk
R10—Write-off Ratio/Adjusted Write-off Ratio
R11—Risk Coverage Ratio/Adjusted Risk Coverage Ratio
EFFICIENCY AND PRODUCTIVITY INDICATORS
R12—Operating Expense Ratio/Adjusted Operating Expense Ratio
R13—Cost per Client/Adjusted Cost per Client
R14—Borrowers per Loan Officer
R15—Active Clients per Staff Members
R16—Client Turnover
R17—Average Outstanding Loan Size/Average Adjusted Outstanding Loan Size
R18—Average Loan Disbursed
Source Small Enterprise Education and Promotion (SEEP) Network

Micro Insurance Performance Indicators

- In October 2006 ADA and BRS in collaboration with the CGAP Working Group on Micro insurance organize workshops for micro insurance practitioners and experts from around the world with the aim of sharing experiences and initiating discussions about measuring micro insurance performance.

- The workshop was concluded with the selection of eight key principles and ten key performance indicators, which were then described and briefly discussed in a workshop report. In July 2007 a second workshop was held to confirm the selected principles and indicators and to test them further with a second round of data provided by the participating practitioners. For this purpose, BRS developed a micro insurance factsheet which together with a handbook will constitute a toolkit that will enable practitioners to use the indicators in their organizations.

- The initiative and the workshops among practitioners concluded with a recommendation of nine principles and ten performance indictors including measures for social performance indicators.

- The key principles and indicators that were established during the workshops are applicable to all micro insurance providers, irrespective of legal structure, environment, organizational setup and type of micro insurance product offered, although there may be some differences in performance and interpretation.

- These indicators are expected to set the standard for the entire micro insurance industry.

Micro Insurance Performance Indicators

Micro insurance Performance Indicators	
Indicator	**Measures**
A. Product Value	
Indicator 1: Incurred Expense Ratio	Incurred Expenses/Earned Premium
Indicator 2: Incurred Claims Ratio	Incurred Claims/Earned Premium
Indicator 3: Net income Ratio	Net Income / Earned Premium
B. Product Awareness and Client Satisfaction	
Indicator 4: Renewal Ratio	Number of Renewal/Number of Potential renewals
Indicator 5: Coverage Ratio	Number of Active Insured /Target Population
Indicator 6: Growth Ratio	(Number of Insured n – Number of Insured n-1)/Number of Insured n-1)
C. Service Quality	
Indicator 7: Promptness of claims settlements	Time to process a claim
Indicator 8: Claims rejection Ratio	Number of claims rejected /Number of Claims in the sample
D. Financial Prudence	
Indicator 9: Solvency Ratio	Admitted Assets / Liabilities
Indicator 10: Liquidity Ratio	Available cash or cash equivalent/short term payable
Source: Garand Denis, John Wipf. Performance Indicators for Micro Insurance. A Handbook for Micro insurance Practitioners	

Auditor’s Perspective

Audit Criteria

- **Standards against which compliance with charter, legislation, regulatory framework, internal policies and procedures, acknowledged best practices may be reviewed;**

- **Standards against which operations (organization, financial and management systems and management controls) for “economy” (price of inputs), “efficiency” (translation of inputs to outputs), systems in place to measure effectiveness may be reviewed.**

- **Standards against which internal and external reporting may be assessed.**

- **Accounting system and Audit**

Undertaking Performance Audit

The amount of time required to conduct an appraisal, performance audit depends on the perspective (e.g., funder's desired outputs and deliverables; auditor's review).

A qualified, experienced analyst would need at least two to three weeks to complete a comprehensive appraisal—including a site visit of 5–7 days or more—depending on how much information is readily available from the MFI.

A complete comprehensive appraisal would be appropriate only for significant situations, e.g., major funding decisions. The topics and scope of the performance audit and topics for analysis should be carefully selected. There are cases in which a full appraisal and performance may not be needed and would be undertaken only after having undertaken a reduced performance audit and appraisal.

A shorter appraisal and performance audit may involve 2–3 days in the field and lighter reporting.

