Micro's moment

While capital markets remain volatile, can microfinance become the big winner? **Sam Mendelson** reports on an evolving investment model

The current crisis, which has spread like wildfire from the global credit markets to the broader banking system and on to the global economy, needs no summary. Blame will be apportioned and – one hopes – lessons learned for some years to come. It may be that certain of the innovative financial instruments that have characterised the bullish past few years have already seen their zenith. Who knows whether the collateralised debt obligation squared market will ever surface again.

Microfinance, by contrast, is at the same time both new and old, simple and complex, fantastically successful and tragically disappointing. But it is big, poorly understood by many, and – if this financial and economic crisis is a mere periodic recession rather than a 1930s-scale global depression – potentially a big winner.

Microfinance exists in various forms. It can be charitable, and consist of grants or donations provided to non-governmental organisations (NGOs) in the developing world to provide small interest-free loans to the poor. It also exists within developed countries. In the UK, the Community Finance Development Association (CDFA) oversees Community Finance Development Institutions (CDFIs), which seek to marry the traditional finance industry with the community development movement.

Microfinance also includes the model most popularly recognised: the Grameen method, pioneered in modern times by Muhammad Yunus, which provides small enterprise loans, predominantly to women.

But the microfinance sector has evolved, too, from its original microcredit incarnation to encompass such sectors as microinsurance, savings and remittances. In short, microfinance is the provision of financial services to those individuals generally and otherwise excluded due to poverty and a lack of collateral. Globally, around 200 million people are microfinance clients and many argue that the potential market is 10 times greater. Large, diversified, securitised and for-profit microfinance is becoming an increasingly popular model.

For some time, the securitisation of microfinance loans had been seen as the next step in the process of introducing enterprise and wealth creation to poverty-stricken parts of the world. In June 2007, Standard and Poor's released a paper called the *Report of the Microfinance Rating Methodology Working Group*. In this, S&P observed that the microfinance sector had stopped asking itself "does microfinance work?" and had instead begun wondering "how do we scale up?" At this point, the market was becoming more and more sophisticated. Earlier that year, BlueOrchard, in collaboration with Morgan Stanley, issued Bold 2, which was the first international microfinance securitisation to be rated by a leading ratings agency. But since the credit – and now economic – crisis took hold in August 2007, the question is whether securitisation can continue to push the sector up the development curve.

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So what is the future of microfinance? Can it be the big winner from all this instability?

F.H. Abed is the founder and chairman of the Bangladeshi Rural Advancement Committee (BRAC). It has a $528m loan portfolio with total assets of $619m and reaches seven million women in 70,000 villages in Bangladesh alone. It also has a significant presence in many other developing countries.

"The impact of the credit crisis on microfinance has been minimal or non-existent as of now, but it's not yet fully clear," says Abed. "However, as microfinance is inherently stable, with a very low default rate, and co-operative systems [exist] for covering losses between borrowers, it is probably a good investment in the long run".

BRAC generates 70-80 per cent of its $78m annual expenditure through its various enterprises and businesses. Along with Grameen Bank (Yunus's creation), it offers a diverse portfolio of services. It supports SMEs as well as micro entrepreneurs and, in addition to focusing on village organisational lending, has been at the forefront of the move to the securitisation of microfinance. One notable transaction from 2007 was the $180m securitisation of BRAC's microcredit receivables. The deal was denominated in the local currency, the taka, with $15m-equivalent disbursed every six months for six years. Microfinance is no longer just about feeding the hungry.

Professor Malcolm Harper is the former chairman of Basix and the current chairman of Micro-Credit Ratings International Limited (M-CRIL), which is the world's largest microfinance ratings agency. He thinks the picture is mixed.

According to Harper, microfinance should benefit from the current crisis because its clients repay and are quite insensitive to interest rates. But, citing expert opinion, he contends that big money is running away from anything unfamiliar, even good things such as emerging markets, back to US dollars. So the effect will be bad.

But there is a silver lining. The current crisis "may lead more MFIs to look to

client savings instead of big money," says Harper. Though this may be dearer it is more sustainable and better for clients, who need to save. "Community-owned, co-operative-type MFIs should benefit, because they have money from member savings. This is healthier in the long run".

Rakki Sahay is just as cautious. She is a manager at M-CRIL, and works closely with Mix Market – an independent, global, web-based microfinance information platform. Mix (mixmarket.org) provides Microfinance Institution (MFI) data on outreach and impact, financial data and audited financial statements; donor/investor portfolio data and country information, and is central to the increased transparency in microfinance necessary for greater loan securitisation. She is ambivalent about the effect of the current crisis.

