

Forum: ECOSOC

Issue: Promoting the growth of small businesses through microfinance in LEDCs

Student Officer: Tetsushi Aoyama

Position: Deputy President

Introduction

LEDCs today face a major challenge in many aspects of the economy. Uncertainty in today's global political climate plays a major role in this uncertainty ('Uncertainty Is the New Tariff, Costing Global Trade and Hurting Developing Economies | UN Trade and Development (UNCTAD)'). LEDCs often have national economies that are vulnerable to exogenous events, including recessions in major trading partners, fluctuations in currency exchange rates etc, where LEDCs are particularly vulnerable due to the economy's reliance on export of commodity goods ('The Least Developed Countries Report 2020: Productive Capacities for the New Decade').

In those contexts, microfinancing plays a major role in the economic development of LEDCs. Microfinancing allows people who did not have access to traditional financial services offered by institutions including banks, such as women or people with low income (Kagan). Microfinancing allows for those people to create a new income stream and therefore be financially more secure. This is particularly important for rural or semi-rural areas, since those areas often lack jobs with stable, regular income as opposed to traditional industries in those areas, such as agriculture (Kumari).

In traditional financial services such as loans offered by banks, the banks often require a collateral to recoup the sum of money they have lent the person. However, more often than not people with low or irregular income do not qualify for those loans (Kumari). However, with microfinancing, those barriers have been overcome by alternative lending approaches, such as the group lending approach, commonly called the Grameen Model, which allows groups of people to borrow money without traditional material collateral, instead relying on social collateral such as peer pressure to ensure repayment (Schurmann and Johnston). This has found success in Bangladesh, where 97% of people are women, who has traditionally faced restrictions on work based on norms of purdah, and a repayment rate of 96.29%, which is even higher than traditional lending schemes (Gjergji).

Those microfinancing opportunities allow disadvantaged persons and SMEs to conduct social entrepreneurship, which allows them to be alleviated out of poverty. Those features have made microfinancing to be an effective policy to lift people out of the cycle of poverty, and this has been

successfully replicated in countries other than Bangladesh, such as China, India and Pakistan. This allows women's participation in total labour to be increased, as they are empowered to start their own small businesses, leading to a growth in the economy (Kayani et al.).

Definition of Key Terms

Microfinance

Microfinancing is the provisioning of basic financial services, such as providing savings accounts, providing loans etc. to people who may not readily have access to traditional financial institutions ('About Microfinance')

Social Collateral

Social collateral is the use of the local community to make sure the debt is returned. This allows the microfinance institutions to lend to economically disadvantaged people without requiring material collateral. There are four important components of social collateral, namely trust, network, group pressure, and training. Trust will encourage the cooperation between group members in the group lending model of the Grameen model. Networking allows for the borrowers to obtain market information from others, eg. See what products are in demand today and potentially start a business in those domains. Peer pressure leads to higher rates of repayment due to the social conditions and the daily interactions a borrower group will have on each other in traditional societies. Finally, training is paramount to the success of microfinancing, as it will instil confidence in women's ability to manage finances, and allow them to obtain skills that are needed to start a business themselves, as women make up a large majority of recipients of the microcredits (Hadi and Kamaluddin).

Grameen Model

The Grameen model is one of the models of microfinancing, where groups of 5 potential borrowers come together to borrow a loan. Initially, 2 out of those 5 who want to borrow will be able to obtain a loan, and if they are successful in consistently repaying the loan on time, of which will be guaranteed by social pressure from the other potential borrowers, then the others will also be able to borrow the loan themselves ('Grameen Bank'). This model has seen a considerable level of success. Firstly, this model is targeted to the economically disadvantaged people, with limitations based on the financial situation of the borrower, such as size of land they own, and household income. This is to ensure only people who can benefit from the microfinancing, which leverage social collateral, are able to participate in its system. Secondly, instead of the cases in traditional banks where clients go to the banks, in this model the services are provided through regular meetings in the community. This allows for lower barriers to borrowing for poor people. Thirdly, this model employs social collateral, as we

discussed earlier. Those features have allowed this model to succeed, with repayment rates over 95%, all whilst the funds being more professionally managed as a bank compared to cooperatives and community based organisations (Joshee).

Social Entrepreneurship

Social entrepreneurship is an entrepreneurship that applies the principles of creating social change or impacting a social cause into business, with the aim of creating strong social change through Business (Coursera Staff).

Microfinance Institution

Microfinance Institutions are a financial institution that is especially established to provide services in business development and society empowerment by giving loans or financing for micro-scaled business of MFI members and society, providing deposit management, or giving consultancy services in business development that is conducted not merely for profit. They are entities that have often started as a non-bank financial institution and are often established by communities or governments (Otoritas Jasa Keuangan).

