ENERGY & CAPITAL
Practical Investment Analysis in the New Energy Economy

The Microfinance Solution

Special Report

You've probably heard it a thousand times before, but it always bears repeating...

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

When it comes to lifting people out of poverty, there is little doubt that you can accomplish a lot more by empowering people than offering hand-out after hand-out. And that's the primary reason we so strongly support microfinance.

What is Microfinance?

Microfinance enables low-income workers throughout the world to gain access to credit, thereby giving them the opportunity to create their own wealth. As well, microfinance allows lenders to make a profit in the process.

The origin of microfinance can be traced back to Chittagong, India, where the world renowned banker and economist, Muhammad Yunus, explored the concept of extending credit to the poor. By carefully examining the economic condition of the region, Yunus created a credit delivery system that provided sufficient funds to low-income workers with an entrepreneurial spirit. This served as the foundation for providing microcredit loans.

Who Benefits?

Microcredit borrowers are typically folks (in many cases, women) who only require small amounts of capital to be used to finance the beginning stages of self-employment. Acquired credit is used to finance both simple and complex business ventures, ranging from one individual sewing clothes to a small, yet organized, supply chain of workers who design and sell quilts.

After launching this new credit delivery system, Yunus decided to formalize and expand his business proposal by starting the *Grameen Bank Project* . With the intent of creating opportunities for both investors and poor self-employed workers, Grameen Bank became quite successful.

Today, Grameen Bank boasts profits of more than $1.3 billion! In addition, over the past 12 years, the bank has provided over $3,807,490,000 in loans.

Of course, Grameen Bank isn't the only player in the game for microfinance; there are 50 microfinance firms ranked and qualified by Forbes today, not to mention dozens more that are just now becoming established.

Overall, these microfinance institutions have a common and unified objective: make a profit by actively lending to some of the world's most poverty-stricken regions.

Lending Money, Making Money

Now one thing you must understand is that this is *not* about charity.

These microfinance institutions aren't just forking over money to anyone looking for a few hundred bucks. Just as any other reputable bank does business, microloans are only available to qualified individuals. But how can lenders trust low-income earners with loans when most have no real credit history or own any tangible goods?

The answer is simple: prudence. Just because these individuals lack significant savings or collateral does not mean they are devoid of the entrepreneurial spirit and the willingness to work hard. Rather, they just lack the opportunity — and credit — to initiate a business venture.

Yes, the greatest challenge within the microfinance industry is being able to discriminate between the individuals that are not worth investing in and the individuals who have a real passion and creative drive for profit seeking.

But this does not mean that the ability to discern between the two is impossible... Just look to the performance of Grameen Bank for proof.

And interestingly enough, the default rates on these loans are roughly less than 5 percent. This, coupled with higher interest rates, does allow microfinance firms to provide an extremely valuable service while also maintaining profitability.

Of course, one would assume that since these borrowers are so poor, interest rates would actually be lower than average. But this is not the case. And there are a few reasons for this.

According to the Consultative Group to Assist the Poor (CGAP), an independent policy and research center focused on advancing financial access for the world's poor:

> *There are three kinds of costs the MFI has to cover when it makes microloans. The first two, the cost of the money that it lends and the cost of loan defaults, are proportional to the amount lent. For instance, if the cost paid by the MFI for the money it lends is 10 percent, and it experiences defaults of 1 percent of the amount lent, then these two costs will total $11 for a loan of $100, and $55 for a loan of $500. An interest rate of 11percent of the loan amount thus covers both these costs for either loan.*
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> *The third type of cost, transaction costs, is not proportional to the amount lent. The transaction cost of the $500 loan is not much different from the transaction cost of the $100 loan. Both loans require roughly the same amount of staff time for meeting with the borrower to appraise the loan, processing the loan disbursement and repayments, and follow-up monitoring. Suppose that the transaction cost is $25 per loan and that the loans are for one year. To break even on the $500 loan, the MFI would need to collect interest of $50 + 5 + $25 = $80, which represents an annual interest rate of 16 percent. To break even on the $100 loan, the MFI would need to collect interest of $10 + 1 + $25 = $36, which is an interest rate of 36 percent.*

MFIs have to charge rates that are higher than normal banking rates to cover their costs and keep the service available. But even these rates are far below what poor people routinely pay to village money-lenders and other informal sources, whose percentage interest rates routinely rise into the hundreds and even the thousands.

For one, institutional stability is integral to long-term success. So it is not uncommon for interest rates to be a bit higher to ensure long-term sustainability. After all, although risk varies from person to person and region to region - there is still risk. And don't forget, this is still a business. And these institutions know that the alternatives are either non-existent or simply more expensive, and in some cases, not quite as safe.

Of course, good judgment also plays a major role when selecting recipients of credit.

Here are a few core strategies that microfinance institutions use when lending money:

- *Progressive lending:* This is when loans begin in small amounts, but rapidly increase as the borrower continues to demonstrate his/her ability and willingness to repay interest while also turning a profit. Consequently, this method reduces the temptation to default because the next loan will be "progressively" larger — and therefore, all the more important in maintaining a profit. Defaulting would not only ruin the debtor's reputation, but also undermine the possibility of attaining credit in the future. This is the tactic lenders most frequently use.

