

## **External Environment and Market Assessment**

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### **1. What This Module Covers**

This module will provide a discussion of the external factors that are commonly faced by microfinance organizations. Though market based, MFOs have to deal with a number of external factors or *the operating environment*. These factors can be subdivided into macro- and micro-factors. Macro-factors include regulatory, political, economic, demographic, and physical environments, including the climate. They influence both the program and its clients' business activity. Micro-factors include competition, client population, donors and other resource providers and their affect is limited by activities of MFOs.

Environmental factors affect MFOs in two different ways: they can influence MFOs indirectly through their effects on the businesses and communities that MFOs work with, and they can cause changes directly to the design and operation of the MFO.<sup>1</sup> This module will prepare program managers to analyze information about the operating environment in order to make any necessary adjustments during the program implementation process.

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<sup>1</sup> Donald Snodgrass, *The Economic, Policy, and Regulatory Environment*, (AIMS, 1996), 3, [\[http://www.mip.org/pdfs/aims/ecopolic.pdf\]](http://www.mip.org/pdfs/aims/ecopolic.pdf)

## 2. Macro-factors

### 2.1 Regulatory Environment

MFOs are regulated differently in each country: from little regulation (e.g. Russia<sup>2</sup>) to more regulated (e.g. Bangladesh, West Africa, Egypt, Colombia, Peru, Bolivia<sup>3</sup>). Some issues in microfinance regulation are highlighted below:

- NGOs with microfinance operations often want to be licensed (and therefore regulated) in order to access deposits from the public, or credit lines from donors or governments.
- Sometimes MFOs, especially NGOs, believe that regulation will promote their business and improve their operations.
- Some NGOs, governments, and donors want financial licenses to be more widely (and easily) available in order to expand savings services for the poor.
- Donors and governments may think that setting up a special regulatory window for microfinance will speed the emergence of sustainable MFOs.
- In those countries, where MFOs are already taking deposits without licensing, the central banks aim to license them in order to protect depositors.
- Many MFOs charge high interest rates. Governments may view these rates as exploitative and want to protect small borrowers from them.
- Local authorities may be troubled by the weakness of many MFOs, and unimpressed with the coordination and supervision being exercised by the donors who fund them.
- Occasionally governments look to regulation as a means of clamping down on bothersome foreign-funded NGOs or other groups that it would like to control more tightly.
- In some countries there is simply no legal structure under which a socially motivated group can lawfully provide loans to poor clients. Unless such a structure is developed, loans may be legally uncollectable, and microfinance providers may even be at risk of prosecution.

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<sup>2</sup> For description and cases see Joost de la Rive Box, *Microfinance in Russia*, Policy Paper, (TACIS, April 2001).

<sup>3</sup> Some examples on West Africa, Egypt, Colombia, and Bolivia etc. are given in the book by Joanna Ledgerwood, *Microfinance handbook: an institutional and financial perspective*, (Washington, D.C.: The World Bank, 1998).

- Finally, microfinance is getting a high political profile in many countries, especially since the 1997 Microcredit Summit. Sometimes attention to regulation springs from a government's sense that it has to do something about microfinance, for reasons that may combine concern for the poor and the demands of practical politics.<sup>4</sup>

Policies and regulations can affect MFOs either *indirectly* through their effects on program clients or *directly* by limiting the MFO's programs.

## I. Indirect Impact

Table 2.1 (see below), developed by Haggablade, Liedholm and Mead (1990), describes policies and regulations that have important influences on micro and small enterprises.

Some of the most significant policies among them are those that work through factor markets: these are exchange rates, tariffs, and interest rates. These policies influence the prices businesses pay for capital, including the price of microcredit.

## II. Direct Impact

- Interest rate ceilings on microlending – unsustainability of microfinance (make microfinance operations unprofitable and stifle deposits).
- Permission to take deposits (this could be qualified as a bank activity):
  - i. Public savings protection.
  - ii. Microfinance development.<sup>5</sup>
- Effective enforcement of financial contracts (makes it possible to reduce transaction costs). For an example see Ledgerwood, *Microfinance handbook: an institutional and financial perspective*, 1998, 20.
- Government credit allocations (could help MFOs access funding from commercial banks).

