

## Economics focus

# Small loans and big ambitions

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## The commercialisation of microcredit and what stands in the way

COMPARTAMOS may not be the biggest bank in Mexico, but it could be the most important. Established in 1990 as a non-profit group making small, uncollateralised business loans to the poor ("microcredit"), Compartamos today reaches over 612,000 clients. It also turns a profit. It is one of the few microlenders rated by international credit-rating agencies, which has allowed it to issue bonds. Last June Compartamos received the green light from the Mexican government to convert into a bank. It is so well run that bankers whisper about a possible public listing.

Microfinance, like Compartamos, has made huge strides in the past two decades. Having started as a foundling industry nurtured by charities, it then won the backing of the big international financial institutions (IFIs), such as the World Bank and the European Bank for Reconstruction and Development. Today it spans thousands of microfinanciers serving 40m individuals. Like Compartamos, many lenders now seek a profit.

Commercialisation is changing microfinance—and stirring debate. Some believe microlenders have no business making money from the poor. In many countries various rules, like interest-rate caps, have been put in place to crimp the industry's growth. This is despite ample evidence that where there is healthy competition in microlending, as in Bosnia and Peru, interest rates tend to drop substantially.

Most experts in IFIs and elsewhere believe the for-profit sector must play a role. Microlenders that can attract commercial funds—deposits, loans, the capital markets—have the potential to become self-sustaining, rather than relying on the charitable instincts of others.

Socially responsible investors are already pouring in. And even the purely profit-minded have begun to open their wallets. According to a study of 200 microlenders by MIX, which collects data on the microfinance industry, commercial funding grew to \$7.3 billion in 2005, from \$4.9 billion two years before.

What stands in the way of more for-profit investment from the private sector? Some banks, particularly big, international ones, shy away, fearing that profiting from the poor could smack of exploitation. An obstacle in some poor countries is the lack of a regulatory framework that would help microfinance thrive. In some places microlenders need to raise \$50m or more to become deposit-taking banks, for example. In Venezuela, Argentina and elsewhere the government is making noises about jumping in with subsidised microloans, which could put profitable microlenders out of business.

Paradoxically, microcredit's biggest backers, the IFIs, may also be an impediment to its further evolution, according to a recent controversial study by a microfinance consultancy and MicroRate, a microfinance ratings agency\*. The paper finds that IFIs concentrate their

loans on the big microlenders that do not need them, pouring 88% more money into these groups in 2005 than they did in the previous year. This crowds out commercial investors, argue the authors. Many bankers agree, noting that IFIs often tie other handouts to loans and undercut commercial lenders by up to 3%.

The problem is acute, because only around 300-400 of the world's 10,000 microfinanciers are as yet "investable", argues ACCION International, a microlender. The rest of them lack the capacity and expertise to take investors' cash. According to the Consultative Group to Assist the Poor (CGAP), a consortium of development groups, investors can choose from 74 microfinance funds, which channel investment to the sector. But a quarter of this investment flows into just ten of these funds.

Why would IFIs get in the way? The authors claim that these groups, which have an urge to lend and spend, have grown lazy. Investing in a handful of large microlenders is easier than making dozens of smaller loans to untested, fledgling ones. It is also safer and more profitable. This bolsters the donors' own balance sheets and also strengthens their case whenever they must convince sceptical finance ministries and taxpayers that their largesse does yield results.

## Killing them softly

Not all IFIs are guilty of course—and even the "guilty" ones do good work in other areas. But the problem, says Don Terry of the Inter-American Development Bank, is real. "We and others have proved the model works. Now it's time to move on. Our job is to go where others won't, not where they will." The bank is selling its stakes in successful MFIs. Indeed, it exited the first microfinance debt fund, which it helped create, three years before its ten-year commitment ran out, because there was so much interest from the private sector.

	Credit rating			
	Alpha	Beta plus	Beta	Beta minus
Average portfolio of microloans, \$m	50	14	9	11
Average RoE, %	28	22	13	15
Average IFI* debt, \$m	2.1	1.3	0.6	0.1
Average increase in IFI debt, %	88	12	nil	-25

Source: MicroRate \*International Financial Institutions

Although the MicroRate paper fingers IFIs, some argue that irresponsible lending by philanthropists is just as harmful. They, too, can crowd out for-profit money and, more importantly, local deposits which provide sustainable funding, and also a safe place for the poor to save. Foreign money, public and private, can provide an "important stop-gap", says

Elizabeth Littlefield, chief executive of CGAP, but “I worry that it is not necessarily catalysing the creation of a sustainable, savings-based financial system in poor countries.”

Still, the transformation is happening in snippets, particularly in Latin America. Pichincha, Ecuador's largest bank, established a microfinance subsidiary in 1999 with backing from an American development agency. Today the subsidiary contributes 12% of Pichincha's total profits, with arrears of less than 2%—while providing loans to the poor at competitive rates. Citibank houses its microfinance transactions in its bank, not in its community-development group, as others do.

The turning point will come, according to Ms Littlefield, when microfinance is seen not as a new asset class—which “ghettoises” the poor—but as the newest product line for retail banks. The industry has already transformed itself once, from a financial curiosity to a *cause célèbre*. In so doing, it has created millions of micro-capitalists in poor countries. Now it needs to attract throngs of big capitalists from rich ones.

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\* “Role Reversal: Are public development institutions crowding out private investment in microfinance?” by Julie Abrams and Damian von Stauffenberg