



Building on Success: The Next Challenges for Microfinance

By Henry Wendt and Robert Eichfeld

The growing microfinance sector has had astonishing success in harnessing capital markets to alleviate global poverty where it exists. Expanding microfinance and integrating it with the global banking system have the potential to open doors of economic opportunity for hundreds of millions and unite communities in civil society networks.

In 2001, approximately 2.7 billion people—43 percent of the world's total population—were living on less than \$2.15 per day. Of that number, a little more than 1 billion survived on \$1.08 or less. Unfortunately, official development assistance—with its emphasis on top-down solutions and grand plans intended to “eliminate” poverty—has had little systematic impact in aiding these individuals,¹ in part because their circumstances tend to be embedded in their local histories, politics, geography, and customs, and consequently, they are difficult to change from the outside.

More promising, therefore, are policy approaches that emerge from the ground up from within the developing world. One such example is “microfinance,” a phenomenon that developed out of a 1976 field trip to a poor village in southeastern Bangladesh by Muhammad Yunus, a young Bangladeshi economist from Chittagong University. Yunus and his students came upon a woman named Sufiya Begum making bamboo stools. She had to borrow the raw materials from a trader, who

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dictated the price he paid for the final product, leaving her with just a few pennies of profit.

Faced with this “micro”-level example of the depressing cycle of poverty, Yunus began experimenting with ways to make small loans available to the poorest of the poor and gave a total of less than \$27 from his own pocket to forty-two individual basket weavers. Finding not only that they survived with so little help, but also that his capital ignited the spark of personal initiative, enterprise, and hope that enabled them to lift themselves out of poverty, he began providing “microloans” to the very poor in neighboring villages.

In 1983, Yunus formed Grameen (meaning “Village”) Bank. Its business focused entirely on providing very small loans to impoverished people, mostly women, who organized themselves into small groups of five to help, reinforce, and supervise one another. Loans were typically less than \$80 for first-time borrowers, in contrast to commercial loans that would typically be larger than \$800. Before Grameen Bank, moneylenders were the only source of finance for the poor, and they charged very high interest rates. Those not in absolute poverty could join credit cooperatives, but the amount they could borrow was often too small to meet their needs. Conventional

banks were rarely an option since they required collateral, which most poor people did not have, and they required a great deal of paperwork, which the poor often found intimidating.

Grameen Bank primarily targeted women because Yunus found they were more likely than men to use the loans for productive purposes and repay them. Perhaps this was due to the fact that women in Bangladesh found it much more difficult to access financing from any source and therefore considered this access to credit extraordinarily valuable. Also, women tended to reinvest their profits and use them to improve the lives of their families, thus multiplying the impact of each loan.

Since its modest beginning, Grameen Bank has grown significantly. Today it has 1,512 branches, with 15,000 staff members serving 6 million borrowers in 52,829 villages in Bangladesh. On any working day, the bank collects an average of \$1.3 million in debt-payment installments. Ninety-six percent of the borrowers are women and over 98 percent of the loans are repaid, a recovery rate higher than that of any other bank in Bangladesh—and significantly higher than that of most consumer-loan portfolios in the United States.

Early on, Yunus articulated a set of principles for Grameen Bank's operations that have inspired many other microcredit organizations today. Briefly summarized, these principles are as follows:

- The sole mission of Grameen Bank is to help poor families help themselves to overcome poverty. Only the poor, and especially poor women, qualify as clients.
 - Loans are offered for income-generating activities and for housing, not for consumption.
 - The relationship between the bank and the customer is based entirely on mutual trust; there are no contracts and no collateral.
 - All loans are to be repaid on a regular schedule, usually weekly or biweekly.
 - To obtain a loan, a borrower joins a group of others like herself, usually other poor women in the village or neighborhood.
 - Loans are available in sequence. Once a loan is repaid, the borrower is eligible to receive another loan.
- The interest rate is kept as low as possible, usually close to the interbank rate, thus assuring sustainability of the bank without punishing the borrowers. Interest rates are usually several percentage points lower than rates charged by other banks for consumer loans.
 - High priority is consciously given to building social capital. The focus on tightly knit “borrower groups” of five women who support each other is a common feature. The borrowers also elect the leaders of the groups and some members of the bank’s board of directors from among themselves, and borrowers are otherwise fully engaged in the activities of the bank, as well as those of their individual enterprises.
 - The bank comes to the borrower rather than requiring the borrower to visit the bank branch.
 - The bank promotes credit as a human right. According to the principles of Grameen-style microfinance, nobody should be denied access to credit on the basis of income.

