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Microloan Sharks

By Jonathan C. Lewis

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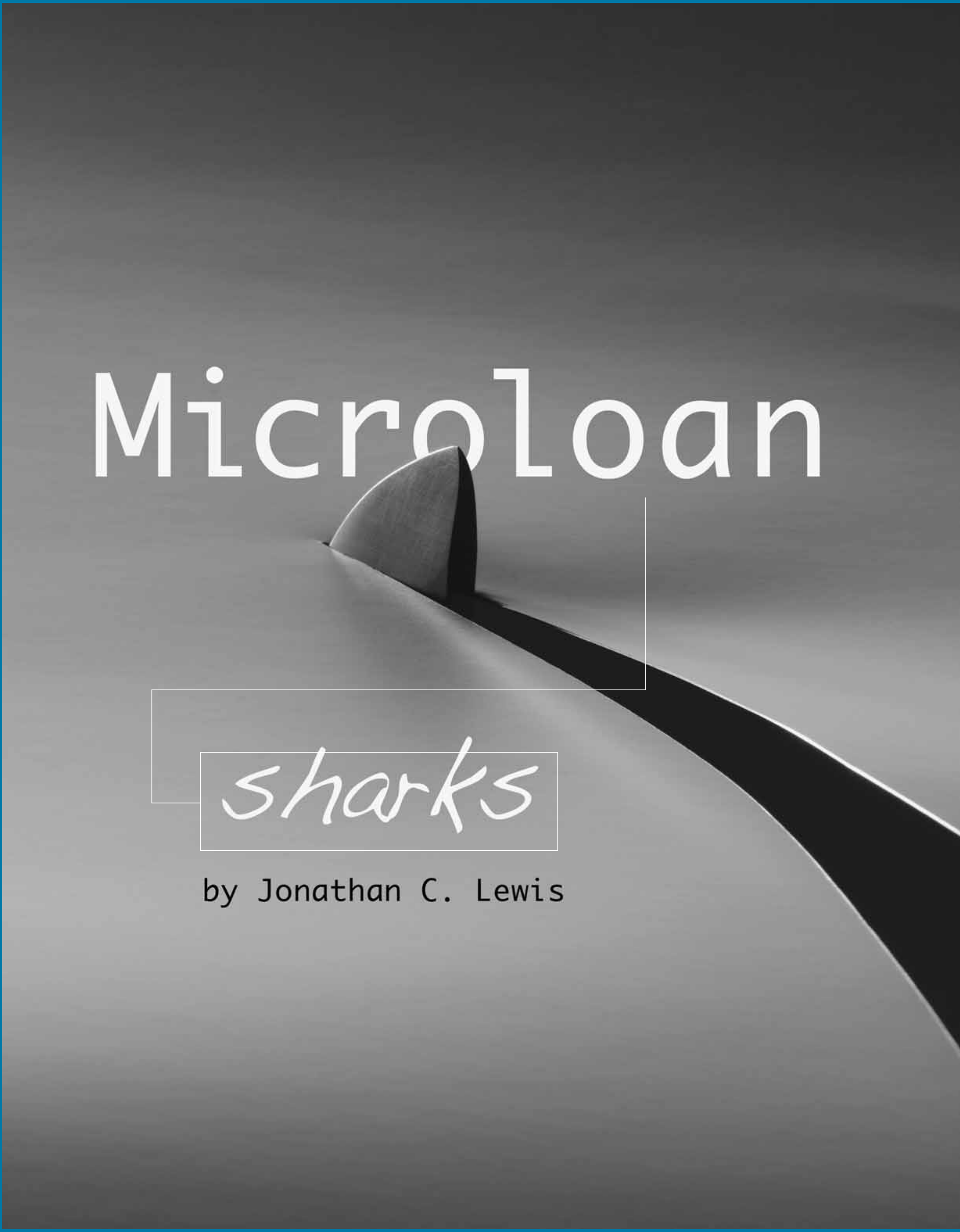

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Commercial microfinance institutions (MFIs) must calculate two bottom lines: alleviating poverty for clients and also generating profits for investors. To achieve the latter goal, some MFIs charge their impoverished clients exorbitant interest rates. The recent Banco Compartamos IPO in Mexico raises a red flag, demonstrating how easily well-intentioned MFIs and their investors can shift from microlending to microloan-sharking.