Comitato Nazionale per il Microcredito e l'Istituto Nazionale Revisori Legali

Il Comitato Nazionale per il Microcredito e l'Istituto Nazionale Revisori Legali hanno firmato un accordo inteso a promuovere e sostenere i progetti finalizzati al raggiungimento di obiettivi strategici quali la creazione di microimprese, la creazione di nuovi posti di lavoro ed il miglioramento delle capacità operative autonome.

In linea con quanto detto in materia di performance audit, training, valutazione, le modality di collaboration sono che l'Istituto Nazionale Revisori Legali:

- Supporterà il Comitato nello studio di modelli di business necessari alla realizzazione delle iniziative istituzionali
- Supporterà il Comitato nelle attività di tutoraggio delle microimprese
- Supporterà il Comitato nella realizzazione di iniziative di natura regolamentare tecnico-giuridica relative alla microfinanza

8. Training

Training

- Training is key!!!

- For whom?
  - For regulators and policy makers
  - For Board members of various organizations involved in MF
  - For executives, managers, professionals of MFIs
  - For clients and entrepreneurs
  - For insurers
  - For supervisors

Training of Clients: Risks/Challenges

- Overcoming bias of potential clients against insurance skeptical about paying premiums for intangible product with future benefits that may never be claimed

- Creating awareness about benefits of insurance is time consuming and costly

Train on What?

Strong management skills, training and capacity building remain as great challenges to microfinance institutions. Building an effective work force is expensive and difficult to make efficient.

Main areas of training :

- Risk management
- Financial Analysis and Accounting
- Business plans
- Governance
- Mid-level management in microfinance
- Leadership
- Technical training of trainers

There is a huge need of specific training in a large number of areas, e.g., Financial Instruments to enable Graduation of Clients; Credit Bureaus; Micro leasing; Venture capital; Computer and Technology; Linking with commercial banks; Group Lending: theoretical advances and practice; limited liability vs. joint liability; credit guarantees; Targeting the Hard-core poor; Creating enabling environment for micro-credit institution; product development for the MFIs, e.g., micro-leasing, loan for family members, flexible savings schemes and smart card; Financing of MFIs issue bonds, based on income receivable; raising funds in developed stock markets.

Type of Training and Constraints

Workshops and Seminars for general audience, on site and online

Academic Training

There are a limited number of programs, graduate and post graduate focusing on Micro finance.

- Master in Micro credit development, Universidad Autónoma de Madrid
- European Micro finance Program, Académie Wallonie-Bruxelles (ULB and UMons), Paris-Dauphine University & Wageningen University
- Post Graduate program in management of Micro finance, Siddaganga Institute of Technology
- Post Graduate Diploma in Management: Development Sector & Social Entrepreneurship Entrepreneurship Development Institute of India
- Diploma in Microfinance and Community Economic Development; Bachelors degree in Microfinance and Community Economic Development, Uganda Martyrs University
- Microfinance Management Institute (MFMI), New York

Constraints and Opportunities

Constraints for Micro Finance Training Programs:

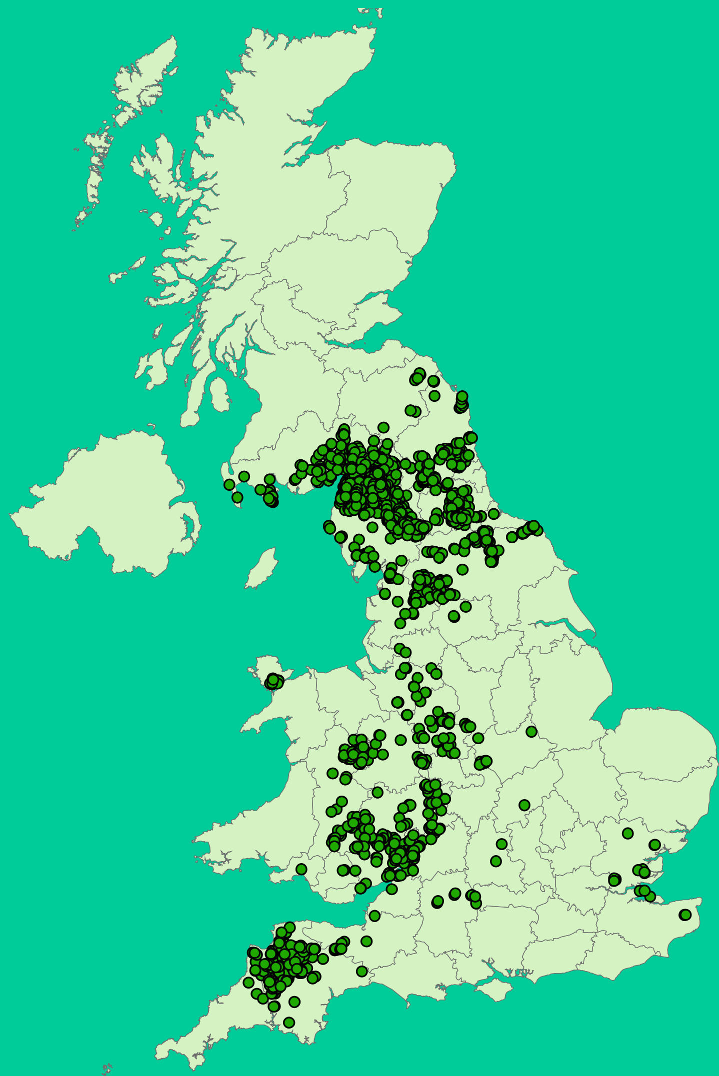
- Budget
- Long term view
- Credibility
- Partnerships

