

TIME TO REFLECT

WHAT DOES THE SUBPRIME MARKET'S DEVOLUTION MEAN FOR MICROFINANCE?

From some angles, the development of the subprime market doesn't look that different from the development of the microfinance sector. What are the similarities, and what should we watch for? How can we prevent a similar downfall? Cecelia Beirne, an expert in mortgage-backed securities, and a Portfolio Manager at MicroVest, reflects on the implosion of the subprime sector and asks pressing questions of microfinance stakeholders.

The subprime market seems to have evolved in a relatively short period of time – reaching a very broad market and earning very attractive returns before imploding into the disaster that we see today. As this market evolved the major players grew comfortable with more risk each year until eventually the entire industry spiraled out of control. Only in retrospect do we appreciate the magnitude of risk that was considered acceptable by the mid 2000s.

The meteoric growth of the subprime industry resulted from early success in a new market and the resulting infusion of capital from the secondary markets. This success led to a tendency to relax standards and to take shortcuts with respect to due diligence.

There is no reason to believe that the microfinance industry will develop in the same manner as the subprime market. However, we have seen a massive infusion of capital to microfinance and the entry of new, inexperienced investors. Caution will have to be taken to maintain the stellar performance seen in microfinance to date,

and to manage risk in the industry. Now is the time to reflect on the evolution of the subprime market and to note the warning signs in its devolution.

Evolution of the Subprime Market

The following is an examination of events in the subprime market that led (ever so slowly) to the assumption of additional risk. In each case, we look at comparable challenges in the microfinance industry and ask questions to help to guide its growth.

Easing of Regulation → Opening of Underserved Market

The 1980s brought deregulation of the US mortgage market and tax reform, making higher cost loans (accompanied by tax savings) both legal and attractive:

- 1980 - Depository Institutions Deregulation and Monetary Control Act permits lenders to charge high rates and fees to borrowers
- 1982 - Alternative Mortgage Transaction Parity Act permits the use of variable interest rates and balloon payments

- 1986 - Tax Reform Act prohibits the deduction of interest on consumer loans, while permitting deduction of interest for a primary residence and one additional home¹

Lenders developed the subprime loan product in an effort to extend financial services to the broader market. The loans would carry higher interest rates than prime loans to compensate for increased credit risk. But the borrowers would become home owners, a traditional route into the middle class, and neighborhoods would become more stable, benefiting society as a whole.

Initially, underwriting standards were comparable to those used in the prime mortgage loan market (serving only those borrowers with strong credit histories). Banks were prudent in following procedures in approving loans. But over time, and with generally acceptable performance in the industry as a whole, banks relaxed their underwriting criteria and aimed to meet their monthly volume targets.



The challenge for microfinance is to avoid the unraveling experienced in the subprime market.

Challenges for microfinance

Microfinance has opened a huge, previously underserved market to lenders. Are all lenders carefully analyzing the opportunities and challenges of the enormous and unique new market?

To date the sector has built a record of extremely low default rates despite rapid growth. All participants in the industry – investors, lenders and regulators – will need to operate with caution to preserve this record going forward.

Oversupply of Capital → Entry of New Players

The subprime residential mortgage market was a success, offering home ownership to renters previously excluded from the American dream. By the late 1980s, Wall Street saw the opportunities to benefit from the spreads between the high interest rates paid on subprime loans and the returns expected in the fixed-income markets. Investment banks earned substantial fees from their clients for structuring deals secured by mega-pools of subprime loans. With very attractive yields, the secondary market flourished.

The massive inflow of capital from the secondary market fed the vast appetite of borrowers for loans. New lenders appeared on the scene, often lacking the experience of prudent lending and traditional underwriting standards. Mortgage brokers were

added to the chain insulating the lenders from the borrowers. The quicker a loan could be processed, including final approval, the better for all parties.

Challenges for microfinance

The opportunities within the microfinance sector have attracted a surplus of well intentioned but overly-zealous investors fueling the growth, typically, of very young institutions. Will increasing capital flows spur the new microfinance market to grow too quickly? Will microfinance investors stick to their prudent standards even if competitors sprint ahead of them in growth? Will they take the long-term investment view rather than striving to satisfy the short-term demands of investors?

To date, lenders to the sector generally have been prudent with the majority of capital flowing to the top-tier or middle-tier institutions—to those institutions with strong, documented track records. The best microfinance investment vehicles have employed thorough underwriting standards, including on-site due diligence; they also negotiate effective loan agreements containing the necessary covenants to protect all parties. All participants, especially new entrants, will need to maintain the high standards of due diligence set by the successful early commercial investors.

Very High Expenses → High Interest Rates

Subprime lending primarily served borrowers with less-than-perfect credit histories. As such, subprime loans required a higher-than-average interest rate as a risk premium. That is, investors expected higher delinquency rates and higher losses in the subprime sector. A “cushion” against these losses came from the excess interest collected on the performing loans.