Since its inception thirty years ago, Grameen Bank has seen its business model replicated in numerous microfinance organizations (known as microfinance institutions, or MFIs) throughout the world, spanning Latin America, Africa, the Middle East, and Asia. Bangladeshis are predominantly Muslim, but the model has taken root among people of every major religion, cultural identity, and race.

In the early 1990s, the World Bank commissioned a comprehensive study of microfinance and focused on three of the largest programs in Bangladesh: Grameen Bank, BRAC, and RD-12. It concluded that the women who were clients of these three institutions increased their household consumption by 18 percent and that by borrowing and participating in microfinance programs, 5 percent of clients escaped poverty each year.² Other findings, such as those of the Assessing the Impacts of Microenterprise Services (AIMS) Project of the United States Agency for International Development (USAID), have documented similar successes of microfinance programs in India, Zimbabwe, Peru, and the Philippines. In the case of India, clients of the MFI SEWA Bank were shown to have higher household incomes and higher annual growth rates than non-clients.³ Clients of the MFI Zambuko Trust in Zimbabwe

were found to have higher average monthly household incomes and lower poverty rates than non-clients.⁴ Results from Peru showed that clients of MFIs earned \$266 more per household member per year than non-clients.⁵ In the Philippines, 22 percent of the MFI ASHI's clients escaped poverty altogether, as opposed to two percent of non-clients.⁶

In addition to alleviating extreme poverty, MFIs have been found to generate another important benefit. By observing the ten principles first articulated by Yunus, microfinance can create social capital by promoting horizontal and vertical networks of workers within a community, establishing new norms of behavior, and fostering a new level of social trust.⁷ Social capital can be defined as the collective value of "social networks" and the inclinations that arise among their members to do things with and for each other. The creation of such social capital improves the ability of communities to tackle other problems such as schooling, environmental degradation, and lack of medical care, and enables the people to do so on their own terms, rather than on the mandates of distant authorities.

The Grass Is Growing—Rapidly

When Yunus founded Grameen Bank thirty years ago, there was little expectation that it would develop beyond a cottage industry. Initially, microfinance projects were funded by a few philanthropic individuals and nonprofits. As the years passed, government organizations, development agencies, and some private foundations also began to support the effort. The technology boom of the 1990s provided the information systems necessary for managing bigger portfolios and new products, while leading financial institutions and organizations that gather funds for microfinance, began to set standards and improve governance within the industry.

An important turning point in the history of MFIs took place in 1997, when 2,900 delegates from 137 countries met at the first Microcredit Summit and set the goal of providing microcredit to 100 million of the poorest families in the world by the end of 2005. At that time fewer than 8 million families were being reached. As of the end of 2004, by contrast, 92 million poor and 62 million of the poorest were being helped. If the program continues to grow at its historic rate of 39 percent annually, the Microcredit Summit goal will be reached as early as 2007.⁸

Today, several large microfinance institutions have established themselves as leaders and innovators. Some

have transformed themselves into regulated financial intermediaries and are candidates to go public in the not-too-distant future. They have begun to access private capital markets and are demonstrating that microfinance portfolios can become a low-risk class of assets that will garner the attention of mainstream investors. Evaluated according to a set of benchmarks—such as

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outreach, net income, operational self-sufficiency, and portfolio yield—and established and tracked by the Microfinance Information Exchange (the MIX Market), these institutions have demonstrated high performance and have prospects for a bright future. The microfinance industry also tracks the social performance of MFIs, using tools like the Poverty Progress Index (PPI) developed by the Grameen Foundation, which advocates Grameen Bank-style microfinance around the world. The PPI provides data on client poverty levels and how they change over time, so that MFIs are able to evaluate progress in achieving their social goals.

