

The hidden wealth of the poor

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From The Economist print edition

Financial services are at last spreading from the rich to the developing world—and even making money, writes Tom Easton (interviewed [here](#))

IN RICH countries, financial services on the whole work remarkably well, despite the exotic salaries, the crackpot deals and the occasional bust. The vast majority of people have access to interest-bearing savings accounts, mortgages at reasonable rates, abundant consumer credit, insurance at premiums that reflect the risk of losses, cheap ways of transferring money, and innumerable sources of capital for funding a business.

By contrast, financial services for poor people in developing countries—a business known as “microfinance”—have mostly been awful or absent. With no safe place to store whatever money they have, the poor bury it, or buy livestock that may die, or invest in jewellery that may be stolen and can be hard to sell. Basic life and property insurance is rarely available. Home loans are costly, if indeed they can be found at all. For many people, the only source of credit is a pawnshop or a moneylender who may charge staggeringly high interest and beat up clients who fail to pay on time. In the Philippines, lenders who zip from town to town on motorcycles expect six pesos back for every five they lend. That translates into an annual interest rate of over 1,000% on a loan for a month.

For workers from poor countries who venture abroad to earn a better living, sending money home to relatives can be hugely expensive. Such remittances have become an important source of income in many developing countries, dwarfing other inflows of capital from overseas such as foreign direct investment and multilateral aid. But if the money is being sent, say, from America to Venezuela, charges can amount to as much as 34% of the sum involved, according to Dilip Ratha of the World Bank.

Why are the poor so badly served? The easy answer, that people who have little money do not make suitable clients for sophisticated financial services, is at most a half-truth. A better explanation, this survey will argue, is that the poor have been hurt by massive market and regulatory failure. Fortunately that failure can be, and increasingly is being, remedied.

In most developing countries, the barriers to providing financial services for the masses are all too clear. Inflation tends to be high and volatile; government is often incompetent; and the necessary legal framework for financial services is often missing. Property laws can make it impossible for poor borrowers to use assets such as their home as collateral for loans.

In the past, many countries have outlawed “usury”, and today many Islamic countries prohibit the charging of interest. Governments in developing countries often impose caps on the interest rates charged on loans for the poor. Despite their popular appeal, such caps undermine the profitability of lending and thus reduce the supply of loans.

Incomplete and erratic regulation of financial institutions has also undermined the confidence of the poor in the financial services that are available. When they can find an institution that will accept their tiny deposits, it often lacks the sort of government deposit

insurance that is routine in rich countries, so when a bank goes under, savers suffer. For example, Indonesia's PT Bank Dagang Bali, once known for its work with poor clients, was closed by regulators last year after it was discovered to be insolvent and riddled with fraud. Many savers did not get their money back.

Corruption is also commonplace in many developing countries. A recent study by the World Bank found that in two poor states in India where the financial system is largely controlled by the government, borrowers paid bribes to officials amounting to between 8% and 42% of the value of their loans. Corruption raises the cost of every financial transaction, allows undesirable transactions to take place and undermines consumer confidence in the financial system. This, and the related curse of cronyism, explains why access to financial services in countries where the state has control over the financial sector is poorer than where it does not.

Inadequate basic public services add to the burden on financial firms. SKS, a fast-growing microfinance institution in India, has had to build back-office systems that can work on two hours of power a day; it closely monitors voltage when its computers are running and keeps a diesel generator on hand. Many others simply give up on the idea of modern technology and continue to use paper instead. This makes them vulnerable. The tsunami in December 2004 wiped out financial records at many small Indonesian banks.

But not all the blame goes to poor-country governments. Financial-services firms too have failed to do enough to deal with the lack of the sort of data (for example, about a client's financial history) that are taken for granted in rich-country financial systems, and to find ways of reaping economies of scale. Many have simply dismissed the possibility that serving the poor might be a viable business.

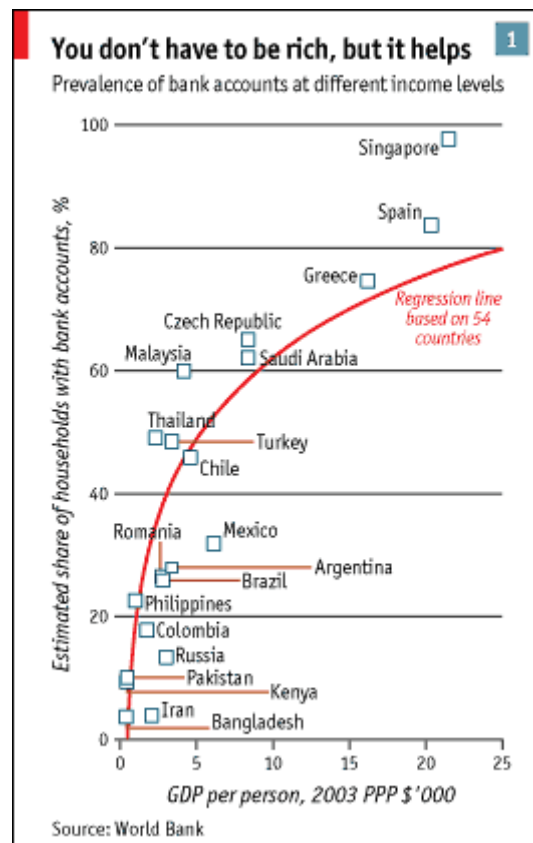
The start of something big

In recent years, at least in some parts of the world, this bleak picture has begun to change, first in credit, then in savings and more recently in remittances. Even insurance—not only the basic life sort but also more sophisticated forms for things like cattle and weather risk—is gradually being introduced.

