

# Microfinance on the Rise

*A Socially Inspired Business Model about to Emerge into an Asset Class*



Microfinance has already reached millions of households worldwide. This practice of extending small loans to very poor people for self-employment projects does not limit itself to third world countries, but can also be found increasingly in European countries. Too often lending to the financially challenged is being confused with the bad mortgage dilemma in the US. This is highly unjustified, since most microfinance institutions (MFIs) actually surpass the repayment rate achieved by traditional lending institutions and exhibit promising risk/return ratios. As a result of the unmet demand for microfinance which is estimated to stand at around \$250 billion, microfinance looks set to emerge as a significant new asset class.

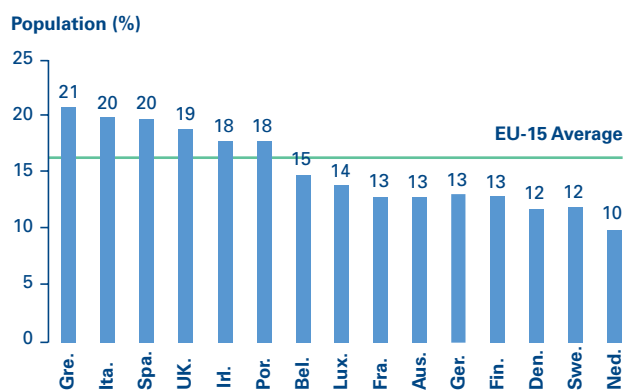
Small stallholders, selling everything from handicrafts to tissues to food, are a feature of the downtown area of every major city in the developing world. This network of enterprises is testament to the entrepreneurial abilities of the world's poorest citizens. What many of these enterprises lack, however, is access to reliable and affordable sources of credit to support their sustainability and growth. Microfinance has evolved to fill this gap.

## What is microfinance?

Microfinance is founded on microcredits. These are "programs that extend small loans to very poor people for self-employment projects that generate income, allowing them to care for themselves and their families"<sup>1</sup>. In addition to basic loans, the programs commonly provide a combination of services and resources to their clients, such as savings facilities, training and peer support. The broader offerings of microfinance reflect the demand for additional services by low-income clients, particularly in Western economies. Especially in the developed countries, the low income customer segment has been barely addressed properly yet, although it represents a significant part of the population (see figure 1).

Furthermore, the low income customer segment has been increasing its net income faster than the average population over the past ten years (see figure 2 overleaf), leading to an increasing purchasing power and credit worthiness.

Figure 1. Low income consumers – segment size



Source: Arthur D. Little analysis, Eurostat (2006)

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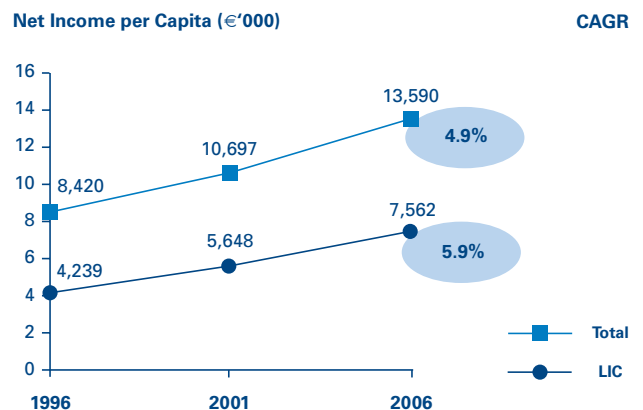
<sup>1</sup>Source: www.microcreditsummit.org

Conventional creditors are typically reluctant to lend to the very poor because such borrowers lack collateral. (see figure 3). In addition, administrative costs typically make giving many small loans much less profitable than making larger loans to fewer, secured borrowers. Nevertheless, microcredit programs around the world have achieved strong collection records, often higher than those of conventional lending programs. Repayment rates are high because borrowers are held accountable through peer pressure.

### Microcredit business models – what works?

The Microcredit Summit Campaign, a project committed to ending hunger and poverty in more than 137 countries, reports that on December 31, 2006 there were over 3,316 microfinance institutions worldwide (compared with 618 nine years earlier). Many of these institutions currently rely on subsidies, but in order to achieve their long-term goal of lifting billions out of poverty, they must achieve self-sufficiency; they are unlikely ever to attract sufficient subsidies to provide microcredit to the millions who could benefit from it. As a result, MFIs must be highly efficient in terms of operating costs and employee productivity.

