

FINANCIAL COOPERATION AS A LOW-COST TOOL FOR EFFECTIVE MICROFINANCING**Brigita Baltača, Tatjana Mavrenko***BA School of Business and Finance**E-mail: brigita.baltaca@ba.lv; tatjana.mavrenko@ba.lv***Abstract**

Microfinance is often associated with provision of such financial services as savings, credit, payment transfers, and insurance, to low income people, so they can level their income, invest in economic opportunities, increase their assets, cope with emergencies, and plan for the future. Microfinance has also proven itself to be an effective tool for reducing the vulnerability marginal social groups.

Although in most European countries there is a well developed and efficient banking sector, many individuals as well as small and micro businesses still has considerable difficulties in obtaining loans for their investments. As seen by traditional financial intermediaries, small scale customers often mean an unfavourable cost/income ratio.

Thus it is necessary to offer micro credits through a type of financial institution that would be able to meet interests of people with small income and possible deposits at the same time covering its own operational costs. There are several operative microfinance models. In Latvia one of the most efficient has proved to be financial cooperation known as Credit unions. A Credit union is a non-profit financial cooperative owned and controlled by its members. It mobilizes savings, provides loans for productive and provident purposes and have membership which is generally based on some common bond. Because credit unions exist to serve their members best rather than to make the biggest profit, the service at a credit union is generally considered superior to that given by banks.

Keywords: Microfinance, micro-credit, cooperation, credit union

Currently with the global slow down in the economy, it is very important to assist individuals to get involved in entrepreneurial activities and generate additional means in order to maintain acceptable living standard. Any entrepreneurial activity requires definite start up capital. So access to finance in most cases becomes the critical issue for those individuals who belong to the so called sensible groups of society, including young people, single mothers, and unemployed and low income people. One of the solutions to the problem of access to finance is micro-credit. In most parts of the world, microfinance offers people excluded from formal financial services the opportunity to obtain micro-loans in order to generate income and engage in productive activities, often by expanding their small businesses.

All over the world microfinance has been associated with elimination of poverty in developing countries. Micro-credit consists in making small loans to low-income earners who usually have no access to bank loans because they are insufficiently solvent and/or because the cost of managing such loans is considered too high. Micro-credit loans enable the beneficiaries to create or expand micro enterprises or other income generating activities.¹

Over the last years microfinance has experienced considerable growth all over the world. To emphasize the importance of microfinance, year 2005 had been proclaimed as *International Year of Micro credit*, by United Nations. Micro-credit had very often been used as a means of encouraging self-employment and the formation and development of micro-enterprises. Therefore micro-credit can become an efficient tool in realization of Lisbon strategy for growth and jobs and the promotion of social inclusion that has become very important with the enlargement of European Union. More and more often economic issues within European Union are being considered in relation with social sphere and thus focus on employment increases.

¹ The development of microcredit in the European Union - A tool for growth and social cohesion - Executive Summary. Eurofi. [direct link] www.eurofi.net

Demand for micro-credit is sustained by three major trends:

- The growing importance of small enterprises
- Unemployment and exclusion
- The role of the informal sector

In 2007 Commission of the European Communities came out with “A European Initiative for the Development of Micro-credit in support of growth and employment”. The document acknowledges that there is an active micro-credit sector in many member states and regions and at the same time states that it is very essential to ensure that national legislation facilitates the provision of microfinance (loans less than €25 000). Such loans offer an important means to encourage entrepreneurship through self-employment and micro-enterprises, in particular among women, and minorities. This instrument favors not only competitiveness and entrepreneurship, but also social inclusion.²

The development of Micro-financing as a sector started in the 90's and has progressed at different pace in individual countries. Several networks have been created to foster development of within Europe: *Microfinance Centre*, *European Microfinance Network*) and the *Community Development Finance Association*. Activities of all these networks have aimed at overcoming social and financial exclusion in the East and West

Micro-credit in Europe is defined by:

- **its target:** micro-entrepreneurs, the self-employed, and socially excluded people lacking access to traditional sources of capital;
- **its object:** the creation or expansion of income-generating and job-creating activities or micro-enterprises, whose principal need is usually the financing of initial investment or of the working capital;
- **the small amount of the individual loans required** which in turn relates to the limited debt servicing capacity of the target clientele. Typically, this amount does not exceed EUR 25 000. The average micro-loan provided by Micro-finance Institutions (MFIs) in Europe is approximately 7 700 euros;
- **a more labor-intensive delivery system for making loans**, involving greater knowledge of borrower capacity and a close relationship with the borrower, especially during the start-up phase of the micro-enterprise, through mentoring and general business support.³

Institutions offering microfinance:

- credit unions,
- commercial banks,
- NGOs,
- cooperatives,
- and sectors of government banks

Fig. 1 shows institution that provide micro-loans within 21 EU state together with Norway

Table 1 demonstrates that total amount of micro loans issued within 21 EU states together with Norway. Total amount of micro loans had grown from 210 mil. EUR in 2005 to 394. mil. EUR in 2007. Respectively loans issued had increased by 20% between year 2006 and 2007 and by the end of year 2007 the number of active clients had reached 121 677.

² A European Initiative for the Development of Micro-credit in support of growth and employment, COM (2007) 708, [direct link] <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2009:077:0023:01:EN:HTML>

³ A European Initiative for the Development of Micro-credit in support of growth and employment, COM (2007) 708, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2009:077:0023:01:EN:HTML>

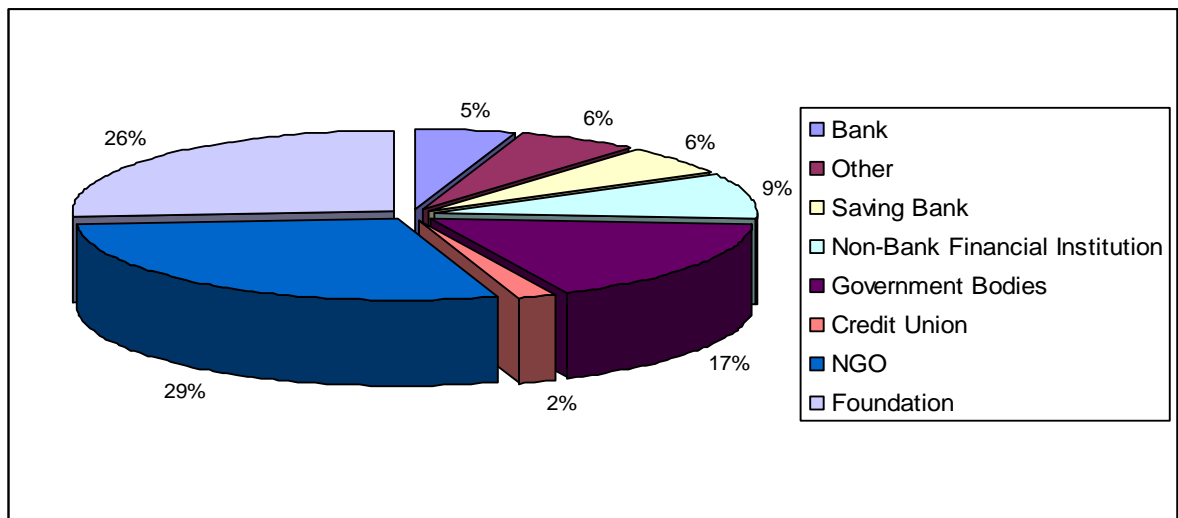


Figure 1: Institutions providing micro-loans, 21 EU states and Norway, 2006-2007⁴

Table 1: Total amount of micro loans issued within 21 EU states and Norway, mil. EUR, 2005-2007⁵

	2005	Δ 2006/2005 %	2006	Δ 2007/2006 %	2007
Number of loans	27,000	32%	35,553	20%	42,750
Amount of loans million EUR	210	40%	295	34%	394
Average loan	7,778	7%	8,298	11%	9,216