These changes have recently received a lot of attention in policymaking circles. Grand claims have been made that credit can end poverty. A World Bank report by Thorsten Beck, Asli Demirguc-Kunt and Soledad Martinez published last month shows a strong correlation between lack of financial access and low incomes (see chart 1). Earlier research by the first two authors and Ross Levine concluded that a sound financial system boosts economic growth and particularly benefits people at the bottom end of the income league. A long-term study in Thailand by Robert Townsend of the University of Chicago and Joe Kaboski of Ohio State University showed that families with access to credit invested more, consumed more and saved less than those without such access.

What makes microfinance such an appealing idea is that it offers “hope to many poor people of improving their own situations through their own efforts,” says Stanley Fischer, former chief economist of the World Bank and now governor of the Bank of Israel. That marks it out from other anti-poverty policies, such as international aid and debt forgiveness, which are essentially top-down rather than bottom-up and have a decidedly mixed record.

Studies by Stuart Rutherford, who runs an experimental bank that provides loans and takes deposits in the slums of Bangladesh, show that the poor attach great value to having a safe place to keep money and some means of providing for life's risks, either through savings or, better still, through insurance. When financial services are available to them, the poor, just like the rich, snap them up.



In one sense, microfinance has been around for a long time. What is now generating so much hope and excitement is less the discovery of some entirely new way to deliver financial services to the poor than the effect of the rapid innovation that has taken place in the past three decades.

From pawnshop to Citigroup

The oldest financial institution in the Americas is a pawnshop on Mexico City's central square. Set up in 1775 under an edict by the Spanish crown to assist people in financial trouble, it is called Monte de Piedad, variously translated as the mountain of mercy or the mountain of pity. Pity or mercy come in the form of cash in return for valuables. Unclaimed items end up for sale in a series of glittering rooms near the main banking hall.

By transforming trinkets into capital, pawnshops perform an important (if under-appreciated) service, but they have three limitations. They advance cash only to people with assets. Their loans are based on the value of collateral, not of a business venture. And the valuables held as collateral cannot be used to fund businesses, as banks' cash deposits can.

There have been two notable attempts to find alternatives. One has been the creation by developing-country governments of state banks, particularly to finance the rural poor. These have mostly been a disaster. The other, much more successful one involved a number of organisations extending uncollateralised loans to very poor borrowers. In 1971, Opportunity International, a not-for-profit organisation with Christian roots, began lending in Colombia. ACCION International, also not-for-profit, made the first of what it called "micro" loans in 1973. Grameen Bank started in 1976 and soon became extraordinarily famous for offering "microcredit" to women in small groups.

To qualify, Grameen's customers had to be extremely poor, probably earning less than a dollar a day. To overcome the lack of collateral or data about creditworthiness, group members were required to monitor each other at weekly meetings, applying varying degrees of pressure to ensure repayment. As loans were repaid, people were allowed to borrow more. The group replaced the security that pawnshops gained from collateral. The model is not perfect, but it does have real virtues and has since spread around the world.

Why did these organisations start with providing credit? They assumed that poor people were unable to save, and that their sole need was for capital. But that was not the whole story. When BRI, a failing state-controlled rural lender in Indonesia, was transformed into a bank for the poor in 1984, it offered not only the usual loan products but also a government-guaranteed savings account with no minimum deposit. This has been an extraordinary success: BRI now has 30m savings accounts.

Nobody knows how many institutions are providing microfinance in some form, but the number is certainly huge (see [article](#)). They are growing fast and serving a vast number of people in absolute terms, although still only a small proportion of the billions who earn only a few cents a day. Local banking giants that used to ignore the poor, such as Ecuador's Bank Pichincha and India's ICICI, are now entering the market. Even more strikingly, some of the world's biggest and wealthiest banks, including Citigroup, Deutsche Bank, Commerzbank, HSBC, ING and ABN Amro, are dipping their toes into the water.

The downsides

Not everyone has been pleased with the prospect of better financial services for the poor. Islamic fundamentalists have bombed branches of Grameen in Bangladesh and attacked loan officers of other institutions in India. Maoists have looted microfinance offices in Nepal. The head of a microfinance effort in Afghanistan was murdered, possibly by drug traders.

To drug lords in Afghanistan, the availability of credit is unwelcome because it gives a choice to farmers who were previously forced to grow poppies for want of other ways to finance their crops. For the elites in closed markets running inefficient monopolies, credit raises the prospect of future challenges from entrepreneurs. For radical Muslims, it means that women (who in many countries make up the bulk of microfinance borrowers) are able to run viable businesses and become independent. And for everyone in poor countries, credit can mean social upheaval as merit and enterprise replace inheritance, family ties and position.

Nor does microlending always have a happy outcome. The clients of K-Rep, an excellent Kenyan microfinance bank in a small town on the fringes of Nairobi, are a pretty resourceful

lot, but when the government stopped repairing roads, picking up rubbish and spraying for malaria, some were at their wits' end. Drainage in the marketplace was plugged by uncollected garbage and customers stopped coming. Maria Njambi, a single mother with a ten-year-old child, used to have a viable business selling fruit and vegetables she bought with credit from K-Rep, but she had to watch her inventory rot and has stopped repaying her loan. She is not alone in her misfortune. A report in 2002 by CARD, a microfinance organisation in the Philippines, offers the following explanation for borrower attrition: "It is a tragic fact that over time, husbands will fall sick, *sari-sari* [variety] stores will be robbed, harvests will be poor and children will die."