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<sup>4</sup> Robert Peck Christen and Richard Rosenberg, *The Rush to Regulate: Legal Frameworks for Microfinance*, CGAP Occasional Paper No. 4, April 2000, [\[http://www.cgap.org/html/p\\_occasional\\_papers04.html\]](http://www.cgap.org/html/p_occasional_papers04.html)

<sup>5</sup> Donald Snodgrass, *The Economic, Policy and Regulatory Environment* (AIMS Paper, Washington, D. C.: Management Systems International, 1996) [\[http://www.mip.org/pdfs/aims/ecopolic.pdf\]](http://www.mip.org/pdfs/aims/ecopolic.pdf)

Governments may establish minimum standards for MFOs, such as:

- Minimum capital requirements for an MFO entering the market,
- Capital adequacy standards limiting the proportion of the organization's assets that can be funded externally and from its own sources,
- Liquidity requirements. A certain part of organization's funds must be held in cash, or be convertible to cash in order to cover the financial risks the organization has to deal with,
- Asset quality (disbursed loan portfolio security), and
- Portfolio diversification (among several market segments).<sup>6</sup>

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<sup>6</sup> Adapted from Joanna Ledgerwood, *Microfinance handbook: an institutional and financial perspective*, (Washington, D.C.: The World Bank, 1998), 23-25.

**Table 2.1**  
**Inventory Of Policies Affecting Employment And MSE Growth By Functional Grouping**

1. Trade policy
  - a. Import duties
  - b. Import quotas
  - c. Export taxes or subsidies
  - d. Exchange rates
  - e. Foreign exchange controls
2. Monetary policy
  - a. Money supply
  - b. Interest rate
  - c. Banking regulations
3. Fiscal policy
  - a. Government expenditure
    - (i) Infrastructure
    - (ii) Direct investment in production, marketing, or service enterprises
    - (iii) Government provision of services
    - (iv) Transfer payments
  - b. Taxes
    - (i) Business income/profits
    - (ii) Personal income
    - (iii) Payroll
    - (iv) Property
    - (v) Sales
4. Labor policies
  - a. Minimum wage laws
  - b. Labor codes covering working conditions, fringe benefits, etc.
  - c. Social security
  - d. Public sector wage policy
5. Output prices
  - a. Consumer prices
  - b. Producer prices
6. Direct regulatory controls
  - a. Enterprise licensing and regulation
  - b. Monopoly privileges
  - c. Land allocation and tenure
  - d. Zoning
  - e. Health regulations

Source: Haggblade, Liedholm and Mead (1986).

## ***2.2 Economic Environment***

### Wealth of the Nation

- Increasing the wealth of a borrower makes it easier for her to repay her loans. A borrower who is moderately wealthy, or at least liquid, and whose income is rising, has a better ability to repay.

- The incentive to repay is also important, as the poorer borrower has few available sources of credit, and is thus strongly motivated to repay loans if the availability of credit in the future depends on prompt repayment.
- Average repayment rates seem to be higher in periods of economic growth than in the times of recession. GDP analysis enables forecasting of economic outlooks and an estimate of the amount of resources required by MFOs.
- If the level of unemployment goes up in stagnant economies, then more people turn to self-employment and become potential microfinance clients.

#### Inflation

- Complicates financial contract making due to unexpected and tremendous price fluctuations.<sup>7</sup>

The following tools may be used to protect an MFO from high or unstable inflation:

- 1) **Loan size:** A program is able to change loan sizes in response to inflation trends. If the inflation increase is predicted, it would be better for a program to offer smaller average loans.
- 2) **Loan Denomination:** This has become one of the most common ways to protect funds from inflation in countries with unstable currencies. However, a program may set up interest rates based on the dollar value of a loan. This system does not completely protect against inflation since the U.S. dollar also experiences some inflation every year.

