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The battle for the soul of microfinance

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Bob Annibale's corner office, high up in one of London's few real skyscrapers, overlooks the Thames and the Millennium Dome from one window, Greenwich Park and the Royal Observatory from another. It is the kind of enviable perch you'd expect Citigroup's senior treasury risk manager to enjoy. But that is the job Annibale left three years ago; now he is Citi's "Global Director of Microfinance".

Microfinance, the system of providing tiny loans and savings accounts to the poor, seems an unlikely and somewhat ironic candidate for Citigroup's attention. It was because banks weren't interested in serving the poor that the pioneers of microfinance saw a gap to be filled, back in the 1970s.

The most celebrated microfinance institution, the Grameen Bank, was born in Bangladesh in 1976 after a young economics professor, Muhammad Yunus, discovered that craftswomen were struggling to deal with the high costs of borrowing in order to buy raw materials. Village moneylenders charged up to 10 per cent interest per day. At such rates, a debt of a single cent would balloon to the size of the US economy in just over a year.

Yunus began lending – originally, less than a dollar each to a group of 42 families – and found that the poor were capable of investing the money, lifting themselves out of poverty and paying back the loans with near-perfect reliability. "All people are entrepreneurs," he proclaimed.

From small beginnings, a global movement has developed, with perhaps $25bn of loans outstanding and 125 million-150 million customers of microfinance institutions. It has been blessed by the United Nations, which declared 2005 the International Year of Microcredit, and by the Nobel committee, which awarded the Nobel Peace Prize to Yunus and the Grameen Bank in 2006.

Now multinational banks at last see microfinance as a profit opportunity. "Colleagues asked me if was giving up a business role," says Annibale, who became Citi's first microfinance chief in 2005. "I'd say, 'No, I'm taking up a new one'." He plans to make money for Citigroup by providing technology, advice and investment banking services to microfinance lenders. And so far his division has been unaffected by this year's market turmoil.

A history of microfinance

1300+
Forms of microfinance and collective lending have existed for hundreds of years. These include the "susus" of Ghana, "chit funds" in India, "tandas" in Mexico, "arisan" in Indonesia and "tontines" in

The Citigroups of the world are not the only commercial players to get involved in what was once a purely philanthropic endeavour. Sequoia Capital, the venture capital fund that backed Google, Apple and Cisco, has taken an $11m stake in SKS Microfinance, a large Indian lender. Private equity groups such as Helios Capital are making similar moves. Pierre Omidyar, founder of eBay, gave $100m to Tufts University in 2005 with the stipulation that the donation be used to create a fund seeking its returns only through investments in microfinance. The fund's director, Tryfan Evans, recently predicted that it would be fully invested by the end of this west Africa, **writes David Patrikarakos.**

1865
Friedrich Wilhelm Raiffeisen develops the concept of the credit union. From 1870, unions expand across the German states. The co-operative movement spreads to Europe, north America and developing countries.

1895
Indonesian People's Credit Banks or The Bank Perkreditan Rakyat (BPR) opens, specialising in an early form of microfinance. Today it is the largest microfinance system in Indonesia, with 9,000 operations.

1961
With $90,000 raised from private companies, Joseph Blatchford founds Acción International in Venezuela. Initially concerned with building schools and water-systems, it turned to microfinance in 1973. It becomes one of the premier microfinance organisations in the world.

1971
Al Whittaker and David Bussau begin lending to micro-entrepreneurs in Indonesia and Colombia. In 1979 they form Opportunity International, lending across south-east Asia and South America.

1976
Muhammad Yunus discovers that a loan of $27 can change the lives of 42 families in an impoverished village in Bangladesh. They pay him back with interest and begin to lift themselves out of poverty.

1983
Yunus creates Grameen Bank. To date, it has lent more than $983m. Its methods have become the basis for modern microfinance.

1992
Acción helps found

year.

Most surprising and controversial are those microfinance institutions that have been transformed from charities to profitable companies through hugely successful initial public offerings. The most notorious, Mexico's Compartamos ("Let's Share"), used a $6m investment to turn itself into a billion-dollar company in less than a decade, expanding rapidly while charging very high rates to borrowers. What was once an idealistic movement is now a fast-growing industry, and one that is rapidly losing its innocence.