Yet microfinance institutions typically claim extraordinarily low loan losses of 1-3%, a bit better than the rate for big banks in rich countries and much better than for the big credit-card companies. Given the difficulties facing businesses in poor areas, some critics question the accuracy of these figures. Many of the banks lending to the poor are not-for-profit organisations whose accounts are rarely scrutinised by outsiders. Much of their capital has been provided by governments or philanthropists, and often does not have to be repaid, so perhaps microfinance institutions are being quietly lenient with their customers. Indeed, large-scale defaults in microfinance may go unreported. The Townsend-Kaboski research project in Thailand informally tracked hundreds of microfinance institutions and found that in the five years before the Asian financial crises, 10% failed and a quarter stopped lending.

So there is room for scepticism, but also plenty of reason for hope. The biggest of these is just how much progress the industry has made in the past 30 years.

What do you know?

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A beginner's guide to microfinance

MICROFINANCE may be intended for the masses, but its vocabulary can be understood only by professionals, and then only up to a point. The industry is so fragmented as to be virtually unfathomable. There is not even a proper definition of the term, which could mean anything from what a village priest provides when handing out alms to what state banks and credit unions offer to their least affluent clients. The coveted title of a genuine "microfinance institution" from a "practitioner" may owe less to what the institution does than to its public-relations skills. Fortunately none of this matters to the customers, who simply want a service that makes their lives richer.

Nobody knows even roughly how many microfinance institutions there are. Indonesia alone says it has in excess of 600,000, and Bangladesh and Uganda too claim to have many thousands. Even on stricter criteria, such as recognition by a regulator, Indonesia alone has perhaps 60,000 finance companies that provide credit of one sort or another, often to people who have very little income and almost no assets. Self-professed experts distinguish between institutions providing consumer finance (which they do not count as microfinance) and business finance (which they do). But how do you classify the purchase of a stove that is used for cooking both the family meals and the food for sale on a tiny stand? Or a motorscooter that serves both as a delivery vehicle and as family transport? For people who have very little, money and assets are fungible.

The foggiest place in the industry is "on the ground" (another favourite microfinance term), where familiar words suddenly become oddly unintelligible. An item labelled "profit" lets you keep mum about the losses transferred to a money-losing charity affiliate. An "operationally sustainable" business is one that can pay for its running costs but not its capital, which is often the largest single expense for a financial firm. But the worst thing are the acronyms, which make learned analyses of microfinance next to unreadable. All this may sound trivial, but industry practitioners seem to care deeply.

From charity to business

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Panos



Can I borrow a lollipop?

In its short history, the microfinance industry has undergone profound changes

TO ANYONE familiar with banking in the rich world, the world of microfinance can seem rather odd. The main providers have not been motivated by anything as straightforward as making money, at least until recently. The core of the industry today consists of some three dozen multinational networks of microfinance providers, which despite their superficial similarities and inspirational rhetoric compete fiercely and fight over everything.

The main areas of strategic disagreement are whether the financial needs of the poor are best met by group or individual loans; by market or capped interest rates; by catering for all the poor or only the very poorest; by concentrating on credit only or offering savings accounts and insurance too; and whether financial services should be provided alone or in conjunction with education, health care and, in a few cases, religion.

The biggest networks include Opportunity International, FINCA, ACCION, ProCredit, Women's World Banking and arguably Grameen (which has no formal ties to other banks but a "replication" programme that it says encompasses more than 100 institutions around the world). There are also national networks, regional networks and even networks of networks, each with their own set of institutions and strongly held views.

At one end of the spectrum are those organisations and networks that, by intent, are barely profitable and concentrate on providing credit, such as Grameen and most of FINCA's and Opportunity's operations. They offer relatively lenient repayment terms and interest rates that do little more than cover costs. Typically, these groups are not-for-profit, or owned by

customers or by investors of the religious and philanthropic sort, rather than by shareholders seeking a financial return.

Beyond their core operations in financial services, some of these institutions are also involved in a range of other activities, both charitable and for-profit. Grameen Bank has a loose relationship with a variety of other companies, including a highly profitable mobile-phone business that has been praised for providing jobs for women but criticised for charging excessive rates.

Rather than pursue profit, microfinance providers at this end of the spectrum often seek to be "sustainable", a flexible concept that can mean anything from covering all costs to covering all costs but capital. However tenuous the "sustainability", there seem to be plenty of donor funds, particularly for institutions that can generate lots of good publicity. During 2004 the big development-aid agencies committed about \$1 billion to microfinance, according to CGAP, a donor consortium affiliated to the World Bank. Further significant sums have come from private hands. Added to that must be the benefit of very low-cost capital and free technical assistance.

As these financial institutions have grown, however, demand for their funds has often expanded beyond what can reasonably be obtained from donors and special funding deals. Retained earnings help; deposits, if they can take them, help far more, but still not enough. A growing number of microfinance institutions, taking their cue from the success of banks in developed countries, have concluded that the best way to reach the vast number of poor people in the world is to become profitable and operate much like conventional rich-world financial firms. Ultimately that will include things like issuing debt and equity and securitising loans.

Only this way, the institutions argue, will they be able to raise capital in sufficient quantity, at sufficiently low cost and with sufficient speed to transform microfinance from an interesting niche into a ubiquitous service. This argument is beginning to convince a growing number of policymakers interested in development and poverty eradication, who until recently would have regarded trying to profit from the poor as inherently evil.

Time for ACCION

The evolution of microfinance from a charitable social service into something resembling modern commercial banking can be seen in the work of ACCION International, a network of financial institutions based in Boston and Washington, DC, with 27 loosely affiliated members in 22 countries and direct investments in ten. ACCION has an odd history. It was founded in 1961 by Joe Blatchford, a young law student and accomplished tennis player who was sent on a goodwill tour of Latin American cities by the American government. Appalled by the poverty he witnessed, he created an aid group to build schools, install electricity and the like.