BANCO COMPARTAMOS, THE LARGEST MICROFINANCE institution in Mexico, is the acknowledged poster child for commercial microfinance institutions (MFIs). From its inception in 1990 until 2000, Compartamos operated as a not-for-profit nongovernmental organization (NGO), receiving $4.3 million from international development agencies and private Mexican donors. In 2000, the organization was reaching 60,000 borrowers—mainly poor women in rural areas. To tap commercial funds for even faster growth, the NGO and other investors converted it to a for-profit business. By the end of 2006, the corporation was serving some 616,000 borrowers—a tenfold increase.

The corporation went public in 2007. For its initial public offering (IPO), Compartamos' owners sold about 30 percent of their shares to new investors, raising a total of $450 million for the original investors—not bad for an initial total investment of $6 million. Following the IPO, the corporation was valued at more than $1.5 billion. That comes out to an internal rate of return to investors of roughly 100 percent a year, compounded over eight years, reports the Consultative Group to Assist the Poor (CGAP).[1]

Many observers hailed the Compartamos IPO as an unalloyed success. "The financial markets have shown the true value created by high-performance, double bottom line–oriented microfinance institutions. We hope that this is the first of many [IPOs]," concluded ACCION, a U.S.-based microfinance network, in a document on its Web site.

Yet the realization of Compartamos' commercial bottom line has come at the expense of its social mission. Compartamos' borrowers routinely pay annual percentage rates (APR) of more than 100 percent. In contrast, microlending institutions worldwide average an APR of 31 percent, according to a Dec. 13, 2007, *BusinessWeek* article. Even Americans with bad credit histories get better terms on their credit card debt, receiving APRs that range from 22 percent to 29 percent, according to the same article.[2]

Virtually every MFI argues that it must charge high interest rates because servicing very small loans in rural areas to people with no credit history is an expensive business. Commercial MFIs add that they must charge high APRs to generate profits and attract private investment capital, which in turn will allow them to scale up their ventures and reach even more impoverished people.

Yet the Compartamos IPO generated such high returns that many are now asking whether microfinance should be about poverty alleviation or profit generation. Can it be about both? Can microfinance serve two masters?

The field of microfinance is still too young for observers to know the answers to these questions. But the Compartamos IPO raises a red flag: There is something decidedly unseemly about profit-maximizing investors backing an MFI that charges 100 percent interest, compounded annually, to the world's poorest people. And it's all the more unseemly when new studies—such as one by Women's World Banking—find that commercial MFIs are helping fewer of the very people whom they were designed to help: poor women.[3]

In all the talk about market solutions to poverty, investors seem to be forgetting that microfinance markets do not operate like typical markets. Indeed, many places in which MFIs operate have no markets and few, if any, banks that serve the poor. Moreover, some MFIs like Compartamos do not yet face market pressures or legal requirements to disclose the information that both investors and impoverished borrowers need in order to make the best choices.

Microfinance lending—like all financial and budget decisions—is a reflection of values. The time has come for the microfinance establishment to recommit itself to alleviating poverty.

The industry's thought leaders should reexamine the ideology that appears to embrace many kinds of MFI behavior on the grounds that eventually the marketplace will correct itself. Instead of adopting a big-tent, everything-goes attitude, microfinance funders and practitioners should decry an MFI's interest rate pricing if it exploits the poor, just as they decry money lenders who prey on vulnerable people and commercial bankers who ignore them.

Microfinance funders—including foundations, microfinance investment vehicles, government agencies, and microfinance technical assistance providers—should disassociate themselves from profiteering MFIs. Microfinance investment vehicles should as a matter of policy not fund MFIs that abuse the marketplace. For instance, MicroCredit Enterprises (MCE), which I chair, recently rejected a loan application from an MFI that charges high interest rates.