Background Information

Microfinancing serves as a powerful way to empower historically economically disadvantaged persons, including those living in LEDCs. This is possible because microfinance allows those people without any material collateral to borrow capital, which then will empower them to start a business.

Economic structure of LEDCs

LEDCs have a structural barrier in growing their economy. LEDCs collectively account for 40% of the world's poor, despite only accounting for 13% of the world's population. Not only this, but they also account for only 1.3% of the world's GDP, and only about one-fifth of the population in LEDCs have access to the internet (*About Least Developed Countries | Office of the High Representative for the Least Developed Countries, Landlocked Developing Countries and Small Island Developing States*). Those characteristics pose a problem for LEDCs, as LEDCs often have a large primary sector, such as agriculture or fisheries, because those industries can be operated even with a lack of capital. In addition, many LEDCs have rich natural resources, exacerbating those trends. Those characteristics create a situation for those countries to not invest in education as much, since those sectors do not require education, and those does not enrich the people's lives in those countries, as goods produced in those economies, such as agricultural crops and seafood produced, or raw natural resources that are

mined are then sold to foreign buyers to obtain foreign income. Those characteristics have historically hampered LEDC's ability to grow the economy, as secondary and tertiary industries often require upfront capital, and the need for skilled workers who are required to be highly trained (*Development*).

Legal issues and compliance requirements

For any financial institution, the importance of being legally compliant with the laws and regulations of the country is paramount. Those laws serve as a safeguard to customer's interest in many ways, such as imposing anti money laundering regulations, and risk management principles. Those allow for trust and faith in financial institutions in those countries. Those regulations often include regulations on loan/ mortgage approval process, requiring compliance with anti money laundering and know your customer rules, and implementing capital adequacy and liquidity criteria for those financial institutions to safeguard both business and customer's interests (Austin). However, those often become an obstacle for microfinance institutions. While MFIs provide loans similar to traditional financial institutions, they tend to be smaller, as MFI clients are often considered risky by traditional institutions. Those features causes MFIs to have a financial risk, which may in turn be in non-compliance with the regulations set by the authorities, such as one regarding credit risk, fraud, or security, financial management risks, and make them vulnerable to external factors, such as change in regulations, and wider macroeconomic conditions amongst others (Lagha). Traditionally, MFIs operated in a legal gray zone, as they were relatively smaller in size compared to traditional financial institutions. In addition, imposing too many regulations on MFIs cause them to not fulfil their societal purpose, as extensive compliance procedures can cause the borrower to bear the burden of the compliance cost and the time required for such compliance, often in forms of high interest rates, which limit inclusivity of the poor people which MFIs were originally targeting ('Navigating the Money Laundering Challenge in the Microfinance Realm').

Financial Literacy

Financial literacy is a skill that is required to allow individuals to make informed financial decisions and achieve long term economic stability. For low income households, financial literacy plays an important role in lifting them out of poverty ('Navigating the Money Laundering Challenge in the Microfinance Realm'). For example, some poor people in those countries might invest their hard-earned money into buying cows. However, in some countries, cows have a low or negative return on investment. This is because since those people lack financial literacy, they do not view the act of buying cows as an investment (Mas). In those contexts, providing financial literacy allows for a more informed financial decision, including using the microfinance loans for entrepreneurship purposes, which could otherwise put them in deeper debt. In addition, the involvement of for-profit microfinancing institutions has led to some borrowers becoming heavily indebted, in a fashion not too dissimilar to

traditional loans. This is also exacerbated by the fact that microcredit loans tend to have a higher interest rate, with many Asian microcredit typically having an interest range of 30% to 70%, as they do not have collateral or formal credit histories (Burnett). In addition, Randomized Controlled Trial results of the impact of microcredits which were published in 2015 have cast a doubt on the effectiveness of microcredits (Morduch). Therefore, financial literacy serves as an important method to alleviate those problems so that borrowers can borrow from institutions that support the borrower's aspirations and financial sustainability. (Finch and Kocieniewski).

Major Countries and Organisations Involved

Grameen Bank

Grameen bank is an MFI that has pioneered the microfinancing model that continues to today. This model uses social collateral instead of material collateral to allow borrowers without significant assets to borrow capital to start their own business, leveraging their potential. This bank was founded in Bangladesh, and with government support such as its non-profit status, it has allowed many economically disadvantaged people such as those living in rural areas or women to be entrepreneurs, and invest in things previously not possible, or start their own business. Grameen bank states that two thirds of women supported through its microfinancing programme had better socioeconomic outcomes than before, which highlights the effectiveness of MFI to alleviate poverty from those who are traditionally economically disadvantaged (Sivasankar).