As it can be seen from Table 1, demand for micro loans has been growing year by year. In 2005, 210 millions EUR were distributed as micro loans to 210 thousand clients. In 2006, 295 millions EUR were lent out for 35,6 thousand clients. Significant growth in number of loans – 32%, and 40 % growth in volume of loans prove that necessity of micro loans increases year by year. In 2007, number of distributed micro loans increased by 20% more and reached number of 42, 7 thousand loans. Amount of distributed loans already achieved 394 millions EUR showing additional growth by 34%. One more significant ratio is average amount of distributed micro loans. As it can be seen form Table 1, average amount of loan had grown from 7,778 EUR in 2005 up to 9,210 EUR and 2007. Thus proving that micro-loan is becoming one of the most efficient instrument to support small business start ups.

Hopefully these tendencies will be followed also in future. Taking into account global slow down of economy, necessity of microfinancing services should grow even faster.

Nevertheless one of major problems, that might be faced, can be low development of microfinancing network in separate countries, undeveloped legal regulation of microfinancing institutions, and lack of knowledge in society about microfinancing services.

As it can be seen on Graph 2, development of micro credits varies from country to country. In 2007 leaders in micro lending in Europe were France, Bulgaria, Germany and Romania.

4 Jayo, Bárbara, Rico, Silvia, Lacalle, Maricruz. Overview of the Microcredit Sector in the European Union 2006-2007, EMN Working Paper n°5 [direct link]. Paris: European Microfinance Network:
http://www.european-microfinance.org/data/file/overview_final_bdef.pdf

5 Jayo, Bárbara, Rico, Silvia, Lacalle, Maricruz. Overview of the Microcredit Sector in the European Union 2006-2007, EMN Working Paper n°5 [direct link]. Paris: European Microfinance Network:
http://www.european-microfinance.org/data/file/overview_final_bdef.pdf

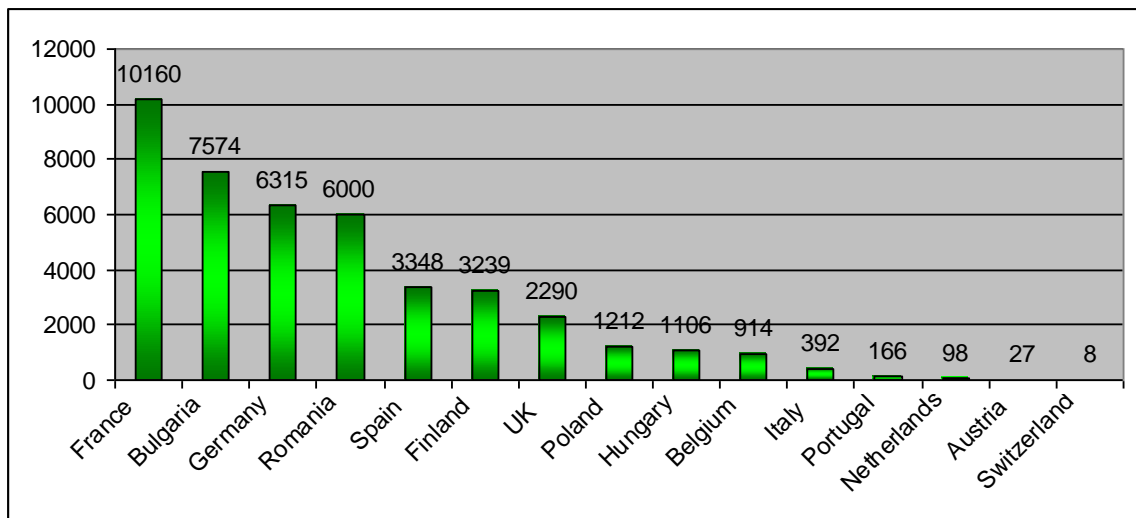


Figure 2: Number of loans disbursed within microfinance sector in Europe, 2007⁶

Latvia as a member state of EU also follows the same policy of development of availability of microfinancing services to local people. Activities in the microfinance activities identified in Latvia can be assigned to the following institutions: (1) commercial banks; (2) cooperative credit unions and (3) and non government based programmes and projects.