Collectively, the industry needs a code of conduct to which every funder subscribes. Social investors, foundations, and government aid agencies should adopt a unified set of standards and criteria that define expectations and set the bar for acceptable lending policies.

As the Alliance for Fair Microfinance has noted: "In microfinance today, growing numbers of practitioners are relying on practices that would be considered illegal or unethical in mature financial markets—untrue information, unlawful repossession, and usurious interest rates in particular. Lack of adequate customer protection in emerging markets thus easily opens the door to exploitation of poor people."

Indeed, the Microfinance Network—an international association of 37 MFIs from 31 countries—and its individual members, including Compartamos, sign a fair-pricing pledge that states that members will price their services at fair rates. They agree that their rates will not generate excessive profits, but will be sufficient to ensure that the MFI can survive and grow to reach more people. But as the Compartamos IPO exposes, enforcement is voluntary, and the definition of "excessive profits" is left to the imagination.

We in microfinance can do better. Investors in microfinance should accept responsibility for conducting more aggres-

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sive due diligence. Money is power. Microfinance investment funds need to reveal how they are using investment capital, and the marketplace needs to hold them accountable. Every microfinance fund reports to investors on the MFIs in which it invests, describing their geographic balance, average loan size, poverty indicators, and sustainability metrics. But they rarely—in fact, I have never seen an exception—report on MFIs' interest rates or other consumer protection policies.

Finally, the microfinance industry should anticipate governmental regulation and become proactive. Microloan borrowers operate their businesses in the informal economy, free from governmental regulation and protection. No enforceable usury laws, no consumer rights lawyers, no small claims courts, and no Better Business Bureau promotes or monitors ethical lending. As government officialdom learns of Compartamos-like abuses, regulations to redress these abuses will follow. Smart, mature, and successful industries have learned that outrageous marketplace behavior by the few invites governmental oversight of the many.

Not Business as Usual

The most orthodox and compelling rationale for high interest rates is that they stimulate investment, growth, competition, and, ultimately, better rates for consumers. With more investment come more MFIs competing for both investors and customers. Customers then have a wider array of products and providers from which to choose, and thus demand better services and lower interest rates. In other words, as competition and scale increase, charging the destitute of today high interest rates in the near term may give the destitute of tomorrow lower interest rates.

Yet in most regions of the world, competitive microfinance markets are a long way off. The microfinance industry estimates that 2.5 billion poor are either unbanked or underbanked, and that it currently meets only 10 percent of this demand. Indeed, a 2007 Microfinance Network analysis of microfinance market competition could report only on three countries (Uganda, Bangladesh, and Bolivia) with sufficiently developed microfinance industries to warrant review. Whatever the theoretical argument for lowering interest rates via competition, the poor have a long wait ahead of them.

In addition, growth does not guarantee competition. Scaling up microfinance could produce competition, but it might as readily produce monopolies or cartels. In the American experience, the steel, oil, telecommunications, and aircraft industries are examples of growth unchecked by competition. Small, impoverished regions—the very areas that need the most help—may never be able to support two or more local microfinance institutions. Without competition between MFIs in these regions, the poor will always be at the mercy of MFIs that have no market incentives to lower unnecessarily high interest rates.

Even for regions with many MFIs, competition does not necessarily guarantee lower prices. In the global heartland of capitalism, the United States, competition has not lowered the price of basic necessities for the American poor. Indeed, the poor pay higher prices for many items because they are geographically and educationally isolated, trapped by circumstance and condition. Payday lenders in America's ghettos and barrios have long capitalized on this fact.

In the developing world, rural villagers and urban slum dwellers confront additional market hurdles. Classic economic theory holds that a willing buyer (the poor borrower) and a willing seller (the MFI) will voluntarily determine the price of goods and services—including loans. But a poor woman driven by economic adversity has very little power to negotiate interest rates with a microlender. Moreover, because most microloan borrowers operate in informal economies with neither governmental regulation nor governmental protection, they are further disadvantaged. Add to this mix functional illiteracy, financial ignorance, and language diversity, and the likelihood of ethical lending practices taking root in impoverished regions plummets.