The commercialisation of microfinance has sparked a fierce debate between profit advocates such as Carlos Danel and Carlos Labarthe, the founders of Compartamos, and traditionalists such as Muhammad Yunus, who see microfinance lenders such as Compartamos as indistinguishable from the moneylenders he set out to replace in 1976. Between these two poles lie the majority of microfinance practitioners, eager to gain access to capital and commercial expertise, but concerned that competitive market forces may not help the poorest.

Commercialisation is a huge opportunity to lift people out of poverty. Despite the credit crisis, most of us take for granted the ability to save, to borrow for emergencies or to buy assets, to move money around and to insure ourselves. But several billion people lack these basic, life-improving services. The microfinance industry today serves fewer than one in 10 of them. Few people believe microfinance can grow quickly enough under its own steam without adopting a more commercial model.

It is not just that commercialisation would provide plentiful access to foreign capital – although that is likely – but also that expertise from commercial players might allow microfinance lenders to move beyond simple loans. If lenders could take deposits, they should easily be able to fund their own loans: many poor people are would-be savers who lack a safe place to put their money. But as the credit crisis has made clear, deposit-taking is a difficult business requiring regulatory supervision even in rich countries. Commercial expertise is therefore indispensable for a deposit-taking bank.

Yet this is also a dangerous moment. Microfinance is a way of harnessing market forces to bring basic financial services to the poor, but many microfinance institutions do much more than that. Using donor funds or reinvested profits, coupled with their reach into remote villages, they provide subsidised education, healthcare and business advice. There is a risk that commercial logic could threaten these subsidised services by repelling donors or poaching the best customers. There is also the risk that competition misfires, leaving the poor paying higher interest rates, rather than lower ones.

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More than 500 years before the birth of modern microfinance, Franciscan monks in Perugia, Italy, developed their own method of social finance. They would lend money to the poor in times of crisis; as collateral, they would hold some precious item and

BancoSol of Bolivia, the first commercial bank dedicated solely to microfinance. It now has more than 70,000 clients.

1997
The National Microfinance Bank in Tanzania (NMB) is created. Meanwhile, Deutsche Bank enters microfinance as part of its drive to embrace social investing.

2001
The Microenterprise Access to Banking Services initiative in the Philippines helps integrate rural banks' microfinance loan clients into the credit system.

2005
The UN names 2005 the International Year of Microcredit. Citibank opens Citi Microfinance. Based in London, New York, India and Colombia, its goal is to broaden the outreach of its financial services.

2006
The Microfinance Summit Campaign Report estimates that there are more than 3,000 microfinance institutions serving 100 million poor people in developing countries. The total cash turnover of these institutions worldwide is estimated at $2.5bn. Yunus is awarded the Nobel Peace Prize. Barclays Launches Ghanaian Microfinance, tapping into one of Africa's most ancient forms of banking, "Susu collection". International Finance Corporation, part of the World Bank, announces a $45m investment in credit-linked notes to be issued via Standard Chartered bank to facilitate microfinance lending in Africa and Asia.

2007
JP Morgan launches a microfinance unit as part of its emerging markets strategy.

charge a fee for its safekeeping to cover their operating costs. The idea was endorsed by the Pope and widely emulated. The monks called the fund a "Monte di Pietà", a Fund of Mercy. Today, we would call it a pawnshop.

This cautionary tale – told by Larry Reed of the Boulder Institute of Microfinance – resonates in a social movement that is sharply divided over how to respond to commercialisation.

The crisis was provoked by Compartamos's initial public offering in April last year. Compartamos was founded in 1990 as a non-profit, but after a decade converted itself into a profit-making company, with investors including Acción International, which is part-funded by the United States Agency for International Development (USAID) and the International Finance Corporation, which is the World Bank's private sector lending arm. (Disclosure: I used to work for the IFC.)

Many microfinance initiatives have a profit-making structure, including Yunus's Grameen Bank; what was unusual with Compartamos was just how profitable it turned out to be. The initial investments of about $6m, between 1998 and 2000, were worth about $1.5bn at the time of the public offering in 2007. That valuation was justified by a combination of fast growth and high interest rates. Just how high is not quite clear – to their discredit, it is rare for microfinance lenders to report such things – but a report from the Consultative Group to Assist the Poor, an independent microfinance think-tank housed by the World Bank, estimated that Compartamos charged interest rates of more than 100 per cent APR (or annual percentage rate), after tax.