Latvian Rural Women Association is one of the non government organizations that had been very active in a specific micro-lending model – group lending. As this is a specific model that usually needs some donor funds to be started it would not be analyzed in this paper. Commercial banks have not been active in micro-lending due to the fact very often micro-lending means issuing loans to low income people with no prior experience in using financial services.

Credit unions are globally recognized microfinance institutions which help people to access financial services. Micro-loans are provided by credit unions to their members including those who are financially excluded and rely on low or no regular income. Also UN Secretary-General Kofi Annan’s in 2005, *International Year of Micro credit*, had stated that cooperatives and microfinance, when used and managed appropriately, can help give those most in need the power to improve their lives.

The average amount of a credit provided by credit unions in EU member states is far below the threshold used by EU institutions to define micro-credit (EU definition: >€25,000.) The average credit union loan in Poland: €1,000; in the Republic of Ireland: €8,150; in the UK: £1,000; and in Romania: €700. Loans are used by members for various reasons, including consumer purposes, starting a small business, growing an existing small business or financing a university education or other studies.⁷

Credit unions are democratic, member-owned financial cooperatives. Each member, regardless of account size in the credit union, may run for the board and cast a vote in elections. As financial intermediaries, credit unions finance their loan portfolios by mobilizing member savings and shares rather than using outside capital, thus providing opportunities for generations of members.⁸

Credit union way is educating and savings before credit. This approach works to ensure a commitment to repay after a loan is granted. As seen from Graph 3, credit unions are self

6 Jayo, Bárbara, Rico, Silvia, Lacalle, Maricruz. Overview of the Microcredit Sector in the European Union 2006-2007, EMN Working Paper n°5 [direct link]. Paris: European Microfinance Network:

http://www.european-microfinance.org/data/file/overview_final_bdef.pdf

7 European Network of Credit Unions. [direct link] http://www.creditunionnetwork.eu/eu_and_cus

8 World Council of Credit Unions Inc. [direct link] <http://www.woccu.org/about/creditunion>

supporting - capital of credit union consists mainly from members' shares and savings. Capital is used for providing loans to credit union members. Borrowers pay back principal amount and interests. Earnings from lending operations are used to cover operational expenses, paying interests to savers and building up credit union reserves. This brief description of credit union financial mechanism proves that financial cooperative totally depends on its members and exists only for members' financial and credit needs.