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<sup>7</sup> Donald Snodgrass, *The Economic, Policy and Regulatory Environment* (AIMS Paper, Washington, D. C.: Management Systems International, 1996), 9-10.  
[\[http://www.mip.org/pdfs/aims/ecopolic.pdf\]](http://www.mip.org/pdfs/aims/ecopolic.pdf)

- 3) **Interest Rates:** Effective loan interest rates should cover the inflation rate. However, in reality the inflation level is floating. Hence, it is better to link interest rates with inflation rates in order to upgrade interest as the rate of inflation changes.
- 4) **Loan Terms:** Programs should practice very short-term lending, when it is impossible to set up floating interest rates according to currency exchange or inflation rates. By doing so, they will reduce fund devaluation as loan conditions may be updated in time.<sup>8</sup>

### ***2.3 Physical Environment***

Geographical areas with disadvantageous environmental conditions are usually poor and lightly populated, posing a real challenge for microfinance development.

“Yet a substantial fraction of humanity – and a far larger share of poor people – does live in tropical regions, where, as Andrew Kamarck (1976) has pointed out, environmental conditions pose many serious challenges to development that are not encountered in temperate regions. Among the barriers to development analyzed by Kamarck are rainfall and heat, low-quality soils, agricultural enemies (weeds and insects, locusts, and others), lack of relevant agricultural research, paucity of mineral deposits, a wide range of health hazards, and a lack of research on how to overcome them. In their broadest application, these factors help to explain why the great majority of tropical nations are poor and why most of the world’s poor people live in tropical regions.

Countries with physical environments that pose difficulties for economic development may be heavily populated because international migration is difficult and people have nowhere else to go. Within particular countries, where barriers to movement are far less severe, the most difficult regions tend to be lightly populated.”<sup>9</sup>

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<sup>8</sup> Charles Waterfield, Ann Duval, *CARE Savings and Credit Sourcebook*, (CARE, 1996), 30-31.

<sup>9</sup> Donald Snodgrass, *The Economic, Policy and Regulatory Environment*, (AIMS Paper, Washington, D. C.: Management Systems International, 1996), 5.

Establishing MFOs in such regions, especially in vast areas with low population density (see Box 2.2), will require high operating costs, including transportation expenses to reach clients in remote rural areas. Organizational staff will have to travel extensively, which may reduce the organization's overall efficiency.

However, these operating costs can be minimized. The main way is through the choice of an appropriate lending methodology. In areas of low client density, it may be possible to apply one of the group lending approaches. These approaches do not require frequent contacts with individual clients and delegate much of the loan management responsibility to the clients themselves. A field agent is able to work with many clients at a time while reducing marginal costs.

### **Box 2.2 - Geographical Factors in Russia**

The Russian Federation, as a large country, has diverse population density and transportation infrastructure. Russian regions are very different in their social and economic development. Hence, the number of clients per one MFO in any one region may vary. Therefore, geographical factors should be taken into account during the program design process.

Because population density is different, MFO clients are distributed unevenly all over Russia. Most of them are centered in the western region, where economic and regulatory environments are better. For instance, the amount of economically active population, living in the biggest part of the country – Siberia and the Far East - is only 22.3 percent. Therefore, numbers of individual entrepreneurs and micro-enterprises are also low (See Table 2.2).

**Table 2.2 Microfinance client distribution in Russia.**

	<b>European part</b>	<b>Ural</b>	<b>West Siberia</b>	<b>East Siberia</b>	<b>Far East</b>
<b>Economically active population, %</b>	63.8	14.0	10.5	6.2	5.6
<b>Individual entrepreneurs, %</b>	60.0	14.4	13.4	4.6	7.3
<b>Micro-enterprises*, %</b>	73.8	9.9	8.8	4.1	4.1

Source: *The Analysis of Supply and Demand on the Microfinance Services Market in Russia*, (FINCA International, Moscow, 2000).