Like any newly emerging industry that has grown rapidly, microfinance has reached a stage at which consolidation is bound to occur, particularly among the top two or three hundred microfinance institutions. Some will become banks, integrated into the formal financial sector; at the same time, established commercial banks and other financial institutions will enter the microloan market.

Capital Markets to the Fore

In order to deliver on its potential to reduce poverty, microfinance now needs to do three things simultaneously: First, it needs to scale up rapidly, especially in those regions that are home to large numbers of the world's poor. Second, it must realize its potential as a broad platform and social movement. Third, microfinance must tap additional philanthropic, quasi-commercial, and most importantly, commercial financing. It is this third element that will promote the first two goals. Increasingly, commercial institutions must

represent the largest source of financing if the microfinance industry is to scale up appreciably.

Subsidized financing, long an important source of funding, is now insufficient for growth. The World Bank's Consultative Group to Assist the Poorest estimates that less than 5 percent of total demand for microfinance is being met, while a white paper published by Social Enterprise Associates, entitled *The Business Case for Investment in Microfinance*, estimates the market demand for microfinance services is more than \$300 billion. Market supply today, by contrast, is only in the \$4 billion range.⁹ Despite the important and catalytic role played by the international donor community in promoting microfinance, it has invested a little over \$1.5 billion in the sector and allocates an incremental \$1 billion per year in new financing.¹⁰ This falls far short of meeting demand. Viewed in this light, it becomes obvious that only the commercial financial markets have the available resources to produce optimal growth.

Microfinance institutions that have demonstrated financial and operational sustainability and good corporate governance and have produced a wealth of business data have already begun to benefit from a number of pioneering financial transactions. Bond and debt issues in U.S. dollars and other hard currencies have been consummated, as have debt issues in local currencies (in

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Mexico, for instance). Credit facilities in various local currencies have been extended. Commercial banks have begun to partner with MFIs in innovative ways, including mutual outsourcing arrangements whereby the MFI performs all of the lending operations and the commercial bank books the risk on its own balance sheet.

Still, creditworthiness remains a major issue. Because microfinance—in spite of its track record—has not yet been generally recognized as an asset class with a history of high portfolio quality and low correlation with major economic events in both domestic and international markets, commercial lenders and investors are requiring that any capital market transactions be backstopped with some form of collateral. This has taken the form of cash,

first-loss letters of credit, government- or aid-agency support, or other forms of security such as letters of guaranty provided by socially responsible investors through their banks. A letter of guaranty is potentially a highly effective way to bridge philanthropy and capital markets and to generate large amounts of medium- to long-term finance at market rates with little foreign exchange risk for both the investor and the microfinance institution. With their attributes of low cost and low risk, such instruments are attractive to both the rapidly growing MFI and to those looking to help transform the industry and to promote the growth of capital markets in developing countries.

A Groundbreaking Deal

In January 2004, a landmark loan-portfolio purchase agreement—a precursor to securitization, which transformed the way commercial banking was done in the developed world twenty years ago—was signed by ICICI Bank, India's largest private commercial bank, and SHARE Microfin Ltd., a leading microfinance institution. Established in 1991, SHARE is based in Andhra Pradesh, India, where as many as 45 percent of its 75 million citizens live in poverty. The institution has experienced rapid growth since transforming itself in 1999 into a non-bank finance company (a type of regulated financial institution) and has grown from eight branches and 8,136 borrowers in March 2000 to 108 branches and 212,838 borrowers four years later. Cumulatively, SHARE has loaned its very poor clients more than \$81 million, with \$18 million in loans currently outstanding and an excellent credit history. The average loan size is less than \$150.¹¹ Over the next five years, taking advantage of the financial leverage of the commercial credit markets, SHARE intends to expand fivefold, growing to 475 branches, with a total loan portfolio of about \$120 million, to reach 1 million very poor households.

