Microfinance, Microcredit and Social Performance

The Financial Crisis: Taking Stock

As the end of the first quarter of the year approaches, it might be worth making an initial appraisal.

In the wake of the financial crisis, financial institutions throughout the world have lost almost $1.2 trillion, and in the last quarter alone, equity investors suffered a paper loss of $3 trillion (Bloomberg, 2009).

Among the most notable victims have been Bear Stearns, Lehman Brothers, and to a lesser degree many of the world's top banks: some of which have been rescued by their governments (Royal Bank of Scotland, Lloyds Bank, and UBS, to name a few) and others, like Merrill Lynch, became a liability on the balance sheet of their new owners. Lehman Brothers was allowed to go bankrupt. Citibank shares have fallen from $20 in October 2008 to under $2, and Bank of America shares from $26 to under $6 (Bloomberg, 2009).

These losses were not caused by defaults on loans made to entrepreneurs and local economies – something banks are expected to undertake – but mostly on exotic investment instruments like collaterised debt obligations (CDO's) and leveraged derivatives.

The Irony of banking

All this is ironic. As every entrepreneur knows, banks are generally reluctant to give credit, especially to those starting a business without proper collateral. Hence the saying that the bank gives you an umbrella when it's sunny but not when it's raining. While many small business were being denied credit due to an insufficient guarantee or perceived high risks, banks were quietly losing billions in sub-prime mortgage triple-AAA-rated CDO's which provided an apparent guarantee that the investment was secure.

What about credit for the poor? With few exceptions, the costs of handling microcredits (loans as small as $100), and the perceived risks associated with them, make such poor entrepreneurs "unbankable" and thus of no interest to commercial banks (Council HSR, 2002), not least because it seems unlikely that banking to the poor could lead to the multi billion dollar bonuses that Wall Street and many international banks are so accustomed to.

Microfinance: A simple and socially sustainable idea

The term microfinance covers the provision of financial services as a whole to the poor (Microcapital, 2009). This includes microcredit, microinsurance and savings. The best example of microfinance has been provided by Nobel Laureate Muhammad Yunus in Bangladesh. What is now the Grameen Bank started with an experiment by Prof. Yunus in 1976 to lend his own money to the poor villagers of Jobra turned small entrepreneurs (Armendariz, 2007). Thanks to some innovations like group guarantees provided by cooperatives of small entrepreneurs, and the support of various organizations including the Ford Foundation and the governments of Sweden, Bangladesh, Norway and the Netherlands, from such a small beginning an institution has grown to serve 7.4 million borrowers. The Grameen model has been replicated successfully throughout the world.

The success was partially fuelled by:

The decision of the World Bank to establish in 1995 the Consultative Group to Assist the Poor that included donations from several financial institutions and national governments.

ii) The Microfinance Summit of 1997 when over 1,500 organizations from 137 countries pledged to reach, through microfinance, 100 million poor families. The summit also highlighted that microfinance would be sustainable without continuous subsidies (McGuide & Conroy 2000).

According to the Microcredit Summit Campaign (Microcapital, 2009), as per end 2007 the 3,552 microfinance institutions (a broad terms that includes a diverse set of providers like cooperatives, associations, rural banks, etc,) reached over 154 million clients, thus meeting the objective defined in 1997. To have an idea as to how rapidly microfinance is growing, one need only compare these data to those of 2002 when only 67.6 million clients were reached (Armendariz, 2007). The gross loan portfolio for the period 2004-2006 was reported to be $23 billion (CSR wire, 2007).

Microfinance Critics

Microfinance credit does not come for free. Owing to the high costs involved in serving small loans (transaction costs and costs involving risks of default and collections are similar for a loan of $100 or $1,000), the interest rates are as high as 2-4% per month (ResponsAbility, 2009). Critics like Prof. Adams of Ohio State University (McGuide & Conroy 2000) and Prof. Harper (Harper, 2007) interpret microfinance as essentially a phenomenon that can lead poor people to incur debts which they cannot serve. According to Harper, the model should be first to educate people to save and then to take a loan, as the Raiffeisen rural cooperatives did in Germany and Austria for several of their early years. However, Harper missed the important point that many of the countries benefiting from microcredit are neither Austria nor Germany (Cambié, 2007) and for them a model of Save First, Borrow Later would simply not be applicable.