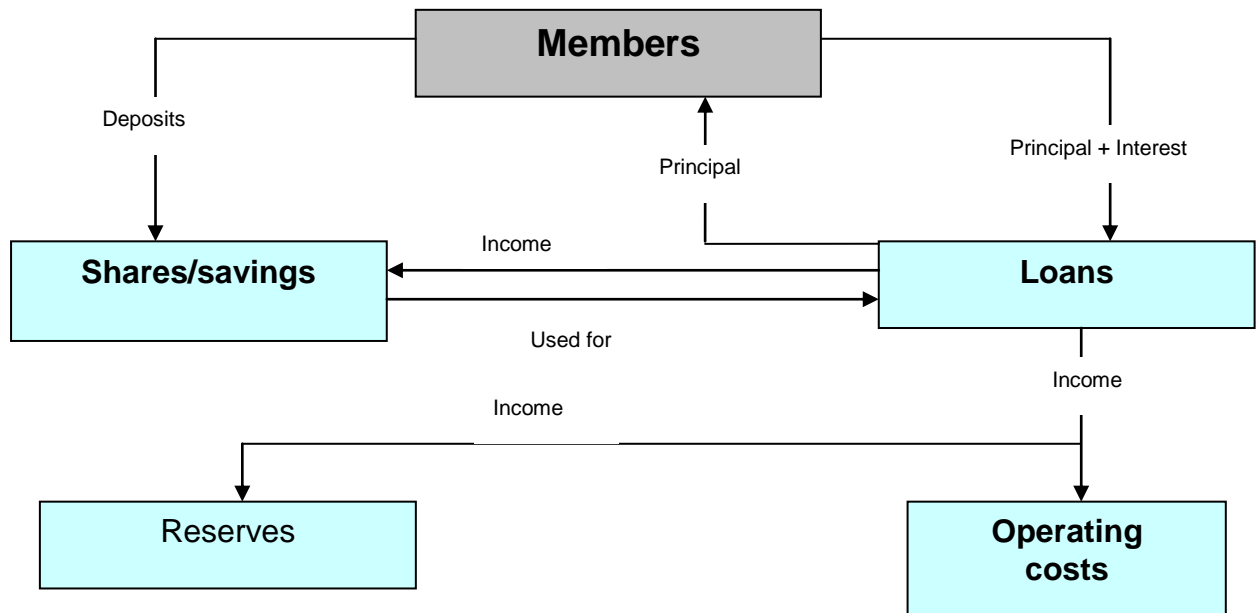


Figure 3: Self-sufficiency of a credit union⁹

Credit unions operate on a not-for-profit basis. All excess earnings are re-distributed to members through dividends and affordable credit. This is particularly valuable for low-income people. Thus credit unions represent for many the only affordable and safe way to access financial services

Being a financial cooperative, credit unions follow the very strict operating principles:

Open and Voluntary Membership. Membership in a credit union is voluntary and open to all within the accepted common bond of association that can make use of its services and are willing to accept the corresponding responsibilities.

Democratic Control. Credit union members enjoy equal rights to vote (one member, one vote) and participate in decisions affecting the credit union, without regard to the amount of savings or deposits or the volume of business. The credit union is autonomous, within the framework of law and regulation, recognising the credit union as a cooperative enterprise serving and controlled by its members. Credit union elected offices are voluntary in nature and incumbents should not receive a salary.

Service to Members. Credit union services are directed to improve the economic and social well being of all members.

Distribution to Members. To encourage thrift through savings and thus to provide loans and other services, a fair rate of interest is paid on savings and deposits, within the capacity of the credit union.

⁹ Dennis Schroeder. Savings Mobilisation. World Council of Credit Unions, Inc. Kendal/Hunt Publishing Company, 1989

Building Financial Stability. A prime concern of the credit union is to build the financial strength, including adequate reserves and internal controls that will ensure continued service to membership

On-going Education. Credit unions actively promote the education of their members, officers, and employees, along with the public in general, in the economic, social, democratic and mutual self-help principles of credit unions. The promotion of thrift and wise use of credit, as well as education on the rights and responsibilities of members, are essential to the dual social and economic character of credit unions in serving member needs.

Cooperation Among Cooperatives. In keeping with their philosophy and the pooling practices of cooperatives, credit unions within their capability actively cooperate with other credit unions, cooperatives and their associations at local, national and international levels in order to best serve the interests of their members and their communities.

Social Responsibility. Continuing the ideals and beliefs of cooperative pioneers, credit unions seek to bring about human and social development. Their vision of social justice extends both to the individual members and to the larger community in which they work and reside. The credit union ideal is to extend service to all who need and can use it. Every person is either a member or a potential member and appropriately part of the credit union sphere of interest and concern. Decisions should be taken with full regard for the interest of the broader community within which the credit union and its members reside.¹⁰

Members of a credit union need to have a common bond. Law on Credit Unions of the republic of Latvia sets the following principles for the common bond of credit union members:

- 1) according to the territorial principle;
- 2) according to the employment principle;
- 3) according to the principle of mutual interests.¹¹

Latvian credit unions in Latvia, after regaining of independence, have proven themselves as good financial partners to their members. The main features of current credit union network in Latvia are the following:

- Two main groups of credit unions - Community and Union credit unions
- Low delinquency ratio
- Good image within communities
- Leaders – elected officials from credit unions members
- Support from community deputies
- The best marketing principle “Member brings new member”
- Easy loan granting process
- Close link between members.