Another way to lower delivery costs is through developing an efficient organizational structure. An organization can place its agents in strategic areas, closer to clients, instead of working with one central office and incurring high travel costs. When distances are great between villages or groups of clients, or the access is especially difficult due to bad roads, field agents may be able to change their place of residence periodically, rotating to different villages in conjunction with loan cycles. Field agents may report to either a branch office or a central office, but limit the frequency of visits to the office in order to reduce travel costs.<sup>10</sup>

Sometimes MFOs have to operate in areas where natural disasters occur often. A number of them were designed especially to overcome disasters (e.g., Bangladesh Rural Advancement Committee).

The main advantage of microfinance for disaster-prone areas is flexibility in funding, loan terms, collateral required and providing the required services in post-disaster situations. MFOs are able to insure capital safety for households and micro enterprises against future disasters through savings mechanisms as well as contribute to the rehabilitation of the economy.<sup>11</sup>

#### ***2.4 Other Factors***

- **Demographic factors** should be taken into account since social conditions directly affect the target population of MFOs and influence the demand for their services.
- **Population density:** In countries with a great number of potential microfinance clients (e.g., Bangladesh, India), MFOs have better opportunities to expand their activities and introduce new products than in countries with fewer potential clients (e.g., Panama, Niger, Nicaragua).<sup>12</sup>

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<sup>10</sup> Charles Waterfield, Ann Duval, *CARE Savings and Credit Sourcebook*, (CARE, 1996), 32.

<sup>11</sup> Geetha Nagarajan, *Microfinance in the Wake of Natural Disasters: Challenges and Opportunities*, (Development Alternatives, Inc., March 1998), 2-3, [<http://www.mip.org/pdfs/mbp/disaster.pdf>].

<sup>12</sup> William Grant, *Marketing in Microfinance Institutions: The State of the Practice*, (Development Alternatives, Inc. November 1999), 10.

- **Increasing urbanization** may encourage MFOs to diversify their services according to the needs of the market.<sup>13</sup>
- **Employment structure and dominant industries** can affect the entrepreneurial potential of the country's population.

### 3. Micro-factors

Whereas the macro-factors have a significant influence on both MFOs and enterprises, the close ambience of an organization plays a very important role as well. Micro-environmental factors answer the following questions:

- **Who** is in the market? (Competition)
- **Who** is the program designed for? (Client population)
- **By what means**? (Financial resource providers)

#### *3.1 Competition*

Until the late 1990s most MFOs found themselves in a near monopoly position. They experienced competition for financial resources, but not for clients, as most MFOs even now remain externally funded entities. Programs could treat the demand for their services as unlimited. However, the situation has changed as well as concerns of the organizations (See Table 3.1.1). Markets in Chile, Bolivia, Bangladesh and Uganda have begun to show the signs of saturation. For instance, delinquency rates are increasing as market growth is slowing.

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<sup>13</sup> Monica Brand, *New product development for microfinance: evaluation and preparation* (Bethesda, MA, USA: Microenterprise Best Practices (MBP) Project, Development Alternatives – USAID, 1998), 15, [<http://www.mip.org/pdfs/mbp/newprod1.pdf>].

**Table 3.1.1 Concerns of Microfinance Institutions Before and During Competition<sup>14</sup>**

<b>Pre-Competitive Stage</b>	<b>Competitive Stage</b>
<b>Objectives:</b> to reach <i>more people</i> and to become <i>financially viable</i>	<b>Objectives:</b> To retain or increase <i>market share</i> , while remaining <i>profitable</i>
<b>Driving motivation:</b> access to <i>funding</i>	<b>Driving motivation:</b> attracting the <i>customer</i>
<b>Management focus :</b> developing the institutions <i>internal capabilities</i>	<b>Management focus :</b> Internal issues remain, but <i>external focus</i> is added: understanding the external environment and adjusting business strategy to it
<b>Growth:</b> <i>High</i> growth projections possible	<b>Growth:</b> <i>Low</i> growth likely
Little need to take the behavior of other players into account	Must study the behavior of clients, prospective clients, and competitors
Client demand taken as given	Client demand can evaporate quickly if competitor provides better service
Low <i>risk</i> , predictable future; <i>high degree of control</i> over outcomes	<i>Rapid change</i> , high uncertainty; <i>lower control</i> over outcomes