An experiment in Brazil in 1973 played an important part in defining ACCION's future role. The Brazilian unit kept clear of the usual development-agency activities, instead concentrating entirely on providing what at the time were called "micro" loans. Initially, the separation of finance from social services was controversial. But slowly a consensus has begun to form, particularly in Latin America, that this kind of specialisation makes it easier to build efficient (and therefore sustainably helpful) financial institutions.

Early on, financial institutions affiliated to ACCION offered “solidarity loans”—small loans to groups of five people that were collectively guaranteed. Variations on this model remain essential to Grameen, FINCA and many smaller microfinance providers. Each member of a group has a tiny amount of money allocated to him or her, and as they collectively meet their obligations the members establish a credit history that allows them to increase the size of their loans.

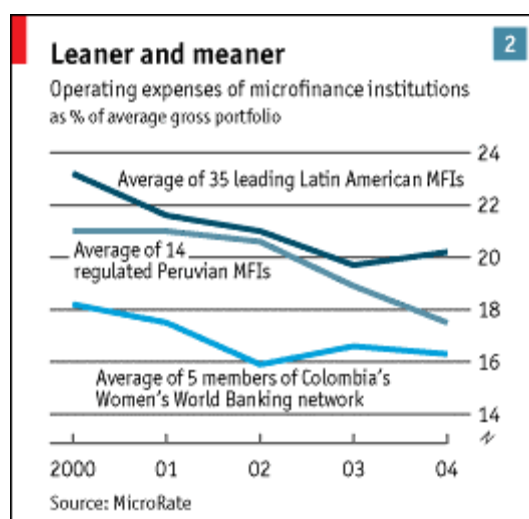
There are virtues to this model, notably the way that social pressure from group members encourages repayments and avoids the twin problems of moral hazard (an unwillingness to repay) and adverse selection (being stuck with bad payers who inflate costs for everyone). Credit screening costs the lender next to nothing. Group meetings may also have other advantages, such as the sharing of clients and effective business techniques.

Even so, a growing number of the institutions tied to ACCION soon discovered limitations to the group-lending model. Over time, businesses financed by group members grew at different rates, and so required different amounts of capital. The members whose businesses grew fastest felt constrained in what they could borrow, and those whose businesses grew more slowly found themselves guaranteeing big debts for other people. The meetings themselves became a problem, consuming time members wanted to devote to their businesses. And, perhaps most importantly, as group members developed personal credit histories through their loan payments, the need for collective guarantees disappeared.

At the beginning, simply providing credit was reason enough to start a small not-for-profit financial-services organisation. As time went on, clients started to demand more products, particularly savings accounts, but regulators were reluctant to grant the necessary banking licences to microfinance institutions that had no clear ownership structure and little prospect of profits. Success also increased the demand for capital.

In a major strategic change, in 1992 Prodem, a small Bolivian not-for-profit organisation in the ACCION network, turned part of its operations into BancoSol, a normal bank run on commercial lines, albeit still seeking to serve the poor. The transition was marred by bitter internal fights. Interest rates charged on loans were initially set at 65%. Yet in the end the transformation worked, enabling the bank to grow and to bring down its interest rates by two-thirds. True, BancoSol has not been an unqualified success, but it has remained viable even as Bolivia has suffered huge financial problems. It is now seen as a model for similar transformations in Latin America, Africa and Asia, with ACCION playing a critical role in managing the change.

Several other microfinance groups followed ACCION's lead. FINCA, another organisation with affiliates all over the world, last summer created a number of for-profit subsidiaries, which allowed it to tap outside investors and almost double its capital. But the best example of this trend is a Frankfurt-based organisation now known as ProCredit.



A credit to the industry

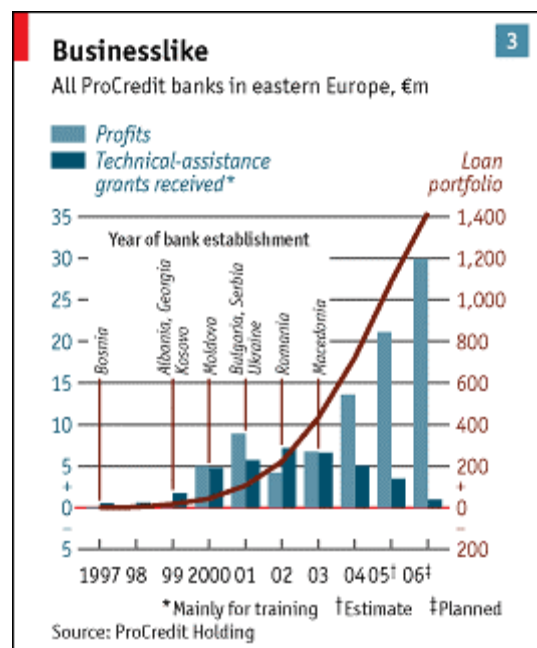
Like ACCION, ProCredit came to banking by an indirect route. Its founder, C.P. Zeiting, began his career in the 1970s by examining Latin American financial institutions that were getting money from German development agencies. When he pointed out that the whole thing was a waste of money, he was, in effect, fired by the agencies. After working on the conversion of various not-for-profit institutions into banks in the 1990s, as ACCION had done, Mr Zeiting became convinced that it would be cheaper and faster to start financial institutions afresh. Backed by investment from various development agencies such as the World Bank's International Finance Corporation, he started out in Bosnia and Herzegovina in 1996 and has since founded banks in 14 other countries and taken a controlling position in four others.