Popularity of credit unions and necessity of microfinancing services in Latvia are proven by growth of number of credit unions during last 13 years, which can be seen on Graph 4. Number of credit unions has grown from 1 up to 35 credit unions. The last tendency in credit union network is not to organize new credit unions, but to strengthen existing ones, using broader membership opportunities.

¹⁰ World Council of Credit Unions Inc. [direct link] <http://www.woccu.org>

¹¹ Krājaizdevu sabiedrību likums [direct link]: LR likums: spēkā ar 01.01.2002.: <http://www.likumi.lv/doc.php?id=711>

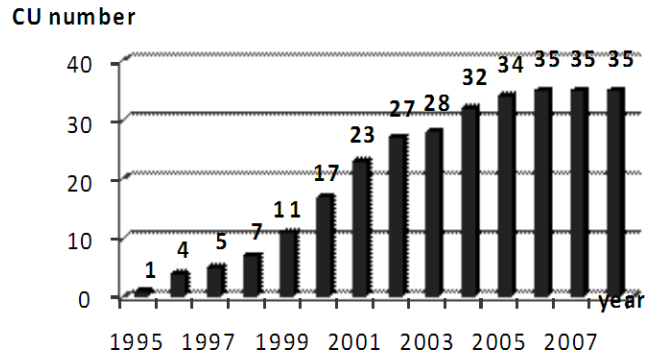


Figure 4: Number of Credit Unions in Latvia, 1995-2008¹²

As it can be seen on Graph 5, Latvian credit unions have proportional growth of main types of services – loans and savings. It is also proves of stability of credit unions and their independence form outside resources and foreign capital.

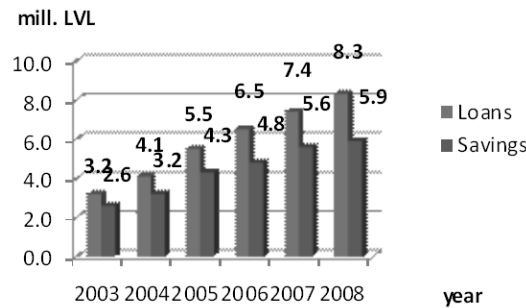


Figure 5: Total Loans and Savings in Credit Union Network in Latvia, 2003-2008, thsd. LVL¹³

Statistics dated by Financial and Capital Market Commission 31.12.2008. shows, that Latvian credit union network has completed fiscal year with the following performance indicators:

- the ratio of the profit/loss from the beginning of the year to capital and reserves (ROE) - 2,2%
- the ratio of the profit/loss from the beginning of the year to assets (ROA) – 0,5 %
- Financial activity efficiency ratio (ratio of administrative expenses to financial activity profit/loss) – 86,7 %
- Capital adequacy ratio – 23,4 %.

Latvian credit union network follows geographical and demographical peculiarities of the state. It means, that credit union network can be divided in two main groups – credit unions in Riga and credit unions in rural areas. Riga credit unions are based on union principle and their membership is based on trade union organizations. In rural areas credit unions are mostly connected with definite communities or groups of communities. In Riga the most popular group of loans is consumption loans. In rural areas credit union members mostly borrow for entrepreneurial needs.

¹² Graph created by the authors

¹³ Financial and Capital Market Commission. [direct link] <http://www.fctk.lv/en/>

Within the framework of this paper the authors' focused on group of rural credit unions in Cesis region, which have proven themselves as good financial partners for local entrepreneurs. As it can be seen on Graph 6, 60% of Cesis region credit unions already operate more than 6 years. 40 % of credit unions already provide their services from 1 to 6 years. These numbers show that rural credit unions become more experienced and have found strong support from local communities.