Benefits of competition:

- Broader geographical coverage of the market, finding new markets;
- Lower loan sizes and interest rates;
- More complete range of products available to microenterprises and new product development;
- Strategically developing MFOs;
- Customers become price sensitive (clients care more about access than price) and begin to show their preferences related to service adjustment:
  - i. Speed of loan turnaround (this has become the main point of competition in Bolivia)
  - ii. Larger loans
  - iii. Less frequent repayments
  - iv. Longer maturities
  - v. Easier applications
  - vi. Personal treatment of clients by the program's staff
  - vii. Most clients prefer individual loans to group ones.<sup>15</sup>

<sup>14</sup> Source: Elisabeth Rhyne, *Microfinance Institutions in Competitive Conditions*, (October 2001), 2, [\[http://www.mip.org/pdfs/mbp/microfinance\\_institutions\\_in\\_competitive.pdf\]](http://www.mip.org/pdfs/mbp/microfinance_institutions_in_competitive.pdf)

<sup>15</sup> Elisabeth Rhyne, *Microfinance Institutions in Competitive Conditions*, (October 2001), 4, [\[http://www.mip.org/pdfs/mbp/microfinance\\_institutions\\_in\\_competitive.pdf\]](http://www.mip.org/pdfs/mbp/microfinance_institutions_in_competitive.pdf)

Competition brings several additional risks to MFOs:

- Organizations may become too flexible;
- The cost of mistakes is high;<sup>16</sup>
- Borrowers may move from one program to another;
- Customer sensitivity requires more efforts and resources in order to adjust services.

Organizations that provide the access to financial services represent the formal, semiformal, and informal sectors (Table 3.1.2). The difference is made between formal and informal according to the existence of a legal environment and regulation that covers the relations among lenders and depositors.

**Table 3.1.2 Providers of financial services<sup>17</sup>**

<b>Formal Sector</b>	<b>Semiformal Sector</b>	<b>Informal Sector</b>
Central bank	Savings and credit cooperatives	Savings associations
Banks	Multipurpose cooperatives	Combined savings and credit
Commercial banks		Associations
Merchant banks	Credit unions	
Savings banks		Informal financial firms
Rural banks	Banques populaires	Indigenous bankers
Postal savings banks		Financial companies
Labor banks	Cooperative quasi-banks	Investment companies
Cooperative banks		
	Employee savings funds	Unregistered self-help groups
Development banks		
State-owned	Village banks	Individual moneylenders
Private		Commercial
	Development projects	Noncommercial (friends etc.)
Other nonbank institutions		

<sup>16</sup> Elisabeth Rhyne, Robert Peck Christen, *Microfinance Enters the Marketplace*, 19-22, <http://www.mip.org/pdfs/usaaid/MicrofinanceEnters.pdf>

<sup>17</sup> Source: Food and Agriculture Organization 1995, 5. Taken from Joanna Ledgerwood, *Microfinance handbook: an institutional and financial perspective*, (Washington, D.C.: The World Bank, 1998), 13.

<b>Formal Sector</b>	<b>Semiformal Sector</b>	<b>Informal Sector</b>
Finance companies	Registered self-help groups and savings clubs	Traders and shopkeepers
Term-lending institutions		
	Nongovernmental organizations (NGOs)	NGOs
Building societies and credit unions		
Contractual savings institutions		
Pension funds		
Insurance companies		
Markets		
Stocks		
Bonds		

Some of the institutions mentioned above currently providing microfinance services or likely to provide them:

### **Commercial Banks**

Commercial banks represent the formal sector and are subject to state banking supervision and regulation. Although they provide loans to small enterprises and individual entrepreneurs, their activities cannot be defined as “pure microfinance” since they are usually inaccessible to low income people. Moreover, the loan source for banks is also different from externally supported microfinance institutions. By definition, credit refers to lending funds mobilized from the public at large, usually in the form of deposits, and it is thus closely equivalent to the concept of financial intermediation.