That is not as usurious as it might seem. Most microfinance lenders charge rates that would make credit-card companies blush – often more than 30 per cent a year – because small, short-term loans are costly: a loan of $50, borrowed at an annual interest rate of more than 50 per cent and repaid over four months, will produce less than $5 in interest repayments. That isn't much to cover overheads. Yet Compartamos was so profitable that it could have lowered rates without jeopardising its expansion. It chose not to.

Yunus's response to that was little short of an excommunication. He declared himself "shocked" by the public offering. In a documentary on US public television, he described his attitude to the profit motive in microfinance. "You [profit-focused microfinance practitioners] are on the moneylender's side. Because your aim is the moneylender's aim. Your thinking is the moneylender's thinking. So I don't want to associate with you, I want to battle with you and to fight you."

Compartamos itself was silent on the subject for a long time, eventually producing a response that defended its motives, beliefs and mission more than a year after the public offering. The language of the battle had been defined: a lexicon of mission and motives, them and us, good and evil. "Yunus is concerned that his legacy, even the language of microcredit, is being appropriated," says Jonathan Morduch, a microfinance expert based at New York University. "But the rest of the world doesn't care and shouldn't care."

There is nothing intrinsically sinful about pawnbroking or intrinsically holy about microloans. What matters is the effect on the clients. And to our discredit, we don't really know what that effect is. There have been only two serious cost-benefit analyses of microfinance – and they've produced a split decision as to whether, given the subsidies involved, microfinance delivered value for donor dollars.

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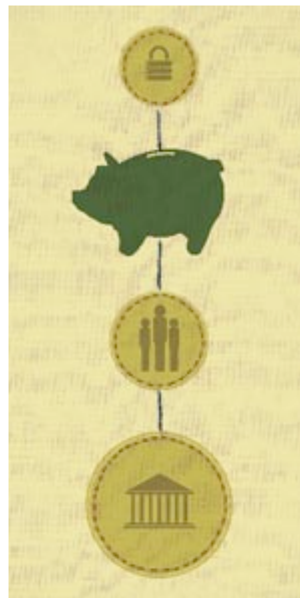
Dean Karlan, a microfinance economist at Yale, is frustrated by this lack of serious research into what works. He also thinks that Yunus's talk of "the moneylender's thinking" is unhelpful. "I don't care why the bank is doing what it's doing," he says. "If you're trying to make the world a better place but you're not, that's bad. If you're trying to make profits and don't care about people, but make them better off anyway, that's good."

So, can you lift people out of poverty by lending money to them at 100 per cent APR? Karlan, with Jonathan Zinman of Dartmouth College, is behind one of the few pieces of research to hint at an answer.



In South Africa, in autumn 2004, Karlan and Zinman persuaded an anonymous consumer finance company that we'll call "ZaFinCo" to participate in an unusual experiment. Ordinarily, almost half of ZaFinCo's borrowers would have been turned away as a bad credit risk. But for two months, ZaFinCo loan officers were instructed to identify marginal applicants who had narrowly failed to pass credit checks. From this pool of near-customers, a computer selected almost half and requested that the branch manager reconsider and offer a loan anyway.

This procedure emulated the way that new medicines are tested, using randomised trials. These trials are a gold standard for evaluation: after all, a more typical, non-random comparison of borrowers versus non-borrowers would not be able to tell whether borrowers were doing well because they had access to loans, or because they were confident, risk-taking, entrepreneurial people.

Karlan and Zinman wanted to know what value there might be in expanding access to credit. ZaFinCo was no dewy-eyed social business, but a hard-nosed, profit-minded company, charging 11.75 per cent per month on a four-month loan, or 200 per cent APR, much more than Compartamos was generally judged to have been charging.

Despite the high rates, the results were astonishing. "We expected to see some good effects and some bad," explained Karlan, who checked in with the experiment's participants six to 12 months after they had filed their initial loan applications. "But we basically only saw good effects."