Another rule of the marketplace is that as economies of scale take root, operating costs fall and interest rates naturally follow suit. But the example of Compartamos is not promising. In 2005, the corporation clocked a 36 percent operating expense ratio, as compared to a median operating expense ratio of 15 percent for MFIs worldwide, according to CGAP. High operating overheads linked to high interest rates suggest poor management and poor mission commitment.

There is something unseemly about profit-maximizing investors backing an MFI that charges the world's poorest people 100 percent interest.

CGAP and most industry leaders point out that MFIs' rates are far lower than those of neighborhood loan sharks, who in countries like India or the Philippines can charge as much as 20 percent per day. Some MFI leaders also argue that poor entrepreneurs can handle high APRs because they have few or no

other business costs, such as taxes, transportation, labor, electricity, and rent. They note that microloan borrowers do pay back their loans at extraordinary rates—the average worldwide microloan repayment rate is 97 percent in well-managed programs.[4] Even Compartamos boasts a microloan repayment rate close to 99 percent. In comparison, U.S. credit card companies experience 95 percent repayment rates, according to the May 15, 2007, edition of *The Wall Street Journal*. From these data, some industry leaders conclude that MFI loan products are affordably priced, if not necessarily fairly priced.

I agree that interest rates must cover MFIs' expenses.[5] No margin, no mission. But funders, foundations, and governmental agencies should reward MFIs that offer lower interest rates to their customers and shun MFIs that unfairly or injuriously earn profits.

In February 2008, for example, MCE issued a $500,000 loan to IMON (which means "faith" in Tajik), an MFI in Tajikistan. We made this loan—which raised our funding package for IMON to $1 million—precisely *because* IMON had decreased its operating expense ratio from 17 percent to 14 percent. This increase in efficiency allowed the MFI to lower its interest rates about 4 percent without impacting its sustainability.

Social investors can also help. Responsible consumers have learned to consider whether children weave their rugs, sweatshop workers cobble their shoes, warlords mine their diamonds, or underpaid farmers pick their coffee. In microfinance, social investors should likewise consider whether predatory interest rates are funding their high financial returns.

Transparent Accounting

As every investor knows, markets without transparency cannot function efficiently or honestly. The Compartamos IPO brings into focus a disturbing lack of transparency.

Compartamos is not the only MFI that keeps its metrics close to its vest. In February 2008, Financiera Independencia, a Mexican MFI and Compartamos competitor, reported total loan portfolio growth of 49.2 percent for 2007. Although its report includes more than 50 performance indicators and extensive data tables, it does not reveal the interest rates it charges borrowers. Instead, the report ambiguously states: "Interest income rose 44.9 percent … mainly as a result of … [an] increase in interest on loans. The average lending rate … of the total loan portfolio decreased. … This lower rate resulted from the strategy of changing the interest accrual methodology to a revolving line of credit with interest charged on the outstanding loan amount, from a direct interest accrual methodology." The social investor remains hard-pressed to understand Financiera Independencia's interest rates.

Other microfinance organizations, both domestic and overseas, are no more forthcoming when it comes to APRs. Like most MFIs, the respected and very successful ACCION has a Web site that presents a slew of information about lending methods, countries of operation, investment options, repayment histories, numbers of clients, and even donor learning trips. The site also features moving client stories. But the site doesn't say a word about interest rates—including that of Compartamos, in which ACCION was one of the original investors.

ACCION profited handsomely from Compartamos' IPO. María Otero, ACCION's chief executive officer, gives a striking endorsement of the bank: "We hope many other MFIs will be able to replicate [Compartamos'] success, demonstrating that access to financial services for the poor has truly become integrated into international financial systems." Yet she says nothing about the soaring interest rates—sometimes more than 100 percent—that Compartamos charges its borrowers.

To improve transparency in the microfinance markets, MFIs and microfinance reporting agencies such as the Microfinance Information Exchange, CGAP, and credit rating agencies must include data on the range of or average interest rates that individual MFIs charge their borrowers. These organizations do not, as a matter of course, collect or distribute these data. Donors and investors, for their part, should demand this basic information.

