



Microcredit Is Becoming Profitable, Which Means New Players and New Problems

Microcredit, the innovative financial tool that provides very small business loans to poor people, is moving into adolescence and must wean itself off non-profit donors to become an established part of the global capital structure, according to Wharton faculty and experts in microfinance.

The movement began nearly 30 years ago with Muhammad Yunus, founder and managing director of Grameen Bank in Bangladesh, which so far has provided \$5 billion in loans to four million people. Since then, similar networks of microfinance institutions (MFIs) have sprung up around the world. Indeed, the United Nations has declared 2005 the International Year of Microcredit and will sponsor research projects and meetings to encourage the use of microcredit to alleviate poverty. "It's a growing market," says Wharton management professor [Keith Weigelt](#). "I view it as the good side of capitalism, using loans to give money to poor people so they can improve their lot in life."

Large commercial financial institutions, including Citigroup and Deutsche Bank, are now showing interest in microfinance, which could increase access to credit for the poor. At the same time, challenges remain in attracting private capital, lowering costs and interest rates, and developing regulation.

More than 500 microfinance institutions around the world have loaned \$7 billion to about 30 million small-business people, says Weigelt, but 300 million could benefit from microcredit to start viable businesses. So far, most of the loans made by MFIs have originated as grants from government or gifts from individuals and foundations. "The big jump now is for microfinance institutions to wean off the donors and subsidies and operate like a commercial bank would," Weigelt adds.

Despite the perception that making business loans to desperately poor people is a bad bet, returns to MFIs rival those of commercial banks. Studies conducted in India, Kenya and the Philippines found that the average annual return on investments by microbusinesses ranged from

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117% to 847%, according to the United Nations. "So now we are seeing more for-profit institutions moving in," says Weigelt. In many cases, MFIs are partnering with large financial corporations to expand the services they can offer clients, such as savings accounts and insurance.

Microcredit works because it is often arranged for a group, which leads to peer pressure on individuals to repay the loans or risk losing microcredit as a financial opportunity for their community. In addition, individuals in poverty are reluctant to default on microcredit loans because if they do, they will have no other options. "This is their last hope," says Weigelt. "It's not as if they can just walk away and declare bankruptcy."

University of Pennsylvania economics professor [Tayyeb Shabbir](#) suggests that microfinance is entering a period of formalization that will give market forces a greater role in the process. That makes some long-time proponents of microcredit uneasy. "People committed to this movement for the last 20 years feel apprehensive. They worry that all these strangers are going to come in and want to dismantle everything. But I think this fear is somewhat misplaced. There will be room for, and a need for, non-profits and for-profit institutions."

He says the social mission of reaching many more people cannot be achieved with continued handouts. At the same time, he notes, microcredit organizations arose because of a failure by markets to provide opportunity to the poor. "There is always going to be a part of the mission which is going to rely on non-market institutions," says Shabbir, who points out that market and non-market institutions exist throughout the economy. "Soup kitchens coexist with posh restaurants."

Before microcredit can begin to make a real difference in global poverty, Shabbir adds, interest rates must come down. Interest rates for microcredit, now at 40%-50% in some areas, would have to fall to 10% to make a difference to lenders, he suggests. "If commercial microfinance is to fulfill its mission, interest rates have to come more in line with interest rates for the great majority of the borrowers." He warns, however, that for-profit financial institutions will not provide much benefit to the world's poor if they simply cherry pick the best borrowers for their microcredit lending. "Doing what seems obviously profitable, without taking any innovative risks, will be the end of the story. To make a dent in terms of poverty, you have to innovate."

High Transaction Costs

Nancy Berry, president of the Women's World Banking Network, a microfinance umbrella organization with 24 affiliate institutions in 19 countries, says the microcredit movement has convinced commercial lenders that the world's poor are no longer unbankable and could become a market for other financial services. "This is not just about lending," she says. "This is about clients building assets." Business-lending relationships could expand into housing finance, insurance or other products. However, Berry points out that when institutions move from lending into savings and investment, they need more regulation.

The biggest problem facing microcredit lenders is the high transaction costs of making many miniscule loans, which drive up interest rates, she notes. The average loan officer working at affiliates of the Women's World Banking Network manages 600 clients at a time. "They are like little machines going to the barrio getting their payments and making new loans, but even at that level the administrative costs are 10 cents to lend each dollar." High costs combined with inflation drive real interest rates above 25%, says Berry, who adds that poor clients are willing to pay these rates because the money lenders charge even more.