"The economic crisis will affect the sector to be sure, but the extent will not be as severe as it is in the mainstream financial markets," says Sahay. As she sees it, the current debate concerns how to reduce the increasing credit rates levied by banks on MFIs. Although, in the short term, it might be difficult for MFIs to meet the increased credit rates (mainly due to liquidity crunches at the banks), in the long run it won't affect them much. "MFIs have close to 100 per cent repayment rates," she says. "This makes them safe. Banks view MFIs and self-help groups as safe creditors with consistent and timely repayment behaviour."

Rosalind Copisarow, former CEO of International Development Enterprises and senior vice-president of Accion International, has 16 years' experience at blue-chip investment banks and 13 years in the not-for-profit sector. She is unequivocally positive in her prognosis.

"I am a total believer in micro entrepreneurs' credit-worthiness as a sector, compared with richer [borrowers], and the current crisis may very well benefit microfinance hugely." According to Copisarow , those looking for new investments want something that will not go bust tomorrow, and micro entrepreneurs as a group are one of the most stable of any. As she sees it, "the risk in microfinance is in the management of the lending organisation and the structure of securitised lending". Managerial risk topped the rankings in the CSFI's 2008 Microfinance Banana Skins survey.

Risk, however, is about more than just poor governance or default rates. As Shafiqual Haque Choudhury, president of the Association for Social Advancement (ASA), writes in the October 2008 issue of *Microcredit Summit e-News*: "MFIs have been affected in many ways. Most Bangladeshi MFIs borrow from the national wholesale microfinance fund… but some do borrow from banks and will be affected by fund constraints. Another challenge is of clients borrowing from multiple MFIs. The rate of overlapping is increasing rapidly, and the number of overdue loans rising sharply. Consequently, the rate of loan recovery is decreasing gradually among most microfinance service providers."

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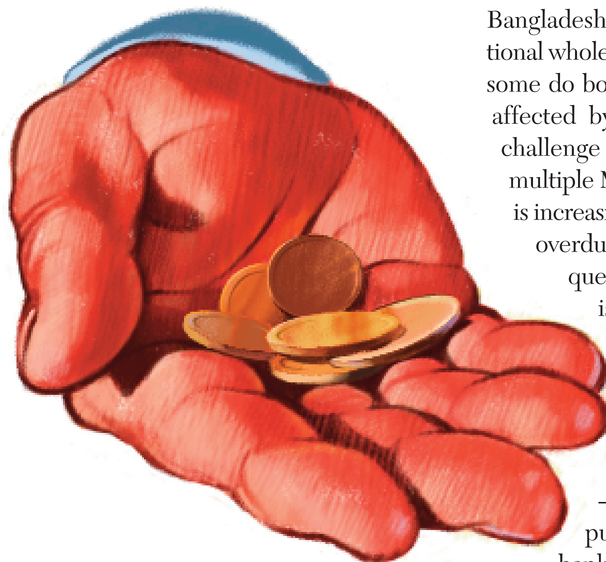

There is another factor that Choudhury identifies: the rise in global food prices – an issue that has been largely pushed off the pages as the banking crisis has worsened. "All NGOs, especially those dealing with microfinance for the poor, have been more or less affected by rising food and fuel prices." As he sees it, wages, and income from other sources have not increased to match rising costs. "As a result," he continues, "many poor borrowers are not in a position to pay back their weekly instalments and it has affected the total loan portfolio of the organisations."

Roshaneh Zafar, president of Kashf Foundation in Lahore, notes that by the end of August 2008, food prices in Pakistan had increased by 34 per cent over the previous year. To cope, clients have been eating less, doing extra jobs, and – most significantly for the microfinance sector – saving less.

Moreover, most micro entrepreneurs are to some extent dependent on the transport of goods, and rising fuel prices have outpaced inflation in much of the world. As M. Udaia Kumar, managing director of Share Microfin Limited, says: "People who were already living at subsistence levels when oil was relatively cheap are extremely vulnerable when oil prices rise, and may simply be unable to afford enough food to survive". Yet the economic cloud may have a silver lining. As oil has plunged from almost $150 to $60 per barrel, repayment rates by the world's poor may well hold steady or increase.

Asad Mahmood, director of the Community Development Group at Deutsche Bank in New York, is pretty gloomy. Because most MFIs receive finance from international investors, he predicts that over the coming year the microfinance industry will face a liquidity crisis "Certainly, the growth of MFIs would be affected and they would have to retrench. The majority of MFIs use step lending in which clients who perform well are incentivised by larger loans. Given that this model would have to be changed, it would impact the credit quality of MFIs."

But Mahmood sees one upside. "The positive aspect of the liquidity crisis is that it may force MFIs to improve their efficiency."