Throughout the 1990s and early 2000s subprime mortgage pools performed well within expectations. But competition within the industry was growing. As a result, lenders pushed the envelope by extending loans to borrowers with weaker and weaker credit histories. They could maintain high borrower interest rates by back-loading cash flows (adjustable-rate loans carried low, initial “teaser” interest rates which escalated, usually dramatically, over the first few years).

Challenges for microfinance

Microfinance is associated with naturally high administrative expenses. As such, microfinance loans require higher-than-average interest rates. Many expect that competition will result in added efficiencies and in a decrease in interest rates. But competition abounded in the subprime market and brought few real benefits to borrowers. Will microfinance institutions be enticed to deploy available capital by relaxing their credit standards, relying on what have historically been extremely low default rates and high margins? Could there be a perverse incentive to drive clients to become over-indebted?

Managers and investors in the sector will need to address these issues head-on. They will need to depend increasingly on credit agencies to monitor client indebtedness and on thorough due diligence.

Market Competition → Innovative New Products

As competition in the subprime market increased, lenders designed new products to attract additional residential mortgage clients. Entrepreneurs with irregular income flows but good credit history and assets now qualified for low- or no- income-

verification loans. Upwardly-mobile borrowers stretching to buy a new home now qualified for interest-only loans. While these were valid products, they proliferated in spite of the lack of reliable data on their effectiveness.

Challenges for microfinance

MFIs have already started designing and delivering new products such as consumer loans, housing loans and micro-insurance. But do these new products perform as well as the traditional commercial loan products? Do microfinance institutions have the resources to analyze the effectiveness of each of their loan products? Are they able to segment their markets and analyze regional needs? Early microcredit products have very short tenors; we need to allow for frequent adjustments as the MFI perfects its lending techniques.

Sophisticated analytical tools are necessary for sustainable growth, especially in times of rapidly changing markets and rising competition. Top-tier microfinance institutions already deploy these methodologies, which need to become industry-standard.

Market Competition → Increased Reliance on Technology

Mortgage origination and mortgage loan servicing are labor-intensive operations. At the same time that competition was growing in the subprime industry, information technology was becoming more sophisticated and less expensive. The way to cut costs and thereby to compete was to maximize the use of technology.

The challenge was to use technology without alienating those clients who often needed assistance in managing their loan payments. It was very tempting to buy impressive, state-of-the-art informa-

tion technology to process loans and to minimize human interaction with borrowers. Too often this resulted in many loans moving from delinquency to foreclosure without adequate consideration of alternatives. Other loans fell through the cracks racking up unreasonable late fees and other charges while they languished without proper attention.

Challenges for microfinance

The growth of the sector depends on the availability of adequate infrastructure, and information technology may be the most important component of infrastructure. Will the promise of cell phone technology to serve rural markets be successfully realized? Will the industry embrace technology to provide standardized reporting and the transparency that investors require? Does the industry exercise caution in balancing its need to embrace technology with its need to remain in touch with borrowers?

The success of the industry to date has depended on the relationship between lender and client, the loyalty of those borrowers underserved by traditional banking. Care must be taken to preserve this relationship.

Be cognizant of the risks ahead

The events described above demonstrate the gradual evolution of some of the risk factors that resulted in the collapse of the subprime market. There were other factors including the proliferation of “liar loans” (not subject to income verification) where borrowers misstated their income in order to meet underwriting criteria, while underwriters looked the other way. There were appraisers who inflated property valuations contributing to borrowers draining all of the equity from their pri-

mary investment. There was a myriad of third parties whose fortunes were linked to the extraordinary success of the mortgage industry and of the secondary market.

Greed was endemic in the market and it enabled the players to tolerate ever-increasing levels of risk while their competition did the same. In retrospect, awareness of the real estate bubble and of the escalating over-indebtedness of most low-income Americans suggested a gathering storm, perhaps the inevitability of a market implosion. But for the most part, it evolved rather gradually and therein lays the danger: It was easy to believe that the extraordinary success would continue.

Commercial microfinance stands at the threshold of the capital markets. Success has accelerated in recent years with significant benefits to investors and with enormous benefits to the end clients (the entrepreneurs at the bottom of the economic pyramid). The buzzwords of the subprime industry (predatory lending, loan defaults, complicated loan products) are unheard of in the microfinance industry. There is no indication that microfinance will likely follow the course of the subprime industry.

But there are potential risks in the evolution of any fast growing industry. Now is the time to recognize how risks escalate, to learn from the mistakes of others and to be mindful as microfinance industry develops. ■

The next issue of *Microfinance Insights* will focus on *Innovations in Technology* for financial inclusion. Submit your article ideas at team@mfinsights.com.

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1. Chomsisengphet, Souphala and Anthony Pennington-Cross. “The Evolution of the Subprime Mortgage Market.” Federal Reserve Bank of St. Louis Review, Jan/Feb 2006, p 38.