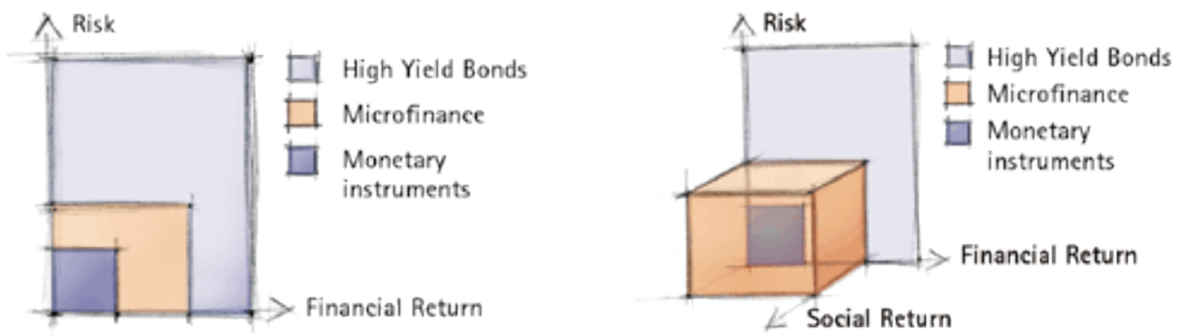
Nor do the critics of the high interest rates tell the whole story. For instance, in Zambia a microlender might provide $150 worth of microcredit at 4% per month interest. If this figure seems inordinately high, we need to consider that i) local money lenders charge 10% per day (!);
ii) the inflationary implications in these countries cannot be compared to those of the developed world; and
iii) the microfinance institutions have to be self-sufficient to cover the high costs of servicing micro loans (ResponsAbility, 2009).

Microfinance as an Investment

In the microfinance world defaults tend to be very low. Grameen Bank has a recovery rate of 98.35% (Grameen, 2009). In general microfinance tends to have low default rates of around 2% of the loan portfolio with low correlation with other asset classes (Dieckmann 2007). Microplace, an online investment marketplace owned by eBay, despite the financial crisis say they have experienced no default with an average 3% rate of return (Microplace, 2009). Institutional and personal investments in microfinance were at around $2 billion in 2007 with an estimated possibility of growth to $20 billion by 2015 (Dieckmann, 2007). A glance at the Swiss funds market highlights how marginal this high growth investment sector currently is: out of 2,135 licensed funds, only one is dedicated to microfinance (SwissFundData, 2009).

According to Dieckmann, microfinance is serving only a fraction (roughly 10%) of the 1 billion micro borrowers throughout the world.

The common stereotype is that lending to the poor is risky. The facts prove the contrary. According to microfinance investment advisor Blueorchard, microfinance investment presents competitive returns, low systematic risk, and due to the high loan diversification, low specific risk (Blueorchard, 2009). The graphic below illustrates that the risk profile in microfinance is slightly higher than monetary instruments but includes a praiseworthy "social return" from giving the chance to entrepreneurs in poor countries to achieve their aspirations and achieve financial independence:

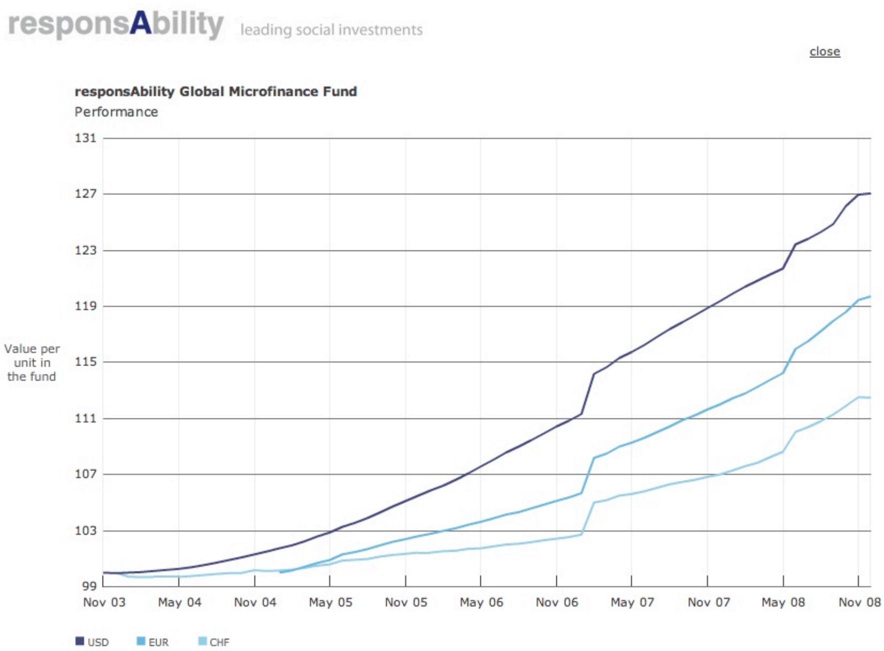


Source: BlueOrchardah but
2009

Although the comparison might sound unusual, I would like to compare two microfinance funds with equities funds.