- *Require borrowers to deliver payments in public:* This method instills an element of social stigma. Because everyone in a village is aware of whether or not the borrower is repaying his/her loans, forcing the debtor to pay in public creates a unique pressure from the other villagers. Another benefit of this approach is that it reduces the likelihood of fraud by a bank representative, since there are many witnesses during the repayment.

- *Accepting collateral:* Because the majority of debtors do not have high-priced valuables such as a house or motor vehicle, this method is a little more difficult to institute. However, the psychology behind this approach is unique and successful; instead of accepting high-valued resale items (which, as we said, the debtor does not have), a microlender will require that the debtor pay with an item that has historical or sentimental value. As such, this serves as a major incentive for households to continue paying their interest and/or loans.

- *Placing requirements:* Microlenders can create savings requirements for potential borrowers. As a result, the savings act as collateral. This is particularly effective if borrowers place a high psychological value on their savings. By forcing their clients to create a savings account, the lender ensures that the savings will cover the accumulated interest — even if the debtor's business goes bankrupt the next day. Another unique feature that this method allows for is providing another opportunity for low-income workers to distinguish themselves. In this sense, a worker who has a large savings account appears more credible than a worker who has none.

- *Focus on women:* Empirically, women are more likely to repay their interest and/or loans. Stereotypical or not, research indicates that women are more sensitive to social repercussions or bank pressures than men are, and thus have a much higher likelihood to repay. Therefore, by focusing their attention on helping women, microlenders can decrease the chance of default while providing the same valuable service to impoverished regions.

Though each strategy can be used separately, when combined, these strategies prove to work quite well when it comes to maintaining profitability.

And certainly the borrowers have a lot to gain, as well.

The Proof is in the Progress

Although there are thousands of success stories, consider the following case studies...

Take Mukhtar, for instance: A 36-year-old Afghani man who owns land on which he uses for agriculture. Looking to expand, Mukhtar took out three loans from a microfinance firm in his region. Though his decision to invest in cotton production did not work out due to low trading prices, his other investments were huge successes. However, things were tough in the interum. In order to repay one of his short-term loans and avoid public stigmatization, he had to sell three golden rings (a tool that microfinance firms sometimes use to ensure repayment). In the end, Mukhtar received a total of 300,000 Afs (US $6,493.51) in gross returns from the sales of his crops. This sale not only enabled him to repay the microfinance loan, but also sustained his plans for business expansion.

Then there's Haleema: Similar to Mukhtar, Haleema was trying to acquire credit with the intention of further expanding her agricultural business. Though Haleema is relatively wealthy in comparison to other villagers in her community, her demand for credit is sourced in a passion to constantly expand and innovate her business. In this sense, her demand for credit illustrates both her desire to solve problems and invest in growing business activities. After receiving her loan, she invested the money in her agricultural production and earned an above-average return on her investment — paying back the interest on the loan with profit still in hand.

And take a look at the impact that a microfinance institution had over the entire Temeke District in Tanzani: Primarily because of gender inequality within the country, women are not given as many opportunities to make decisions; in particular, economic decisions. After a microfinance firm entered the district, women began applying for loans. The increasing amount of credit supplied created new business opportunities.

The presence of a microfinance firm not only contributed to Tanzania's economic growth, but also provided women with an opportunity for self-empowerment. Through access to credit, the majority of the women invested their money well and achieved respectable profits. This process of acquiring credit and investing it instilled leadership and a "can-do" mentality among the women of the Temeke District. In this sense, the results of microfinance in Tanzania were unequivocal: success through profit and empowerment.

Microfinance: A Recipe for Success

As individual investors, we also have the opportunity to take part in microfinance by providing capital for these individuals seeking microloans. This is how a number of microfinance firms raise capital in the first place.

One way to do this is through an organization called MicroPlace.

MicroPlace prides itself on its ability to generate vast revenues while effectively alleviating global poverty. This is not a complex idea. Microfinance institutions have realized that the only way to truly empower and help the poor is by providing them with the tools to help themselves. In essence, microfinance institutions achieve teaching

people how to fish instead of just giving them a fish and calling it quits.

So how does MicroPlace accomplish this?

Small loans, Big Impact

By connecting investors with specific microfinance institutions that are seeking funds, MicroPlace serves as a liaison in the global credit market. Though the firm's average investor only contributes roughly $20-$50, their investment makes a transformative difference for the recipients of the loan; because the majority of low-income workers who use microcredit only generate a daily salary of $2, an investment of $20 unleashes their entrepreneurial spirit.

In addition to providing poor workers with the capital necessary to increase revenue, you can also receive a healthy profit from your investment. As you recall, the interest rates for microcredit loans are higher than the rates on loans you might receive from your average bank in the United States. As such, the return on investment that you receive is typically 6% — a much better deal than the 2% compounded interest that your bank account receives. There is a bit more risk involved, just as there is with any investment.

So what's the end result?

More microfinance, a growing number of energized investors, and fewer people living in poverty.

We'll continue to cover the development of microfinance in *Green Chip Stocks* . From new success stories to new opportunities for you, there's plenty more to come. So stay tuned!

You can view the HTML version here: The Microfinance Solution

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