The most recent addition came this month in Congo, which speaks volumes about what ProCredit considers an opportunity. There is vast potential (60m people and only 50 bank branches), coupled with many evident risks (decades of intermittent war; nearby genocide; no local currency; frequent famine; sporadic government coups). Into this chaos, ProCredit introduces a consistent model (with minor local adjustments) that relies on the company having full control: "We are not polite, we know what we want, we have it our way," explains Mr Zeiting.

The back-office systems of ProCredit banks and its branding are identical around the world, and supervised by some of the same people. Their credit systems depend on careful analysis of the cashflow and business prospects of every client, and even competitors concede that they are unusually good at detecting problems before loans are granted. ProCredit does not do group lending, partly because Mr Zeiting thinks it only really works in rural settings where people are genuinely close, and partly because he feels that individuals should not have to be responsible for the failures of others but should be judged on their own merits. ProCredit also expects clients to come to its branches to repay loans, rather than sending out collection agents to villages, as many other microfinance institutions do.

ProCredit's experience shows that there is a pent-up demand for credit and saving in even the poorest corners of the world, and that poor people will seek out institutions that provide these things effectively.

Its growth has been remarkable. It now has 7,500 employees, of whom 2,500 were hired in the past year. With \$2 billion in assets, it remains tiny by multinational banking standards, but it is not insubstantial. Fitch, a leading rating agency, recently gave it an investment-grade rating, noting that it had operated successfully in some extremely difficult environments. Even in Haiti, where it has lost money in euro terms because of a 30% currency devaluation, it continues to operate profitably in local money. "Any anarchy is frightening," says Mr Zeiting. "But it is an



opportunity as well, because it allows you to impose your own structure and grow faster and become more important and become more profitable.”

ProCredit has not yet left the not-for-profit world entirely. When it moves into a new country, it often accepts subsidies for the first two or three years, a time of high start-up costs and little revenue. But its good performance is now opening up other sources of funds: it recently raised \$54m in the German bond market with the help of Deutsche Bank at an interest rate of just over 5%. Its banks in three countries have been able to raise money via local bank syndicates. It has also seen a huge growth in deposits.

In the not-too-distant future, Mr Zeitinger foresees ProCredit becoming entirely independent of international financial organisations. In some poor countries, he hopes to be able to borrow and lend at rates below those for the government's own debt (which in well-run countries is usually the best-quality credit), reflecting his clients' and his firm's superior record of repayment. That would demonstrate the virtues of normal banking. But what do the mainstream banks themselves make of microfinance?

Giants and minnows

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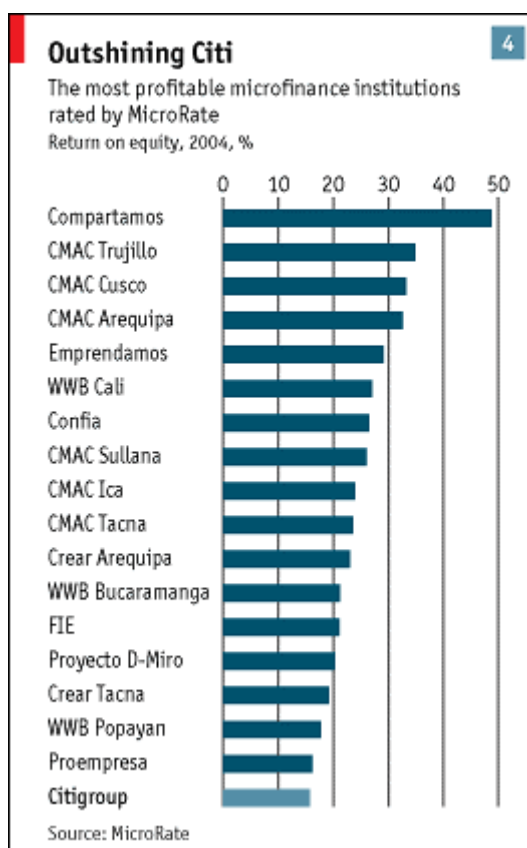
Big banks are discovering the market for poor customers

ONE of the most encouraging trends in microfinance is that the world's largest banks and insurers are becoming interested. At a minimum, they can do something that small local institutions cannot: move money around the world through their own systems, and tap and raise huge pots of capital. They can also reduce the risk and increase the liquidity of small institutions by packaging and reselling their loans, and even provide savings products through tiny institutions.

So-called "bottom of the pyramid" strategies (named after a bestselling book called "The Fortune at the Bottom of the Pyramid", by C.K. Prahalad) are currently in vogue among the world's leading companies in many industries. The idea is that big business has so far ignored a huge number of people who have very little money but nevertheless represent a potentially lucrative market. The big banks have noticed, but they are moving slowly and with great caution. ICICI Bank of India reckons that providing \$1.3m in loans to microfinance clients currently requires 40 times more manpower than a corporate loan of the same size.

Typically, the big global financial institutions are moving into microfinance via their corporate-responsibility or community-development departments, not their core for-profit banking operations. Most of them are pleased to do something that may win them good marks from their usual critics in non-governmental organisations. But they are also worried that if they turn microfinance into a real business, they will be slammed for profiteering from the poor. And there are people working in the big banks who honestly do not believe that microfinance can, or should, be a business.