However, the sector of clients that holds some capital and has good entrepreneurial skills meets traditional bank system requirements. This group is therefore able to make a choice between commercial banks and other institutions (See Table 3.1.3):

**Table 3.1.3 Competitive Characteristics of Commercial Banks**

<b>Advantages</b>	<b>Disadvantages</b>
<ul style="list-style-type: none"> <li>• Public trust in safety and security</li> <li>• Banks can afford a great number of branches</li> <li>• Lower cost of capital for clients</li> <li>• Large loan funds</li> <li>• Well trained staff</li> </ul>	<ul style="list-style-type: none"> <li>• Bureaucratic procedures and paperwork</li> <li>• Collateral requirements</li> <li>• Low accessibility for low-income clients</li> <li>• Urban orientation</li> </ul>

### **Consumer credit organizations**

Consumer credit organizations belong to the semiformal sector and are not usually supervised by state banking authorities, but are generally controlled and licensed by other government structures. They target clients from similar income levels as traditional MFOs do, but use lending methodologies that differ substantially from microfinance principles. They issue very small loans to households or individuals in the salaried sector. Loans are secured by an agreement with the borrower’s employer. On the contrary, microfinance implies lending to people whose income is earned from informal enterprises.

Credit cooperatives are membership organizations established with the aim of providing financial services to its members that are fully, or largely financed from the share capital and savings of its members.

A credit union is an association of individuals, united according to their place of residence, occupation or employment with the aim of providing mutual support to the members of the union. In accordance to current rules of credit unions, only natural persons can be members. Legal entities are excluded from membership and hence cannot receive loans either. Loans are provided to credit union members on the basis of appropriate sureties such as a co-member guarantee, future salary or on the basis of the member’s credit history.

**Table 3.1.4 Competitive Characteristics of Credit Cooperatives and Credit Unions**

<b>Advantages</b>	<b>Disadvantages</b>
<ul style="list-style-type: none"> <li>• Membership stimulates saving and prevents clients from leaving</li> <li>• Good public image in history</li> </ul>	<ul style="list-style-type: none"> <li>• Membership charges</li> <li>• Savings first and credit second</li> <li>• Low accessibility for the poor</li> </ul>

Rural and Agricultural credit cooperatives can lend directly to registered businesses or farms as well as to individuals. The members are usually farmers and agricultural entrepreneurs. These organizations are generally not large, designed to serve the needs of a rural population, and do not have professional personnel.

### **NGOs**

NGOs may belong either to the semiformal or informal sector. They are often legally registered and subject to some state supervision. They serve the part of the market that is not sufficiently profitable for commercial entities. Therefore, NGOs should be able to identify their target clients, which is not easy in a competitive environment.

**Table 3.1.5 Competitive Characteristics of NGOs**

<b>Advantages</b>	<b>Disadvantages</b>
<ul style="list-style-type: none"> <li>• Accessible to the poor</li> <li>• Less bureaucracy</li> <li>• Flexibility in terms</li> <li>• Constant access to growing loan sizes</li> <li>• Alternative forms of collateral</li> </ul>	<ul style="list-style-type: none"> <li>• Lack of professional staff and management</li> <li>• Frequent repayments and meetings</li> <li>• Relatively high interest rates</li> </ul>

### **The informal microloan sector**

The informal loan sector, including friends, family, pawnbrokers, operates without state regulation. Some clients prefer it to more formal institutions for the following reasons (See Table 3.1.6):

**Table 3.1.6 Competitive Characteristics of the Informal Loan Sector**

<b>Advantages</b>	<b>Disadvantages</b>
<ul style="list-style-type: none"> <li>• Credit terms are flexible, including frequency of repayments</li> <li>• Little or no paperwork</li> </ul>	<ul style="list-style-type: none"> <li>• Semi-legal status of the lender</li> <li>• High interest rates</li> </ul>

### ***3.2 Client population***

Client population refers to the demographic and social characteristics of the microfinance market. Typically, a microfinance client belongs to a certain target group of people, who have limited access to traditional bank loans. The program’s general policy and social mission determines its target orientation. For instance, MFOs designed for the poorest often provide additional technical and training support to their clients in addition to traditional loan services.