Figure 2. Low income consumers – purchasing power



Source: Arthur D. Little analysis, Datamonitor (2005)

Examples of best practices can be drawn from the most successful MFIs. These include The Bank for Agriculture and Agricultural Cooperatives (BAAC), Thailand, The Village Banks (Unit Desas, BRI-UD) of Bank Rakyat Indonesia (BRI) and the Grameen Bank, Bangladesh<sup>2</sup>. Excellent examples can also be found in Europe. Credem of Italy, for example, has successfully implemented a microfinance program focusing on low-income clients with a migration background.

Figure 3. Comparison between traditional lending and microcredit

	Traditional lending	Microcredit
<b>Client base</b>	High income, middle class	Poor microentrepreneurs, pre-dominantly women
<b>Lending methodology</b>	Individual borrowers backed by collateral	No collateral, peer or group lending, progressive lending
<b>Lender efforts</b>	Office or internet-based formal loan evaluation, limited or no ongoing follow-up of client business	Labor intensive review process, officers maintain relations with clients and follow-up business performance on a regular basis
<b>Lending portfolio</b>	Medium to large sized loans with relatively large tenures	Generally small loan amounts with weekly or monthly repayment
<b>Ideology</b>	Purely commercial	Idealistic, increasing focus on commercial aspects
<b>Interest rates service fees</b>	Relatively low (depending on particular loan)	Higher than traditional lending to accommodate costs of customer relations, but lower than alternatives (e.g. money lenders or loan sharks)

<sup>2</sup> Global Development Research Center (GDRC)

### Characteristics of successful microfinance

The core elements of successful microfinance fall into three categories: customers, lending processes, and structure and organization (see figure 4).

#### Customers

**Small loans, primarily to women:** Successful programs frequently offer small loans (sometimes less than US\$100) to women. Because women are the stewards of their family’s well-being, improving women’s socioeconomic position usually elevates the physical and social development of their children. In addition, studies have shown that women are usually more creditworthy.

**Peer and progressive lending:** Successful programs often adopt a peer-lending model in which each member of a group of five to ten people assumes equal rights and responsibilities for each loan. If one member fails to repay his or her loan, the entire group takes financial responsibility for the debt. Furthermore, the group model facilitates skill sharing and increases market access for group members.

In addition, many MFIs use progressive lending models: clients are granted larger sums once they develop the skills, discipline and commitment needed for success. Thus, clients are given the chance to build a credit history and qualify for further loans and better conditions.

**Target poor microentrepreneurs:** Careful targeting ensures that loans reach their intended beneficiaries: the economically active population or “microentrepreneurs” among the poor.

#### Lending processes

**Simple and quick lending process:** Application and lending processes have to be quick and simple so as not to discourage applicants. Well-managed projects extend credit within two weeks and disburse subsequent loans even more rapidly.

**Commitment to training:** Microcredit requires a holistic approach, involving peer support, access to markets, skills training and lifestyle changes for participants. In many successful programs, loan officers teach clients about accounting, customer service and marketing to improve their businesses.

**Strong monitoring mechanisms:** Monitoring performance on specific metrics, such as repayment rates, the success of individual microenterprises and self-sustainability, is vital. It is also important to ‘hand hold’ and monitor performance of clients’ businesses regularly, both to support clients and ensure that the loans are being invested appropriately.