One exception is Citigroup, which happily proclaims that, leaving aside its philanthropic activities, it is also getting into microfinance for its potential profits. But the foremost example is Bank Rakyat Indonesia (BRI). Founded by the Dutch in 1895 as an institution for the elite, by the 1970s it had become yet another badly run state bank with an impossible mandate. It was supposed to help farmers to increase rice production, but the government reserved the right to approve borrowers and required BRI to pay more for its deposits than it received for its loans. Not surprisingly, the bank did not bother to collect deposits, and many borrowers did not bother to repay their loans.



According to a report by Marguerite Robinson of Harvard University, an analysis of BRI's 3,600 lending units concluded that not a single one of them made money.

Facing disaster, in 1983 the bank embarked on a complete reorganisation in which it reversed every policy. It increased its loan rates by half and shifted its target client group from the well-connected to poor people without any ties to government or financial companies. It actively marketed deposits and abolished minimum limits on account. Success followed rapidly. The BRI formula has since been emulated around the world.

In some ways, a successful financial institution may find it tougher to move into microfinance than an ailing one. Bank Pichincha, the leading bank in Ecuador, has created an entirely separate subsidiary, CREDIFE, to serve poorer customers. Its results have been remarkable: small loans now make up 5% of its assets but 8% of its profits. Unibanco in Brazil and Banco Santander Chile took similar steps to attract the unbanked poor. Such efforts are not always welcomed by existing microfinance providers. In Colombia, for instance, Women's World Banking complains that mainstream banks are increasingly poaching its best clients.

The power of a balance sheet

After just two years in the field, ICICI, India's second-largest private bank, now has close to 1.5m customers that qualify as deeply poor, and an associated loan portfolio of \$265m. It has achieved this by working through 53 small microfinance banks, which are superb at marketing loans but are constrained by having them sitting on their balance sheet. ICICI lends to the microfinance institutions at 9.5-11%, a bit more than it charges its corporate clients, and the microfinance institutions re-lend the money at 16-30%. The microfinance providers are responsible for the first 5-12% in loan losses to ensure that they proceed with caution. Returns are good and ICICI wants to expand the scheme.



The seeds of a better life

Critical acceptance

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The emergence of rating agencies attests to the industry's growing maturity

WHEN representatives in Kenya of three of the world's largest banks were asked what single event would most encourage their institutions to become more involved with microfinance, they all came up with the same answer: the presence of credit-rating agencies.

Businesses love to complain about these agencies, and financial institutions grumble more than anyone else. It is rare for companies to get the ratings they believe they deserve. But nor are the users of ratings all that happy, because the agencies are generally not very good at predicting default rates. Banks tend to see the agencies as a form of competition, providing information that outside investors use to purchase debt, to the detriment of the banks' own lending business.

Nevertheless, rating agencies provide a relatively objective and consistent credit benchmark that is a great help to big investors. Banks, despite their carping, rely on these outside ratings for developing their own internal credit models, even if their in-house evaluations come out a little different from those of the rating agencies. Without such models, tracking loans, assigning risk capital and managing cash would take up far too much management time.

Being relatively small, most microfinance institutions are reluctant, or perhaps unable, to pay much for a rating. The big agencies—Moody's, Standard & Poor's and Fitch—have so far rated only a few institutions, notably ProCredit of Germany, Compartamos of Mexico, Mibanco of Peru and Acleda of Cambodia. That leaves thousands unexamined.

Several specialist credit-rating agencies have recently stepped into this vacuum. However, they face huge barriers to establishing credibility in the marketplace, because ratings need to prove themselves over a period of time. Meanwhile some have launched other businesses on the side, but these can undermine their perceived objectivity.

MicroRate, the oldest specialist rating agency and the only one that sticks purely to this particular business, was founded in 1996 but did not reach break-even point until this year. It was fired by three institutions for being too hard on them, but that may have been no bad thing for its reputation. Demand from investors has steadily grown, and it now rates 45 microfinance organisations.

Many of those brave enough to have asked MicroRate to run a rule over them have received poor grades for having "financial, operational or strategic weaknesses that have the potential to threaten their viability". This can mean anything from inexperienced managers and boards to a lack of internal controls, too much reliance on a single person (often a charismatic founder) or an inability to raise funds for growth. So why do such companies bother to get rated? They must believe that things can only get better.

Bankable banks

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Are the poor a good investment?

THE enthusiasm for microfinance rests on the idea that people who have next to no money deserve financial services just as much as those who have plenty. This is often justified by notions of equity or fairness: everyone should have clean water and health care, and everyone should have the right to deploy their talent. But on that view microfinance becomes yet another public good, limiting its scope to whatever can be squeezed from philanthropists or governments.

A more optimistic justification is that microfinance can support equity in the strictly financial sense, meaning it can produce profits. If so, it will be able to attract all the investment the rich world can provide to fund all the opportunities poor people can handle.

The evidence cited by the optimists typically comes down to a single fact: that microfinance clients repay their loans. Undoubtedly many of them do, but whether the aggregate numbers hold water is less certain. Industry-wide data are in short supply, and those that are available suffer from what statisticians call "survivorship bias": institutions with terrible repayment records go bust, taking their bad numbers with them and leaving only the better records to be examined.

Worse, there are widespread suspicions that some microfinance banks hide poor repayment rates by rolling over bad loans or extending their due dates indefinitely, which they can keep up as long as there is an inflow of donor funds. Even when repayment rates are high, a microfinance institution may charge an interest rate too low to cover its overall costs or its costs of funds, thus making it more of a charity than a commercial enterprise. Successful microfinance banks often charge vertiginous interest rates, because that is what poor people must pay to be commercially viable customers.