Most MFOs will work with anyone who needs a loan. They do not limit their activities by working with a target group. These programs have reached relatively high numbers of borrowers and issued loans. Other programs address their activities to a specific group: women, social minorities, or low-income individuals. Some organizations even limit their activities to a certain specific group. Such programs are closed for clients from other target groups.

The MFO may identify its target market in several ways. Two possible ways are:

- By the characteristics of the potential clients (gender, poverty level, ethnicity, citizenship, education etc.)
- By the type of business activity it intends to support (new businesses, existing enterprises, specific businesses).

#### **Potential clients’ characteristics**

Age

- Young people may have a stronger intention and energy to improve their living conditions by establishing their own businesses;

- Lending to senior clients may bring additional risks since there is a probability of the client's death before outstanding loans are paid off.

#### Gender

- Women have fewer economic opportunities than men;
- Women have large household obligations, as they are usually responsible for family healthcare and education;
- Women have fewer sources of collateral since the property rights often belong to men;
- Women demonstrate high loan repayment and responsibility about loan procedures;
- Women tend to start smaller enterprises with lower amounts of capital;
- Women's traditional activities include trade, services, sewing, textiles and food manufacturing.

#### Level of Literacy and Education

- Illiterate clients do not meet traditional requirements of the financial sector;
- MFOs may have to spend time teaching the borrowers how to read numbers and sign their names.

#### Urban vs. Rural Clients

- In urban areas clients are more likely to have a higher level of education;
- Urban markets are more developed in terms of infrastructure;
- The level of repayment may be higher in urban areas since MFOs can appoint more frequent meetings with borrowers;
- Providing microfinance products to rural clients may be a more efficient way to reach more poor people.

The market could also be identified according to the amount of capital owned by the clients and their entrepreneurial skills (Table 3.2.1):

**Table 3.2.1 Identifying the target group**

Skills	Capital		
	None	Low	Sufficient
Yes	?	+	-
No	?	+	-

Each group has a different demand for financial and educational resources; the group with no capital is the most challenging. It requires large training and development efforts. MFOs that work with this group often have difficulty reaching financial self-sufficiency. The second group is a group of typical microfinance clients who lack access to capital. Specific features of a program to work with this group are determined by other environmental factors. The third group of clients meets traditional banking system requirements. However, those clients without entrepreneurial skills may still apply to an MFO program to gain training.

The expansion of client businesses and the maturation of client-lender relationships may generate demand for new types of products or increase expectations about product quality and variety. Adding new services may expand the organization's existing technologies. Progress in this direction will improve the quality of microfinance institutions.<sup>18</sup>

### **3.3 Donors**

Donors may provide the following services to new or existing MFOs:

- Grants for institutional capacity building
- Grants to cover operating deficits
- Grants for loan capital
- Loans for further disbursement among microfinance borrowers
- Lines of credit
- Guarantees for commercial funds

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<sup>18</sup> *Evolution of Credit Methodologies – Concept Paper*, (Microenterprise Best Practices Project, USAID), [<http://www.gdrc.org/icm/credit-methodology.html>].

- Technical assistance.<sup>19</sup>

Currently, many MFOs are funded by donor grants, received from multilateral organizations - Microcredit Summit, The Consultative Group to Assist the Poorest (CGAP) -, government agencies, such as the United States Agency for International Development (USAID) and The Canadian International Development Agency (CIDA), and private foundations (e.g. Ford Foundation).

**The World Bank Group** aims to increase access to financial services for low-income households by addressing three principal areas: *Fundamental framework* (the policy, legal and regulatory frameworks that allow innovative financial institutions to develop and operate effectively), *Institution building* (exposure to and training in best practices that banks and microfinance organizations need to expand their outreach and develop sustainable operations, along with performance-based support for capacity building), and *Innovative approaches* (leasing, lending and other products that the World Bank Group utilizes to increase access to financial services).