At a seminar given by Advocates for International Development (A4ID), the effect of the banking crisis on microfinance was foremost in discussions; the panel, however, was cagey. April Rinne, director of Venture Development at Unitus

Investment Group, thought that the jury was still out. She also thought that no financial sector would be left untouched. However if much of the recent investment in CDOs or other investment vehicles had been put into microfinance back in 2000, Rinne was convinced they would be doing fine now.

"At Unitus," she said, "the demand from MFIs for credit is as high as ever, though it will be increasingly difficult to tap capital markets. That said, the volatility of the capital markets may indeed see MF as a safe haven. But there is definite risk in some countries."

Jami Hubbard, head of the microfinance programme at the International Development Law Organisation (IDLO), noted the variability within the sector. "MFIs which have a close fiduciary relationship with their clients will do fine, and will do better than more commercialised ones."

He pointed to some MFIs in Romania that are lending multiple installments of €25,000 ($31,000) – a considerable amount. This is hardly the same thing as an MFI working as a small co-operative in south Asia, which will only lend once the borrower has established a savings record.

Jana Sivcova, principal banker in the Group for Small Business at the European Bank for Reconstruction and Development (EBRD), also described the way that some clients had evolved from seeking EBRD financing to tapping the private sector, but had recently returned because there was not enough financing available.

And due to the squeeze placed on borrowers by inflationary factors, more loans were being used for family or consumer needs rather than enterprise. Ultimately, Sivcova estimated there had probably been a drop in repayment rates from 99 to 95-97 per cent.

Sahay, at M-CRIL, agrees that some MFIs will undoubtedly do better than others. "As far as India is concerned, MFIs with excellent business planning models, a willingness to harness innovative commercial funding and sound HR policies are the ones succeeding." These can be seen as the new-generation MFIs, with strong leadership mostly from people from formal banking institutions, unlike the old-generation MFIs that have transformed from being a typical NGO. Sashay identifies three criteria for the MFIs that will be the big winners: those with diversified portfolios, those using internal savings for loan circulation, and undergoing capital structuring.

By diversifying its portfolio, an MFI may cushion the impact of higher interest rates. Bond issuance and securitisation through capital market and structured debt is another answer. But Sahay says: "It's really not possible to adequately factor in interest rate changes. If the final borrower has to pay unmanageably high rates, the whole system won't work. And if the MFI is not passing on commensurate interest rates to the borrower, it will not be sustainable."

This is crucial. Microfinance has sought to distinguish itself from Overseas Development Assistance or philanthropy by westerners by being sustainable – breaking the cycle of dependence. And as microfinance has evolved from NGOs acting as quasi-banks to a worldwide sector increasingly intertwined with the mainstream financial markets, there is growing debate as to whether microfinance lives and dies with the capital markets in New York, London, Tokyo and Frankfurt.

> 'The credit crunch means that the market for securitised loans has gone cold for the time being'

As Ian Boyd-Livingston – founder of microfinancework.com, a recruitment gateway for MFIs – says: "At the moment, one would expect not, but as it evolves it may become increasingly apparent. The credit crunch means that the market for securitised loans has gone cold for the time being."

Boyd-Livingston thinks this means a pause for microfinance in its evolution, in the broadening of funding, which has hitherto been accelerating. This pause, he hopes, can be used to draw up the standards and codes of ethics to protect the clients of microfinance and prevent mission drift.

Among the big lessons from 2008 for the City of London and Wall Street is that lending against collateral can blind you to the need for checking the repayment capacity of borrowers. As Boyd-Livingston argues: "Investors, seeking to join the flight to quality, realise that lending to people with no collateral is actually a better bet. For one thing, due diligence has to be much greater and, with an average default rate of 2 per cent, the sector is less risky than one might expect."

What is clear is that, as the credit markets have seized up in the mainstream financial sector, so has some liquidity to microfinance. It remains to be seen whether recent government interventions and injections of cash will get the credit markets flowing again. But if they do, it is likely investors will be considerably more risk-averse for quite some time, and bank shareholders less amenable to complicated investment vehicles with alphabetised titles. Public perception of the financial services sector can scarcely have been more negative.

So microfinance is left with the classic chicken-and-egg quandary. It should realise a great deal of increased investment as it is seen by investors as an increasingly attractive proposition, insulated from the credit crisis in a way that other investment options are not, and as having a barely-tapped potential market.

Yet the move to securitisation of microfinance from the classic savings-and-loans NGO model has left the sector more vulnerable to the very financial system it seeks to bring to the developing world, and may restrain those services it is providing to the world's poor. The crisis is both nourishing and destroying what microfinance has become.

There is no consensus on the relationship between the mainstream financial sector and microfinance. But there is an elegant irony in the possibility that, just as microfinance helps a parent to pass on skills that may help a child to realise opportunities the parent never had, so might microfinance be the child that carries the torch for an ailing and outmoded financial system.

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