The first fund is the Dexia Micro CreditFund managed by Blueorchard. The last five years' annualized returns (Swiss Francs class) have been of 3.10%. Since inception (1998), a 20.33% increase. In the last 12 months the fund gained 3.94% (Blueorchard, Feb 2009). In addition to these egregious results, we can also see the social return: over 360,000 microentrepreneurs benefited from loans of the fund.

The Credit-Suisse managed ResponsAbility microfinance fund shares similarly positive results:



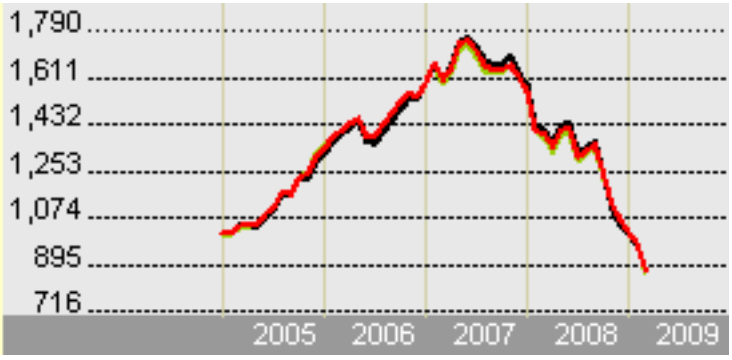
The USD class returned an average annual profit of 4.61%, the Swiss Francs class and Euro 2.24% and 4.45% respectively (the difference is due to currency hedging – a way of protecting against currency fluctuation).

Zürich, 15 March 2009

In the year 2008, probably the worse investment year in the last decade, the Swiss Francs class of the fund returned 4.36%.

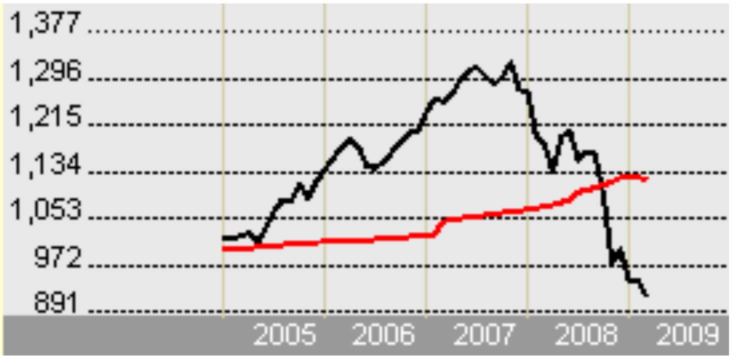
If we compare this microfinance fund with a typical Swiss equities index fund, the Postfinance Suisse fund managed by UBS, we can see not only that in 2008 the equities fund lost 34.4%, but over time would have produced much poorer results:

Growth of 1,000 Swiss Francs invested in the Postfinance Suisse fund



source: morningstar
Since 2005 you would be left with less than 895 Francs

Growth of 1,000 Swiss Francs invested in the ResponsAbility fund



Red Line: ResponsAbility
Black line: average of fonds in the same category
source: morningstar
Since 2005 your 1000 Swiss Francs will now be around 1134

It is also worth noting that the current asset under management in the ResponsAbility fund is $358 million: a stunning growth from the $236 million of March 2008, the $118 million of March 2007, and the $50 million of March 2006.

Conclusions

The returns provided by microfinance funds do have a slightly higher risk profile than money market fund and higher returns. On the other hand, an investment in microfinance provides both social and probable financial returns. While the number of microfinance funds is limited, this is a fast growing market with a great social and financial potential. Despite its critics, microfinance has provided less volatile and more socially quantifiable results than hedge funds and other exotic alternative investment vehicles.

This article might also serve as an invitation to individual investors, banks, endowments, college and pension funds to consider not only financial but also social returns.

More information on this topic and, for our students, how to join the Kiva lending group and becoming a social banker with just $25 are available on the website www.microfinance.fm

Notes:

Becoming a Solidarity banker

Thanks to the not-for-profit organization Kiva.com, anyone can become a microbanker with a simple $25 loan. Interest is not paid to the lender (nor to Kiva) but to the local field partner. The Kiva website allows lenders to select a specific, real entrepreneur to lend to. The simplicity of this system makes it an ideal platform for participating in and contributing to the microfinance world.

I invite you to join the Robert Kennedy College lending group which I have created. Go to www.microfinance.fm), where instructions and links to join and lend are provided.

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