But Training in Micro finance is still an opportunity!!!

9. Geographical Information System (GIS) and Spatial Analysis

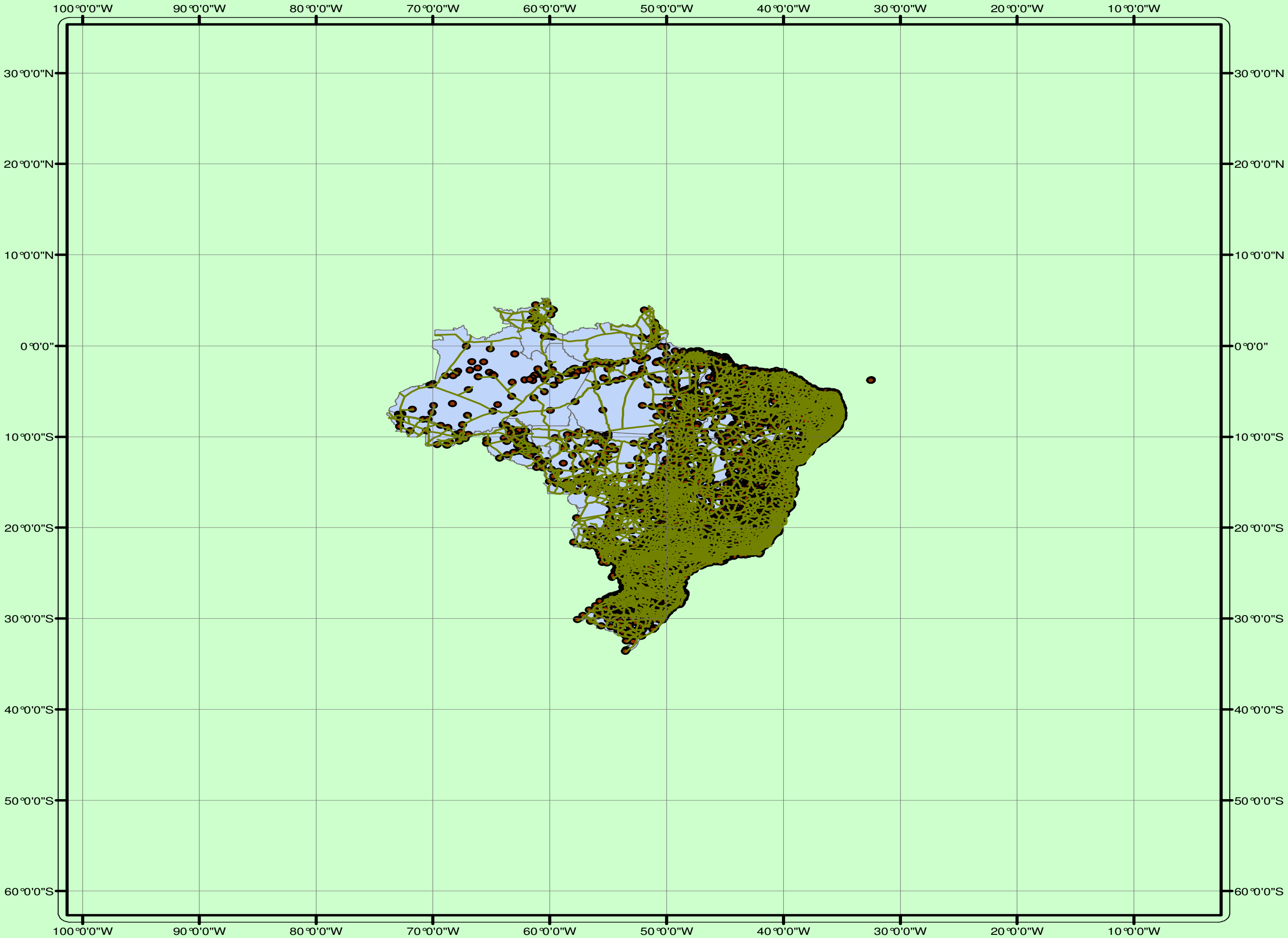
Types of Spatial Data

- Spatially discrete "event location data" => "Point Pattern Analysis"
  - *Examples:* FMD cattle locations, Pneumonia patient locations, Crime locations, Grocery delivery service recipient locations, etc.
  - Geographical data unit: "point" data defined by longitude and latitude ("coordinates")
  - Generally hard to get this type of data (human protection, consent, etc.)



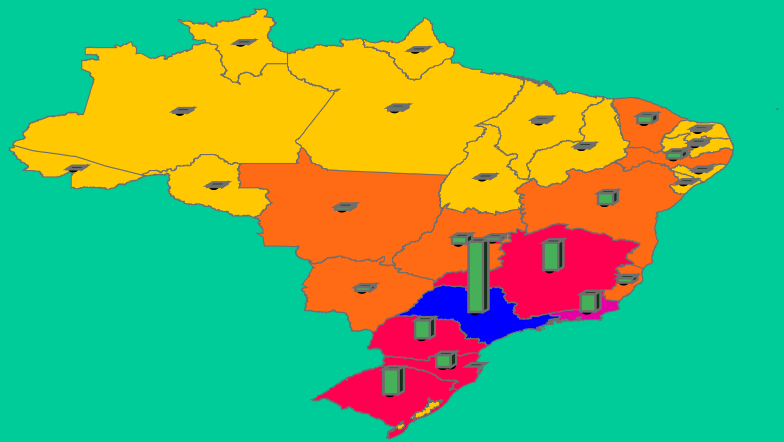
Example: UK Foot and Mouth Disease (FMD)

Brazil: A Federal Country



27 States
5906 Cities or Municipalities
13141 Highways

Insurance premium and number of companies in each state



Why GIS and Spatial Statistics?

- Spatial visualization helps
  - Relationship between the variables , e.g., quality of healthcare services, income, and race; micro entrepreneurs and insurance services in a given area.

- Investigates *statistically significant* spatial clustering (“hot spot”)

- What kind of (spatial) characteristics determine the values of an attribute of your interest? Are they statistically significant?
  - Groundwater withdrawal in Venice
  - Ozone layer depletion

- What could you do in terms of policy?
  - Healthcare agencies: Close down bad quality healthcare agencies?
  - Venice: Close down industrial plants?
  - Insurance and Microentrepreneurs: where to intervene?

Spatial Regression

- Ordinary Least Square (OLS)
  - Example: California rainfall data (Calif_data.sav/dta)
    - Dependent Variable: Precip (Precipitation)
    - Independent Variables:
      - Alt: Altitude
      - Lat: Latitude
      - Dist: Distance from the coast
      - Shadow: Lee side of the mountains = 1 (dummy variable)

Coefficients[a]

Model		Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Standardized Coefficients Beta	t	Sig.
1	(Constant)	-102.808	24.974		-4.117	.000
	Altitude	.005	.001	.597	4.463	.000
	Latitude	3.511	.680	.563	5.164	.000
	Distance from Coast	-.131	.031	-.545	-4.177	.000
	Rain Shadow (1=in shadow)	-13.483	4.152	-.365	-3.247	.003

a. Dependent Variable: Precipitation

Thank you!

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