A good test of whether microfinance customers are truly bankable is whether the microfinance banks are bankable themselves, in the pithy words of Peter Kooi, head of the United Nations capital-development fund's microfinance unit. In other words, are those banks worth investing in? So far, this test has rarely been applied. No microfinance institution has traded seriously on a public stock exchange. Only one, BRI of Indonesia, has a genuine public listing, and that has been going for less than two years, not enough to judge its quality. A handful of others, including Mibanco of Peru, Banco Solidario in Ecuador and Satin in India, are listed but rarely trade.

Until recently, when a flurry of microfinance investment funds were launched, most of the money backing microfinance institutions came from the least demanding sources of capital: governments, multilateral institutions, not-for-profit organisations and "socially responsible"



A credit to her business

private investors who either did not demand market rates of return or valued their returns in unorthodox ways.

There has, however, been one notable exception. In 1995, a handful of social investors, headed by ACCION International, Calmeadow of Canada, Triodos of the Netherlands and Fundes of Switzerland, raised \$23m to create Profund, a Latin American investment pool intended to demonstrate that investing in microfinance could be commercially viable. It was designed to run for ten years, and true to its mission it sold off its last investment this summer. By liquidating its portfolio and turning it into real cash, it became a yardstick for the investment performance of a microfinance institution.

At first sight, its returns look unexciting: just 6% annually, despite lots of risk. But on closer examination this was a remarkable performance. All of Profund's capital was contributed in dollars and then invested in local currency. In every country it operated in, its dollar returns were reduced by local currency depreciations, reflecting the economic chaos in much of Latin America during that decade. Two of the countries in which it had investments, Paraguay and Ecuador, suffered system-wide financial collapse. Haiti, Venezuela and Bolivia faced riots and revolutions. Good banking is, in the end, no match for bad government. Most investors in the region watched their money burn.

Initially, Profund had expected to be a passive investor. It bought stakes in a dozen institutions, hoping simply to hold on and then sell out. But Profund's manager, Alex Silva, soon found himself attending monthly meetings of the institutions he had invested in and getting involved in managing them.

Mr Silva, with ACCION and a German consulting firm, IPC, played a crucial role in helping the institutions that Profund invested in to evolve from not-for-profit NGOs into regulated banks, able to receive deposits. During Ecuador's financial crises of 1998, when all private debt repayment was suspended by the government, Mr Silva helped to arrange a crucial \$5m emergency loan to keep one local microfinance provider afloat. The loan, at an interest rate of 15%, was fully repaid within 18 months. Without it, this well-managed bank would probably have died, taking Profund's \$2m investment with it.

Where's the exit?

Getting out of investments proved equally complex. Unlike in developed countries, there were no local stockmarkets eager for new listings, nor hungry groups of local investors. Profund had to work hard on each exit deal, often under pressure from larger shareholders hoping to orchestrate a squeeze. In the end, three of Profund's investments did blow up. But the fund's investment in Compartamos of Mexico performed spectacularly, and investments in Mibanco of Peru, BancoSol of Bolivia and Los Andes of Peru also did well. Several other investments failed to produce respectable returns only because of currency depreciations.

All this looked very much like the distribution of returns typical in venture capital—plenty of duds, a few stellar performers—rather than in mainstream banking. The fund's success owed at least as much to the efforts of Mr Silva and his investors than to the underlying economics of the industry. One lesson from Profund's experience is that interest rates in this business have to be pitched high to make the loans viable. Compartamos charged more than 100% annually when the initial investment was made, and Mibanco over 80%, though

both of them have since dropped their rates somewhat. Initially, potential clients are less concerned about cost than access to money. Besides, even high interest rates charged by microfinance institutions are probably well below those being offered by moneylenders in the informal market.

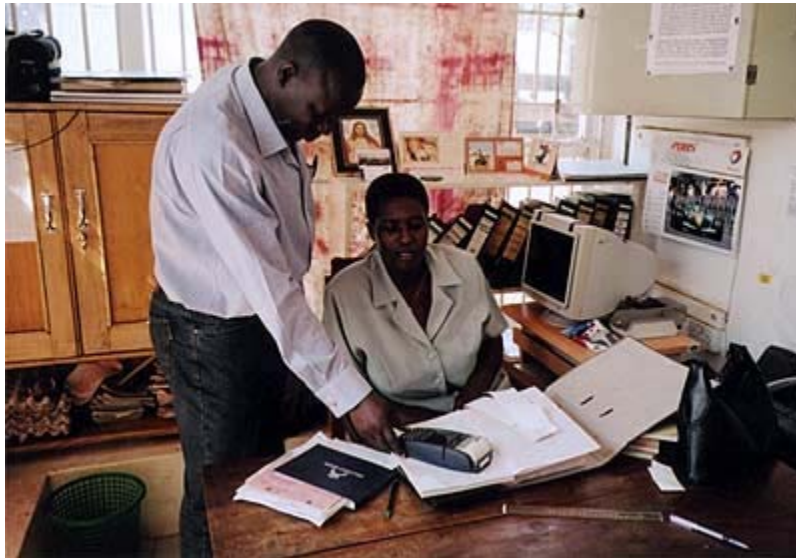
Profund's investors were sufficiently impressed by its success to want to see its charter renewed, but Mr Silva has declined to do so. Unlike in 1995, there is now abundant capital available for investment in microfinance—perhaps too much, he says, at least for Latin America to absorb.

In the past three years, new investment opportunities in microfinance have been popping up all the time, and more are on the way. In the largest example yet, Pierre and Pam Omidyar, flush with money made from eBay, have pledged \$100m to back microfinance projects, a source that is as yet almost entirely untapped. It will not stay that way for long.