United Nations Capital Development Fund

United Nations Capital Development Fund (UNCDF) is a fund that was established by UN member state's mandate in 1996. This fund is focused on deploying its capital as an initial investment to economically vulnerable areas, such as LEDCs, where risks are high, markets are undeveloped, or the local financial system is weak or vulnerable (Kurukulasuriya). This is shown in the visual aid below.

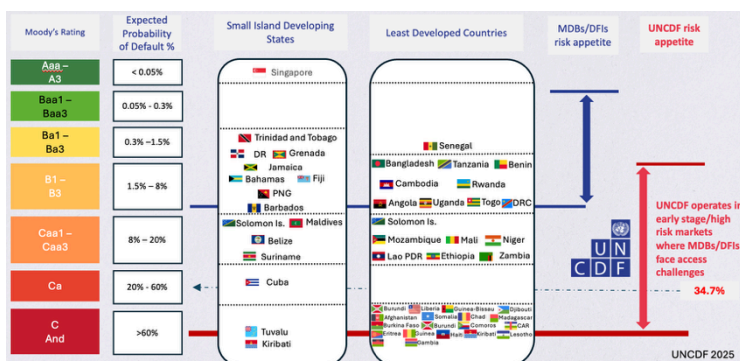


Figure 1: a visual diagram showing countries UNCDF invests in (Kurukulasuriya)

World Bank

The World Bank plays an important role in supporting MFIs worldwide, through its programmes such as supporting the local capital market to create funds that MFIs can use, sharing its expertise on risk management and responsible financial practices with the MFIs ('Ap_driveforfinancialinclusion.Pdf').

India

India has successfully utilised microfinancing as a way to mitigate poverty and systemic economic inequality. MFIs have been crucial to promoting entrepreneurship and creating SMEs, which has seen a rapid economic growth in recent times. For example, SMEs accounted for only 27% of GDP in 2021, but by 2023 it had already accounted for 30% of the GDP. This shows that SMEs, fuelled by microfinancing and microcredits acts as a major driver of economic growth in India (IBEF). In addition, the federal government, in collaboration with public banks, commercial banks, state-owned cooperative banks etc, have launched The Pradhan Mantri MUDRA Yojana (PMMY) programme, which allows aspiring entrepreneurs to start non-corporate, non-farm small and micro enterprises by providing loans in four categories. (PIB Delhi). This allows entrepreneurs to borrow at a lower rate than usual, which reduces the financial barriers to exercise their entrepreneurship skills and allows them to be financially sustainable.

Bangladesh

As a country that had started the microfinancing model, Bangladesh is home to multiple large microfinancing networks, including Grameen bank and BRAC (formerly known as Bangladesh Rural Advancement Committee) (Knowledge@SMU). However, it still faces some structural challenges, such as a low labour participation rate of women at 36%. In addition, the unemployment rate of women is double of that of their male counterparts, and women working are often employed in informal sectors (Jahan)

Viable Solutions

There are some viable solutions possible. One of which is to increase education and training in LEDCs. Financial education plays an important role in the success of the microfinancing model, since financial education is crucial to achieve economic resilience and financial empowerment (Omowole et al.)

As for the legal and compliance requirements surrounding MFIs, today most MFIs do not adopt accounting standards for financial reporting standards. General acceptable accounting principles that MFIs use differs from one country to another and from one region to another. This has led to some inefficiency, since MFIs often prepare documents with different standards when presenting to different stakeholders. This is because most MFIs operate in jurisdictions where the use of International Financial Reporting Standards is not mandatory. Considering that MFIs and its microfinancing services

are attractive, adopting standards that allow for greater financial transparency will allow for more capital inflow to MFIs, allowing them to expand operations (Pignatel and Tchuigoua). In addition, instead of adopting one size fits all approach to regulating MFIs, since many small MFIs are local cooperatives which do not benefit or require the rigour of the traditional banks, it may be beneficial to introduce proportional regulation, which is suitable to their amount of transaction and size of the organisation. This includes consumer protection measures, such as adequate information disclosures by MFIs, prevention of financial fraud, and the implementation of credit bureaus ('Clifford Chance').

Providing microinsurance is another solution to promote growth of SMEs. While starting a SME incurs a high financial risk for borrowers of MFIs, especially given that microcredit is a loan which must be repaid, and since there can be many challenges while going through this process such as health issues, insurance against those risks is important. As MFIs have the trust of local, economically disadvantaged people who were previously uninsured, MFIs are in a good position to provide microinsurance, and when combined with improved financial literacy, those people who were previously uninsured or uninterested will be able to obtain financial safeguards. By also offering microinsurance, MFIs can become one stop shops for all financial needs of the economically disadvantaged people (Favre).

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