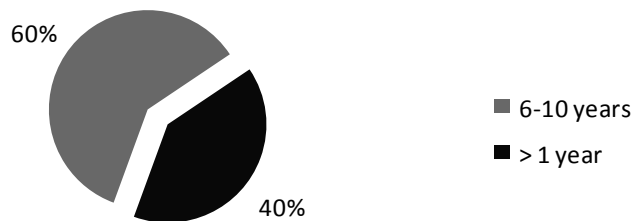


Figure 6: Years of operation of Cesis region credit unions

Graph 7 shows, that lending capital of rural credit unions in Cesis region mostly consists of members' savings 42%, shares 22%. In case of high need of micro loans credit unions borrow from commercial banks, in analyzed credit unions this part of capital is 28%.

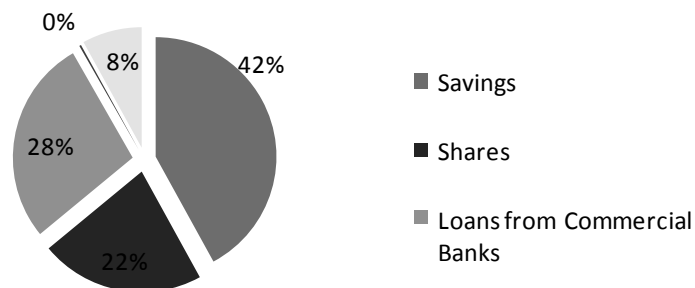


Figure 7: Credit Union Capital for Lending in Cesis Region Credit Unions, 2008

Table 2 proves that Latvian rural credit unions are active in micro-lending, as loans line one to five all are for income generating activities

Evaluating role of credit unions in economy of Latvia, the following positive effects can be mentioned:

- Accumulation of the national capital, which otherwise could stay out of turnover because of mistrust to financial institutions;
- Redistribution of resources;
- Lending to “problematic” domains of economy (mostly in rural regions): micro and medium size enterprises (individual farms), agriculture, forestry.
- Improvement of welfare of households, increase of consumption (in rural regions – mostly of local goods);
- Favouring of investments in actual domains (construction, agriculture, production);
- GDP growth (investments to financial cooperatives increase consumption);
- New working places (development of small business);
- Development of definite regions;
- Increase of competition on finance and credit market

Table 2: Loans classified by their purpose

No	Purpose of the loan	Average loan amount LVL	Total loan amount LVL
a)	Agriculture	1678	15100
b)	Trading	3800	7600
c)	Forestry	1500	1500
d)	Production	2000	4000
e)	Purchasing cars	1809	19900
f)	Home Construction/ reconstruction	1037	19700
g)	Privatization of apartments	1420	7100
h)	Medical services	155	620
i)	Education	800	3200
j)	Travels	500	1500
k)	Furniture	387	1160
l)	Utensils	333	1000
m)	Other	260	1040

References

1. The development of microcredit in the European Union - A tool for growth and social cohesion - Executive Summary. Eurofi. [direct link] www.eurofi.net
2. A European Initiative for the Development of Micro-credit in support of growth and employment, COM (2007) 708, [direct link] <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2009:077:0023:01:EN:HTML>
3. Jayo, Bárbara, Rico, Silvia, Lacalle, Maricruz. [Overview of the Microcredit Sector in the European Union 2006-2007](#), EMN Working Paper n°5 [direct link]. Paris: European Microfinance Network: http://www.european-microfinance.org/data/file/overview_final_bdef.pdf
4. European Network of Credit Unions. [direct link] http://www.creditunionnetwork.eu/eu_and_cus
5. World Council of Credit Unions Inc. [direct link] <http://www.woccu.org/about/creditunion>
6. Dennis Schroeder. Savings Mobilisation. World Council of Credit Unions, Inc. Kendal/Hunt Publishing Company, 1989
7. Financial and Capital Market Commission. [direct link] <http://www.fktk.lv/en/>
8. Krājaizdevu sabiedrību likums. LR likums. Latvijas Vēstnesis 200 (3984), 23.12.2008.
9. Unpublished information of the following cooperative credit unions: Līgatnes Druva; Raunas; Straupes; Taurenes; Vecpiebalgas S; Veselavas; Zosēnu; Cēsu; Nītaures.