Holistic Microfinance

In the hunt for private sector capital, MFIs that dilute their profits to provide free or subsidized general education, business training, women's empowerment classes, and health care will probably fare worse than profit-maximizing MFIs. Inherently, an MFI spending money on nonfinancial, pro-poor "extras" is less profitable. And because markets, as normally defined, are constrained to measure and reward profits in the short to medium term, factoring in nonmonetary metrics is difficult. Indeed, commercial MFI investors may have a legal and fiduciary obligation to evaluate only financial returns.

Yet there is a compelling case for merging banking and social services. Like all businesses, local microfinance institutions must remain competitive, creating ever higher degrees of consumer satisfaction. Education and other services strengthen the microfinance institution-client relationship, giving borrowers an even greater incentive to join the program, repay their loans, and build successful businesses. Education creates stronger business owners. Health care helps borrowers stay productive in the marketplace and take care of their families.

"If you give [borrowers] a loan and don't see that their other needs are met, perhaps they are worse off. They have a debt to repay, but still they have no sanitation, no health care, no education," said Carmen Velasco, president of the MFI Pro Mujer, in a recent article in *The New Yorker*.[6] Similarly, Muhammad Yunus, the founder of Grameen Bank and father of microfinance, notes: "We continue to interpret capitalism too narrowly. … We create a one-dimensional human being to play the role of entrepreneur. We insulate him from other dimensions of life, such as religious, emotional, political dimensions."[7] Indeed, village banking, with its solidarity model, depends on multidimensional entrepreneurs who can compete and cooperate at the same time.

Numerous MFIs have demonstrated that combining microfinance with other social services does not hinder sustainability. A leading example is Crédito con Educación Rural (CRECER) in Bolivia. CRECER's mission is "to deliver integrated financial and nonfinancial services effectively and sustainably." Among its education programs are health improvement and life skills training, village bank management, financial literacy, and citizen rights. Founded in 1999, it serves 90,000 rural and peri-urban clients in 7,000 village banks with a loan portfolio of $23 million as of December 2006. And CRECER has been profitable for years.

Microfinance institutions must reconcile the power of markets to reduce poverty with the power of markets to exploit the poor.

Without policies that encourage them to do otherwise, microfinance funders and investors may redline less profitable MFIs that integrate comprehensive social services with microloans. The industry's benefactors need nuanced investment criteria to help them sort through the estimated 7,000 MFIs worldwide, 73 percent of which have fewer than 2,500 clients.[8]

"There will, for example, be questions about mission," says Ian Callaghan, head of the microfinance group at Morgan Stanley. "But the underlying idea is that finance alone doesn't create the development effects that truly lift people out of poverty. Needless to say, evaluating such fungible definitions can be difficult."[9]

Adding Values

With foreign capital investment in microfinance surging—cross-border investment has more than tripled in the last two years to reach $1.4 billion in 2006[10]—MFIs are poised to harness the power of the market to alleviate poverty. Yet to do so prudently and ethically, they must reconcile the power of the marketplace to reduce poverty with the power of the marketplace to exploit the poor.

The Compartamos IPO reveals that poor people are in no position to speak truth to money any more than they can speak truth to power. As a result, microfinance can spawn interest rates that are offensively predatory.

A common business valuation includes many non-balance sheet intangibles such as goodwill, location, brand reputation, trademark recognition, management competence, and community support. The analogous intangible in the world of microfinance—and its most compelling valuation—is an MFI's social return on investment. In the end, the mission of microfinance is to make a difference in the lives of poor families and to end the scourge of poverty, not build a new asset class based on profiteering.

We in microfinance reject poor management. We reject the lack of accountable performance metrics. And we reject unsustainable charity handouts. But that does not mean we reject our moral compass. We adopt the tools of the marketplace in the service of poverty reduction. But that does not mean we abrogate our individual business ethics or common sense.

Each one of us in microfinance, whether social entrepreneur, donor, or practitioner, has the freedom to act ethically and in accordance with our values. Or not. In the matter of setting interest rates for poor entrepreneurs, we can favor, support, and sustain free markets and we should concurrently use our economic power to advance the cause of economic justice. There is more to microfinance than making money. □

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