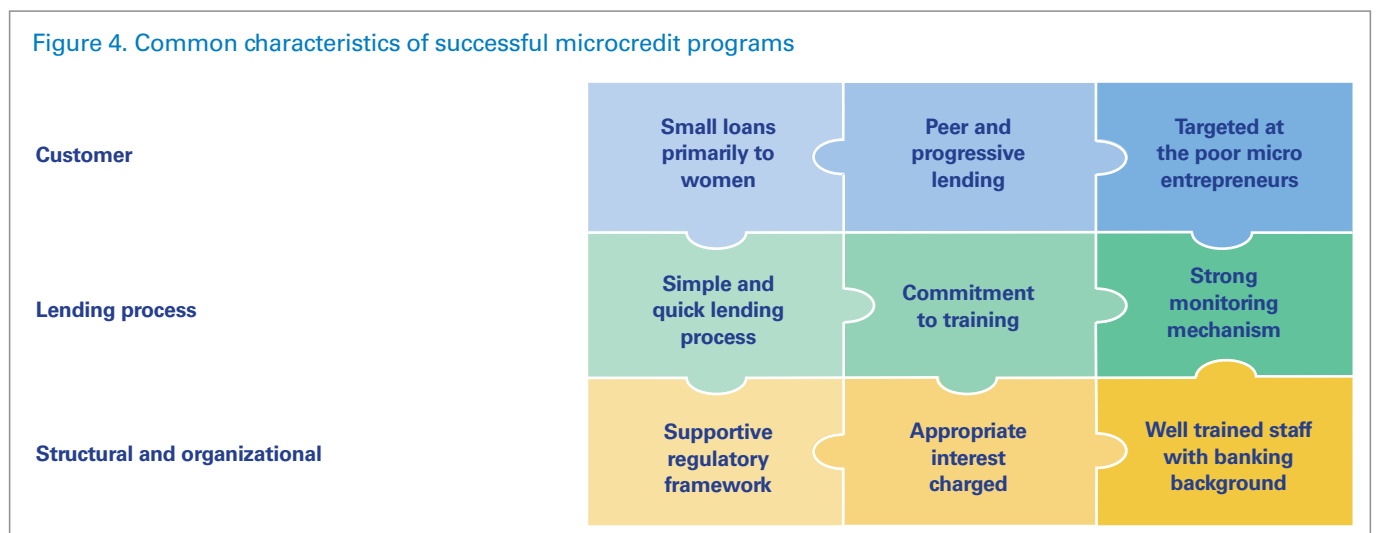
#### Structure and organization

**Supportive regulatory framework:** A supportive regulatory framework that facilitates the expansion of MFIs affects the reach and sustainability of microcredit programs. For example, regulations that cap interest rates inappropriately stifle microcredit programs and discourage their establishment.

**Appropriate interest charged:** Successful programs charge an appropriate level of interest, usually higher than that charged by traditional banks charge, but much less than that charged by money-lenders or loan sharks.

**Well trained staff:** The recruitment, training and retention of motivated staff who have a background in banking and are passionate about their work are essential, given that this business is about relationships and ultimately social benefits.

Figure 4. Common characteristics of successful microcredit programs



### An untapped demand

Microfinance has recently been attracting the attention of for-profit institutions and the sector is becoming increasingly involved with the capital markets<sup>3</sup>.

Untapped demand for microlending is considerable. There are roughly 2.8 billion people with less than US\$2 per day at their disposal. 500 million of them can be considered microentrepreneurs and would consequently benefit from a microcredit. Assuming an average loan size of \$500, this represents a demand for \$250 billion<sup>4</sup>. Today, only around \$25 billion worth of microfinance loans are outstanding. It seems inevitable that traditional investors will fill at least part of the gap between demand and funds.

Furthermore, some MFIs exhibit quite interesting risk/return ratios. Contrary to the perception that high administrative costs make MFIs unprofitable, mature MFIs (those older than 8 years) showed a median return on equity (RoE) of over 10% in 2006. In addition, microfinance supports portfolio diversification, since studies indicate it has a low correlation with conventional capital markets<sup>5</sup>.

Due to these two factors – demand for funding and favorable risk/return characteristics – plus an increasing desire on the part of investors for socially responsible investments, companies such as Deutsche Bank, Dexia, Credit Suisse and Grupo Banco Popular have already launched several vehicles that provide funding to MFIs. While these products offer indirect access to capital markets for MFIs, MFIs are also accessing the capital markets directly. Following the IPO of CompartamosBanco, the Council of Microfinance Equity Funds has reported three more listings. Market capitalization for these four MFIs totaled \$2.85 billion at their offering.

### Conclusion

Microcredit has already reached millions of poor microentrepreneurs and has the potential to lift these people out of poverty. Although the number of microcredit institutions grew more than fivefold between 1997 and 2006, demand for microcredit remains largely untapped. Thanks to innovative business models, a growing number of microfinance institutions exhibit risk/return ratios that are encouraging commercial investors to provide funding. Although volumes are still relatively small, microfinance is on the threshold of emerging as a new asset class. The sector is to be expected to grow substantially in the coming years.

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<sup>3</sup> Deutsche Bank Research

<sup>4</sup> Microfinance Initiative Lichtenstein

<sup>5</sup> Kraus and Walter, New York University