Most strikingly, those "treated" by the experiment – that is, those for whom the computer requested a second chance at a loan – were much more likely to have kept their jobs than the control group. They were also much more likely not to have dropped below the poverty line, and were less likely to have gone hungry. All these outcomes were recorded well after the loan had been taken out and (usually) repaid, so this was not measuring a temporary debt-funded binge.

This seems mysterious. How can a loan at 200 per cent APR help people to stay out of poverty? One answer is that most people turned down for a 200 per cent APR loan would be able to get one at 300, 500 or over 1,000 per cent from an informal moneylender. More important is that these loans were not used to start businesses but to help people keep jobs that they already had. If a smart new blouse or a spare part for the family moped is what it takes to stay in work, then who is to say that an expensive loan isn't a wise investment?

Karlan is the first to warn against extrapolating too much from a single experiment. “This is the last thing in the world that I would use to develop policy,” he warns. “You’ve got to replicate.”

The trouble is that the replication just isn’t happening. For all the optimism about microfinance – and the ZaFinCo experiment only encourages that optimism – it is striking how much we do not know about when it works, and why.

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This matters because non-commercial microfinance projects often depend on donor subsidies. And while microfinance has a good reputation among development professionals, that doesn’t mean guaranteed access to those subsidies. Not everyone is convinced that a donor grant is best used to subsidise a loan rather than, say, pay directly for a primary school. More credible evaluation would help preserve the programmes that deserve to be preserved.

Already, solidly held beliefs about microfinance have been shaken. The “group liability” system, in which a group of borrowers guarantee one another’s loans, is still supposed by many to be the secret behind Grameen Bank’s low default rates. But a randomised trial in the Philippines conducted by Karlan and a World Bank economist, Xavier Gine, found that group liability was discouraging new customers without improving repayment rates. Grameen itself quietly dropped group liability some time ago.

Another sacred cow of microfinance is that women make best use of the money – the Grameen Bank says that 97 per cent of its borrowers are women. But another randomised trial, conducted in Sri Lanka by a team of researchers including David McKenzie of the World Bank, found that male borrowers seemed to make a far higher return on their capital. As with the ZaFinCo study, it’s just one experiment in one country. Yet it raises a worrying question: for how long will donors fund microfinance projects with so little compelling evidence about exactly what kinds of project really work?

While many non-profit microfinance institutions depend on donor subsidies to cover overheads, reduce interest rates, or provide a range of parallel programmes that piggyback village banking, some use profits from the best customers to cross-subsidise their other operations. These parallel programmes can be vast. BRAC, a Bangladeshi microfinance organisation often called the world’s largest NGO, provides primary education, mobile libraries, legal aid and health services, all on an astonishing scale. But what is the future for such programmes in the face of commercial competition? Cross-subsidies are rarely sustainable in a competitive market: the commercially-minded banks will simply lure the best customers – they will tend to be those borrowing the largest sums, and with the best credit records – by offering them better rates. And why shouldn’t they?

The trouble is that the world cannot rely on commercial operations alone; they will miss far too many people. ZaFinCo’s clients were ideal customers for a commercial lender: they were city-dwellers and therefore cheap to reach; they were poor enough to want loans but rich enough that the loans were profitably chunky. A peasant farmer in Ethiopia or Sudan ticks none of those boxes: living in the middle of nowhere, he is expensive to reach and he is so poor that he can only afford tiny loans. Trapped in a barren economic ecosystem, he has no job that a ZaFinCo-style loan can help preserve, and no business prospects either. A mere loan will not catapult him into the ranks of the entrepreneurial class. Then there are the destitute, the disabled, the elderly and the orphans. Such people cannot repay loans at a rate that would cover costs. Heavy subsidies or outright grants would be needed. “All people are entrepreneurs,” says Muhammad Yunus. If only he were right.