After months of planning, analysis, and negotiation, ICICI acquired 25 percent of SHARE's microcredit portfolio of loans. Under the agreement, ICICI agreed to pay \$4.3 million to SHARE for a portfolio of 42,500 small loans, the deal being similar in concept to the way car loans and home mortgages are resold in financial markets in more developed countries. SHARE, which operates along the lines of the original principles of Grameen Bank, will use the \$4.3 million as new capital for expanding its microcredit lending activities to

approximately 50,000 new female clients. The effective cost of this new capital to SHARE was nearly 4 percent less than the interest rate it typically pays on commercial bank loans to finance its growth. This agreement was facilitated by technical assistance and a risk capital, first-loss, collateral deposit by Grameen Foundation of \$325,000 (about 8 percent of the purchased loan portfolio). Consequently, the loans in the acquired portfolio, for which SHARE maintained collection responsibility, remain unencumbered and offer attractive interest rates—both important attributes to the clients.

The agreement made good business sense for ICICI Bank, which could, through SHARE, enter a hard-to-reach market: the poorest of the poor. It also helped the bank meet its government-mandated target for lending to so-called priority sectors (a concept similar to that of the Community Reinvestment Act in the United States). *The Economist* reported on this transaction, noting the deal's high leverage: "Grameen [Foundation] sees its cash deposit multiply twelvefold on its way to the poverty stricken borrower."¹²

With this transaction, ICICI Bank emerged as a pioneer in the kinds of sophisticated, cross-sector financing arrangements that will enable well-managed, poverty-focused microfinance institutions to continue their growth. The transaction set the stage for similar deals to fuel the rapid expansion of MFIs.

An Unusual Conclave

In November 2004, Grameen Foundation organized a small conclave to evaluate the problem of world poverty—specifically, how best to use the global financial system to increase the funds available for microfinance to the very poor. The meeting convened in San Francisco and included a distinguished group of Fortune 100 executives, Silicon Valley entrepreneurs, experienced venture capitalists, along with Muhammad Yunus.

They concluded that one tactic afforded immediate opportunities to provide the advantages of scale to local microfinance institutions: access to guarantees that would protect MFIs against fluctuations of foreign exchange rates and with access to local financing. Historically underused, guarantees offer one of the quickest ways to accelerate the expansion of creditworthy high-growth institutions. Organizations such as Grameen Foundation, for example, can leverage a standby letter of credit backed by an individual's investment portfolio at

any commercial bank. The foreign exchange risk in non-dollar economies is a significant barrier to the use of commercial bank loans originating in dollar-denominated securities. As a result, multinational corporations routinely cover the foreign-exchange risk in dollar-denominated loans to their overseas subsidiaries, thereby reducing the cost of capital for the local enterprises. Similarly, individuals or organizations willing to guarantee the exchange risk will permit local microcredit organizations that are working in non-dollar currencies

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to reduce the cost of capital significantly. These two strategies are among those commonly employed in commerce and business to lower the cost of capital and increase leverage with the prudent use of debt. Their application in microfinance is a sign of the maturity and creditworthiness that many local MFIs have earned through performance.

A few weeks after the meeting in San Francisco, Grameen Foundation, working in partnership with Citigroup, developed the concept of guarantees to catalyze local currency financing for microfinance and brought the results to the attention of potential guarantors, including some who attended the meeting. Through a program called Grameen Foundation Microfinance Growth Guarantees, individuals pledged marketable securities to their bank of choice or used margin accounts to enable the bank to issue a letter of credit through Citigroup to local microcredit institutions for the specific purpose of raising leveraged local currency financing for microfinance institutions. The guarantees have the practical consequence to local microcredit institutions of reducing the cost of capital by as much as 100 basis points.

This innovative approach offered participants in the original meeting the opportunity to advance their role beyond strategy to action. In fact, many pledged millions of dollars against their personal balance sheets to insure the risk of exchange losses on loans to creditworthy microfinance institutions. The first \$31 million round of Grameen Foundation Growth Guarantees closed in October 2005; the total program size is expected to be \$50 million. This vehicle has the potential of

unlocking up to \$300 million in capital for microfinance institutions.

Financing One Billion Very Poor People

Ultimately, the key to unlocking capital market financing is contained within the microfinance story itself: potential investors and bankers need to be made aware of the MFIs, become familiar with their principles, and be apprised of their success.