Microfinance institutions will not be able to squeeze more efficiency out of their workers. Future cost savings, Berry predicts, will come through improvements in technology. She points to the use of ATMs and charge cards to reduce costs, and cites an experiment in Kenya where cellphones are being used as mobile bank branches.

To attract private capital, microfinance institutions have been looking for ways to bundle and securitize their loans, Berry adds. A major stumbling block for microfinance institutions hoping to draw private investment capital from abroad is foreign exchange risk. "The big challenge ahead is to build local capital markets."

In August 2004, Citigroup/Banamex announced the first issuance of peso-denominated investment grade bonds to underwrite microfinance projects in Mexico. The proceeds will finance projects sponsored by a local MFI called Compartamos. Citigroup/Banamex marketed the \$44 million sale to local institutional investors. The International Finance Corp (IFC), the private-sector arm of the World Bank Group, issued a 34% guarantee on the bonds, enabling them to receive an AA rating by the local affiliates of Standard & Poor's and Fitch Ratings.

"This is an important step in Citigroup's goal to link microfinance institutions, such as Compartamos, with the domestic, local currency capital markets," said Bob

Annibale, director of Citigroup's office of microfinance, in a statement. "By raising funds from local investors, Compartamos can expand a self-sustaining business proposition that helps thousands of entrepreneurs -- many of whom are women -- build small local businesses, which in turn strengthen communities and local economies."

Berry says people shouldn't be concerned that big global financial companies will squeeze out traditional non-profit microfinance institutions. "We believe it's very important that a robust financial system for the majority has to have strong microfinance institutions as well as cooperatives and banks involved," she says. "The microfinance institutions have to be smart in terms of their niche vis-a-vis the banks."

Even if commercial banks step in and use microfinance as a way to build deeper relationships with customers, says Berry, there will still be a tremendous need to provide microcredit through non-profit institutions to the poorest of the poor. "Right now we are at about a 10% market share," says Berry. "Microfinance institutions will always have a market at the low end."

Berry also countered complaints that microfinance does not help the very poorest people. She said people benefiting from microfinance institutions are still making only \$1 to \$2 a day. "I don't consider that the rich poor. Microfinance cannot be the answer for every poor person on earth, but it's not true that it is only for the rich poor."

Bringing Down Interest Rates

Other experts in microfinance discussed trends in the field at Wharton's recent Social Impact Management Conference. Bill Edwards, executive director of the Association for Enterprise Opportunity (AEO), which represents microfinance organizations in the United States, noted that the Bush Administration has proposed to cut all federal funding to U.S. microfinance organizations.

The funding cut of \$37 million will affect 15,000 businesspeople, or about a third of all clients receiving microcredit in the country, Edwards said. "It would have a huge impact. It would be a major stumbling block to microenterprise." Ironically, he added, the administration is offering strong support to microcredit programs internationally.

David Satterthwaite, cofounder of Prisma MicroFinance, Inc. of Boston, said his firm -- a retail microfinance lender that

currently finances individual micro-enterprises in Nicaragua and Honduras -- is capitalized by private investors, not donors, through private placements compliant with SEC regulations. Satterthwaite pointed out that one of the challenges facing microfinance, as it attempts to draw private capital, is benchmarking and developing underwriting standards. Prisma uses CAMEL -- an international standard created originally by the U.S. Federal Reserve to evaluate U.S. banks. CAMEL is an abbreviation for capital adequacy, asset quality, management, earnings and liquidity.

Satterthwaite agreed that interest rates remain an obstacle to microlending institutions that share the firm's commitment to end poverty. "The back side of credit is debt; you never forget this is a usurious activity. That's harsh to say, but the interest rates charged are through the roof," he said. "There is a moral obligation to reach scale as fast as we can to bring those rates down."

David Gough, program consultant to Deutsche Bank, said the German bank has been active in microcredit through its non-profit wing since 1998. Now, however, it is expanding its involvement through the Global Commercial Microfinance Consortium, a \$50 million fund aimed at commercial investors. "We really believe the next step is very active private sector involvement. This is a way for these investors to fulfill their corporate social responsibility objectives by virtue of an investment and not as an expense."

Deutsche Bank will brand the fund, he said, but investors will share in positive marketing and public relations spinoffs. He also said investors can help provide expertise to the fund, and microfinance institutions working with the fund can help investors understand local markets. "The message here is that we fully agree that commercialization is the way to go," said Gough "and we think this is the first of many funds that are going to come into this space."



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