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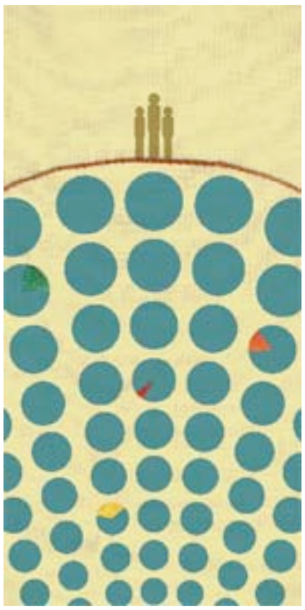
At least commercialisation seems likely to help those borrowers who can be served on commercial terms. After all, if even a 200 per cent APR loan can help moderately poor customers, surely anything goes as long as the market expands? Sadly, the truth is not so easy. The ZaFinCo study showed not that loans at 200 per cent are good for everybody, merely that they are good for the people who choose to apply for them – in other words, that ZaFinCo's borrowers knew what was good for them. Most people will only be helped by loans at lower rates. Competition should bring down those rates, of course, and one of the strongest defences of Compartamos is that its success is already attracting competitors with exactly that effect. Healthy competition is a far better protector of consumer interests than good intentions.

The trouble is transparency. Competition works best when customers know what they're paying and what they're paying for, which is why lenders in the US have been required for the past 40 years to disclose their interest rates in a standardised format. Few microfinance institutions do the same thing, and the results can be baffling. "You have a borrower comparing two institutions across the street from each other, and she can't tell which has the cheaper product," complains Chuck Waterfield, the founder of a non-profit called Microfinance Transparency. "You couldn't. Nobody could."



One common practice is to charge "flat interest", which means borrowers pay interest calculated on the initial loan amount, rather than the declining balance as the loan is gradually repaid. The apparently small tweak almost doubles the effective interest rate. There are others, each of which raises effective rates and muddies the waters.

None of this necessarily means that loans are overpriced, but the lack of a standardised format for reporting loan costs is intrinsically objectionable. It makes it hard to compare what different lenders are offering, so it is an obstacle to competition. Commercialisation without effective competition will help nobody.

It is, in any case, misleading to think that the only aim should be to provide, sustainably, as many cheap loans as possible. That would be the impression gained from Muhammad Yunus, who always emphasises "microcredit" rather than "microfinance". But there is more to finance than credit: even the Grameen Bank has now moved away from pure microcredit to provide a wider range of financial services. That is the right thing to do. Think for a moment about the financial services you enjoy yourself. Loans are useful, to be sure, but probably more valuable to you is the ability to save towards your pension. A checking account dramatically reduces the risk and trouble of using cash to settle all your bills. Then there's insurance. In fact, if you did not have the ability to save or to insure yourself you would be forced to rely on loans to handle emergencies.

"There is lots of evidence suggesting that poor people would rather save, turning small amounts into a lump sum, rather than borrow a lump sum and then pay it back," explains Elizabeth Littlefield, the head of the CGAP microfinance think-tank. "But the only way you can offer a safe place to save money is if you have sound, government-licensed, well-governed institutions. And that is what commercialisation really means."

As microfinance institutions move into deposit-taking, the stakes become higher and the challenges more complex. Governments almost always impose arduous regulations on deposit-taking institutions, and understandably so: just imagine what will happen if the manager of a microbank in Peru or Pakistan or Nigeria decides to use his customers' deposits to fund his retirement. Yet governments, especially in the world's poorest countries, are not famous for their ability to draft the kind of light-touch regulation that will allow a fledgling microbanking industry to spread its wings.

The irony is that if microfinance institutions are able to find a way to provide savings accounts to the very poor – despite sceptical regulators, a difficult business environment and tiny transactions – they will not need much of the foreign capital that commercialisation was supposed to provide. Most poor households are savers, or would like to be. Many poor countries are savers. All that is needed to raise the capital for making fresh microcredit loans is a successful deposit-taking bank for the poor.

The future of microfinance, we must hope, will be one in which the poor enjoy the financial services that surround and support the rest of us. For the poorest, subsidies will still be necessary, and the industry is running out of excuses as to why rigorous trials are still so rare. But Yunus and his fellow pioneers have shown that many poor people can be served profitably by commercial organisations.

Making that vision a more widespread reality will require less finger-pointing, and more thought about how competition really works. The problems of the microfinance industry are beginning to look more like the problems of the retail banking industry in a developed market: accessing wholesale capital, protecting consumers, safeguarding deposits and making competition work for customers. The global credit crisis has reminded us that these are not trivial problems – but beyond doubt, they are symptoms of success.

Tim Harford is a senior columnist for the FT. His most recent book is ‘The Logic of Life’