Over the past three decades, microfinance has proved that small loans to the poor (and especially to poor women helping one another as a group), when administered in a systematic and positive manner, can create sustainable economic businesses. Within a three- to five-year period, these small, privately owned businesses begin to generate discretionary income that is used to secure education, health care, transportation, better nutrition, clothing, and other consumables for the entrepreneurs' families. This reinvestment of earnings in turn creates a generally rising level of prosperity and social cohesion at the village level.

In *The Fortune at the Bottom of the Pyramid*, C. K. Prahalad describes how both local and multinational companies have discovered this market and have successfully designed and sold their products within this vast segment. They have recognized that families that double and triple their incomes through microfinance over a relatively short period of time can become loyal consumers for the rest of their lives.¹³

In a similar manner, the financial sector is now teaming up with microfinance organizations through agency agreements or by creating microinsurance products covering health, life, agricultural, and livestock risks. Technology companies are entering the field by designing data-processing and telecommunications systems serving microfinance units and small businesses at the village level. As one example, Grameen Foundation's Village Phone programs in Uganda and Rwanda enable poor villagers to utilize cell phone technology to improve their communications, run their businesses more effectively, and improve their living conditions.

Fortunately, from ICICI Bank to Citibank, the capital markets at both the local and international level are beginning to participate in this cycle. The financing structures that these banks have created specifically for microfinance organizations in many local markets had been made possible by the very low default rates and the overall quality of the loan portfolios. Several of these

transactions involve long-term credit facilities backed by partial and, in certain cases, no collateral. And in some instances the debt has been resold to both local and international investors in the form of bonds. Other forms of securitization of microfinance debt are also being developed. Consequently, a new asset class has emerged that is attractive to investors interested in a predictable return or a social benefit or both.

The integration of capital markets and microfinance at the village level is fast becoming reality. Philanthropic donors and public funds will continue to be vital sources of seed capital, and the vital investments made by microfinance will need to be augmented by development funds for education, health care, and infrastructure from donor governments and multinational institutions. However, it seems clear that access to capital markets will significantly transform microfinance institutions, allowing a proven bottom-up solution to poverty to begin to scale up to the level of the problem itself.

AEI research fellow Vance Serchuk is editor for the Development Policy Outlook series. Editorial assistant Evan Sparks worked with Mr. Serchuk to edit and produce this Outlook.

Notes

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4. Carolyn Barnes, *Microfinance Program Clients and Impact: An Assessment of Zambuko Trust, Zimbabwe* (Washington, DC: AIMS, 2001), available at www.usaidmicro.org/pdfs/aims/

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5. Elizabeth Dunn and J. Gordon Arbuckle Jr., *The Impacts of Microcredit: A Case Study from Peru* (Washington, DC: AIMS, 2001), available at www.usaidmicro.org/pdfs/aims/core-1a-peru-2.pdf (accessed on September 12, 2006).

6. Helen Todd, *Poverty Reduced through Microfinance: The Impact of ASHI in the Philippines* (Washington, DC: AIMS, 2000.), available at www.usaidmicro.org/pdfs/aims/ashi-impact_of.pdf (accessed on September 12, 2006).

7. Asif Dowla, "In Credit We Trust: Building Social Capital by Grameen Bank in Bangladesh," *Journal of Socio-Economics* 35, no. 1 (February 2006): 102–22.

8. Sam Daley-Harris, *Microcredit Summit Campaign Report 2005* (Washington, DC: Microcredit Summit Campaign, 2005), 1.

9. Jennifer Meehan, *Tapping Financial Markets for Microfinance* (Washington, DC: Grameen Foundation, 2005), 5, available at www.microfinancenetwork.org/images/GFUSA-CapitalMarketsWhitePaper.pdf (accessed on September 2, 2006).

10. Ibid.

11. Ibid.

12. "Microcredit in India," *The Economist*, February 5, 2004.

13. See C. K. Prahalad, *The Fortune at the Bottom of the Pyramid* (Philadelphia: Wharton School Publishing, 2004).