The World Bank Group's country programs work in close collaboration with the World Bank Institute (WBI), the Consultative Group to Assist the Poorest (CGAP), the Small and Medium Enterprise (SME) Department, and the Sustainable Banking with the Poor (SBP) program.

**The Consultative Group to Assist the Poorest (CGAP)** is a consortium of international donor agencies and foundations committed to expanding the quality, quantity and sustainability of financial services to poor and very poor clients. CGAP has a small investment fund of about US\$6-7 million (on an annual basis) to fund capacity building, industry tools and services, and direct grants to microfinance organizations and networks. CGAP funding is made in conjunction with its member donors.<sup>20</sup>

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<sup>19</sup> Joanna Ledgerwood, *Microfinance handbook: an institutional and financial perspective*, (Washington, D.C.: The World Bank, 1998), 16.

<sup>20</sup> Source: [[http://www.cgap.org/html/mfis\\_funding.html](http://www.cgap.org/html/mfis_funding.html)]

**The United Nations Development Program (UNDP)** provides grants through government and UNDP offices to start-up programs. "Contractors" are selected through an international bidding process to help a local NGO set up an MFO.

United Nations agencies and international financial institutions, including the World Bank and the International Fund for Agricultural Development (IFAD), are usually required to work through host country governments, with the exception of the International Finance Corporation. This requirement of working through governments places limitations on the agencies' ability to effectively support effective MFOs, and often steers them toward supporting MFOs in which governments play a role.<sup>21</sup>

**The United States Agency for International Development (USAID)** supports a variety of activities designed to help improve access to credit. However, USAID's principal effort in the area of credit has been the development of microfinance programs, which provide financial services to entrepreneurs in single cities or regions that develop generic models of microfinance acceptable for further wide replication throughout the country.<sup>22</sup>

Currently, USAID supports four American microfinance NGOs: Opportunity International, Counterpart International, FINCA International, and ACIDI/ VOCA.

**Canadian International Development Agency (CIDA)** supports projects in microfinance and microcredit in order to meet the needs in the region for small and medium-sized enterprises, and for the development of basic financial systems. CIDA helps to create employment and – especially through its projects with credit unions – helps to diversify the savings and borrowing options available to individuals and firms.<sup>23</sup>

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<sup>21</sup> Muhammad Yunus, *How Donor Funds Could Better Reach and Support Grassroots Microcredit Programs Working Towards the Microcredit Summit's Goal and Core Themes*, [<http://gdrc.org/icm/summit/4-papers/donorpaperH.htm#Note%203>]

<sup>22</sup> *Microfinance Sector Support Program*: Request for Applications NO. 118-01-007, (USAID), 1.

<sup>23</sup> *Report on CIDA's Programming in Microfinance & Microenterprise Development*, 16, [[http://www.acdi-cida.gc.ca/cida\\_ind.nsf/eff12ba4cbb097c1852566ce00644c8a/f603fd89dd24fc508525684800719152/\\$FILE/micro-rept.pdf](http://www.acdi-cida.gc.ca/cida_ind.nsf/eff12ba4cbb097c1852566ce00644c8a/f603fd89dd24fc508525684800719152/$FILE/micro-rept.pdf)]

**Ford Foundation** is a private foundation supporting organizations that help businesses create employment opportunities and help people acquire, develop and maintain savings, investments, businesses, homes, land and other assets. In workforce development, the Foundation supports organizations that help improve the ways low-income people develop marketable job skills and acquire and retain reliable employment that provides livable wages.

The traditional banking system can be also considered as a potential financial resource provider for MFOs, although the stronger banks are generally uninterested in developing a relationship with microfinance institutions, leaving only weaker banks prepared to deal with MFOs.<sup>24</sup>

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<sup>24</sup> Mehnaz S. Safavian, Douglas H. Graham, Claudio Gonzales-Vega, *The State of Microfinance Activity in Russia: A Selective Review of Operational, Registration, and Regulatory Issues*, (FINCA International, 1999), 17.