Micro no more

Nov 3rd 2005
From The Economist print edition

Financial services for the poor and the rich are becoming increasingly alike



Hewlett-Packard's Ugandan bank-in-a-box

THE group of 30 women in the dusty square of a poor village outside Hyderabad, their children on their laps, passing tiny deposits and loan payments to a young man in their midst, seem to be engaging in a form of finance quite unlike that practised in the City of London or Wall Street. But is it really that different?

Microfinance offers all the transactions you would expect in any branch of finance: loans, deposits, money transfers, insurance. It is distinct only because it involves amounts of money so small that in the past conventional firms did not think them worthwhile. That is clearly changing.

Many microfinance institutions report better returns on equity than do large banks. Five years ago, providing financial services to people with little money might have been dismissed as a tiny niche business or charity. Now all the participants in the capital markets, from big banks to investors to rating agencies, are beginning to open up to it.

The evolution of microfinance into a serious and viable business has many benefits. It means that in future the bulk of the capital is likely to go to the most efficient institutions with the best growth prospects. They will select their clients on the basis of merit rather than cronyism or bribery, of which state banks (as well as some private banks) in poor countries have often been guilty in the past.

Sound institutions will be able to protect their deposits and attract new ones. In the most optimistic scenario, an open, viable financial sector will create a large body of people with economic stakes in their society who will demand decent public services, which in turn should help to promote growth.

Plenty of obstacles remain. Venezuela, Brazil and Colombia, for example, all impose interest-rate ceilings, and other countries are considering them. These discourage new financial firms from entering the microfinance market and encourage existing participants to evade regulation.

But within a few years, the number of people who have access to financial services may expand from hundreds of millions to several billions. Historical precedent suggests that this could bring huge opportunities. In the past, some financial institutions, notably Bank of America, Merrill Lynch and many large European insurers, did spectacularly well by nurturing clients only slightly too poor to be of interest to the leading firms of the day.

But to reach the vast number of people who currently lack access to the financial markets, microfinance will have to change. Four main areas need particular attention: culture, products, funding and the cost of operations.

The cultural challenge is to transform something that started as charity into a proper business. The pursuit of profit may not come easily, but change is already in the air. "We are not paternalistic, we do not lend to the poor," says Mónica Hernández of Banco Solidario, a fast-growing and profitable bank in Ecuador. "We lend to those who do not have access."

To reach this new group of customers, however, microfinance providers will have to abandon their old attitudes and vocabulary and join the mainstream of the global financial system. Transmitting funds, insuring risks, extending credit and holding deposits for people with almost no money will turn out to be little different from doing those things for anyone else.

Beyond credit

One priority is to expand microfinance beyond credit into all the financial products on offer in more sophisticated markets. Today only a few institutions are seriously offering insurance, even though it is particularly valuable to the poor; yet death and illness, for example, are major risks for banks making small loans, and inevitably they charge for bearing that risk. *BASIX*, a dynamic microfinance institution in India, provides not only basic life insurance, but other products that are particularly appropriate to its agricultural clients, notably insurance against drought or loss of cattle.

It matters enormously where the money comes from. At present, the main sources are charities, governments and international organisations. But serious interest from large banks and private investors would greatly increase the amount of capital available and bring down the cost of funds. The emergence of credit-rating agencies to provide an independent assessment of institutions will make it easier for the banks to come in. Credit bureaus for rating individuals too are now being established in a handful of countries.

Microfinance institutions may also tap wealthy investors directly. More than a dozen institutions recently raised money from American investors, including a university, in a deal structured by Developing World Markets, a specialised American firm of financial advisers, and Blue Orchard Finance of Geneva, a microfinance fund manager. True syndication of microcredit loan portfolios may not be far away, though governments in many poor countries will have to strengthen ownership rights and reduce barriers to foreign investment before it becomes commonplace.

Crucially, the cost of microfinance will have to come down. At present it is far too manpower-intensive, more like private banking for the wealthy than retail banking for the middle classes. Typically, borrowers receive visits from their bankers, sometimes daily, rather than going to a branch or using an automated teller machine. Credit evaluation relies on character or cashflow valuation rather than the statistical techniques used by credit-card companies in rich countries. This has been made possible by low wages and an abundance of highly talented people willing to work long hours, but it will not be sustainable.

More competition will help to reduce costs, but the biggest hope comes from new technology. For example, the cost of sending money from Hong Kong to the Philippines has declined dramatically because of new methods that transfer funds via mobile phones, says John Owens, of Chemonix International, a consultancy. And that is only one of their uses. Through arrangements with merchants in small towns, mobile phones can also be used to pay loans, make deposits and get cash, saving time and money. Vodafone is testing a similar system in Kenya, and Hewlett-Packard has just finished a pilot project in Uganda using a point-of-sale machine with mobile-phone technology. Such techniques may eventually make branches, cheques and even cash superfluous.

In the past, the two main obstacles to providing financial services to poor people have been lack of information and costs. Those obstacles are now being overcome. Ultimately lower costs and better information are good not just for the poor, but for everyone. Microfinance may have started as a niche business, but the chances are it will soon be micro no more.

Author interview

Nov 3rd 2005
From Economist.com

A discussion with [Tom Easton](#), New York Bureau Chief of *The Economist*

"The poor, even if they have very little, are not as poor as you think. There's an institution in Bangladesh that works in the slums, which collects as little as two cents in deposits as their minimum collection. That institution now has 10,000 clients and is self-sustaining."

Listen to the audio interview (8:18 mins)

- [RealAudio](#)
- [Windows Media Player](#)



Sources and acknowledgments

Nov 3rd 2005

From The Economist print edition

Leading academic papers on microfinance and links to key microfinance organisations can be found at www.microfinance.com.

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