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Microcredit as a Variant Form of Sub-Prime Lending

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Summary

In a manner uncomfortably reminiscent of 'sub-prime' mortgage lending, foreign capital flows generated by 'financialisation' are funding rapid growth of micro-lending. Such investments typically neglect deposits, the financial service of greatest value to the poor. They may also inhibit autonomous financial development at the grassroots level since the availability of foreign funding tends to repress domestic savings and to retard domestic financial intermediation and financial deepening. By contrast, financially-inclusive and locally-embedded institutions in a 'distributed' system offer the possibility of sustainable financial development for the poor.

Introduction

Negative outcomes of the global economic crisis are evident in many aspects of economic life, especially in disruptions associated with the global reach of financial markets. This reach has been extended, inter alia, by 'financialisation' ('the act of making something sellable or tradable that didn't use to be'). This FDC Briefing Note looks at some consequences of financialisation in the microcredit 'industry', referring to the many entities which confine themselves entirely or primarily to lending operations. Observers may question whether such 'pure-lending' microcredit in developing economies will provide an uncomfortable analogy with 'sub-prime' home mortgage lending in the US.

It is not far-fetched to compare sub-prime lending and contemporary financialised microcredit. Much sub-prime credit was foreign-funded, as is a growing proportion of micro-lending. Both were stimulated by financialisation. Both were accelerated by well-intentioned governments (the Community Re-Investment Act in the US, 'Northern' government ODA and state 'apex' institutions in developing countries). The US sub-prime crisis has had destructive consequences for other financial systems. Foreign investment in 'pure' micro-lending may prove to have negative consequences for 'Southern' financial systems, especially at the grassroots level.

Since Grameen Bank first came to attention, thinking about financial services for the poor has emphasised, first, micro-lending, then 'microfinance', and now 'financial inclusion'. However, pure-lending microcredit operations have continued to grow in the marketplace as the vulgar face of microfinance, while the proportion of for-profit investors has grown rapidly. Most pure-lending investors misappropriate the 'microfinance' label, although by failing to offer products other than credit they reject a central insight of the microfinance industry.

The neglect of savings

It is not surprising that pure-lending operators shy away from deposit-taking. Access to investment funding appears to disincline institutions from seeking deposit-taking status, or from exploiting that status fully even if authorised. Many domestic Microfinance Institutions (MFIs) find it easier and cheaper to rely on external resources (donor funds, loans, investors and apex institutions) than to mobilise the savings of the poor. Many lack the systems, human resources and other capacities to mobilise deposits. Others are barred by regulation from taking deposits without changing their legal form and/or making costly and demanding changes to their operations. But microcredit succeeded, historically, in finding solutions to the problems of uncollateralised lending. It should be possible for microfinance (and its regulators) to find innovative solutions for deposit-mobilisation among the poor[1]. Failure to do so will have unfortunate consequences, at both the industry and the household levels.

Systemically, when financial institutions mobilise savings ineffectively, financial intermediation is hobbled. Resources are not channelled efficiently from savers to borrowers and scarce capital is used inefficiently. Even within a sub-system such as microfinance, more effective financial intermediation contributes to financial deepening and supports domestic financial development. Deposit mobilisation by MFIs is a platform for autonomous grassroots financial development. Greater reliance on domestic funding, especially deposits, reduces the vulnerability of MFIs to external shocks; growing reliance on external capital increases that vulnerability.

For poor households, absence of deposit facilities denies them important benefits, including opportunity to establish financial identity. Discipline gained from saving prepares them to engage in micro-enterprise. Deposits provide a buffer against misfortune, which might otherwise force the vulnerable to divest productive assets. Saving permits consumption smoothing in the face of uncertain income streams and facilitates prudent management of 'lumpy' income flows, such as remittances and seasonal agricultural sales.

To the extent that it neglects or even represses domestic savings, commercial investment in micro-lending does nothing to meet this complex bundle of needs.

Recent growth of micro-lending has been proceeding without corresponding growth in savings mobilised by MFIs. This is confirmed by data from an international sample of MFIs for 2003-2007, reported by USAID. It concluded that 'in 2004, the breakdown of MFI liabilities was approximately 92% deposits and 8% debt, by 2007 the breakdown was only 45% deposits and 55% debt funding despite an increase in the number of institutions authorised to mobilise savings since 2004'[2]. But this is not an inevitable trend. In 2000, Grameen Bank adopted a revised operating model with more emphasis on deposits, since which time it appears to have swum against the stream. By 2009 its deposits had risen from US$202m to US$1263m, while deposits as a proportion of liabilities and capital had grown from 33.6% to 84.7%[3].

The Financialisation of Microcredit

Financialised microcredit stemmed originally from the investment arms of multi- and bilateral development agencies. From the 1990s, entities such as the International Finance Corporation and German agency KfW began to extend finance to MFIs on a 'near-commercial' basis. Supplemented by private foundations and 'social' investors, such funding encouraged MFIs to operate with more commerciality and professionalism. International commercial banks made experimental investments during this period, usually through their charitable foundations. Financialisation of pure-lending microcredit is now evident in a range of financial technologies familiar from mainstream capital markets: the creation of microfinance investment vehicles (MIVs) and the use of securitisation, collateralised debt obligations and structured finance, among other risk-management tools. Examples abound of credit wraps or guarantees, loan syndications and hedging mechanisms. Specialised services, including ratings agencies, support the industry. Substantial initial public offerings are beginning to occur, pointing the way to 'exit' opportunities for private equity investors and increasing the allure of for-profit investment.

Successive CGAP reviews of capital flows chart a rapidly changing landscape[4]. An analysis to end-2004 noted that, while most funding still consisted of grants or highly subsidised loans, 'since 2000 there has been a rapid growth in foreign investment by various agencies and funds that tend to be more commercially oriented'. Genuine private investment (loans and equity) still accounted for less than a quarter of flows during 2004, while fully commercial investments were very few. Two years later, however, CGAP reported that 'Microfinance is experiencing an unprecedented investment boom. The past five years have seen remarkable increases in the volume of global microfinance

investments. Between 2004 and 2006, the stock of foreign capital investment - covering both debt and equity - more than tripled to US$4 billion'. The greatest change was significant entry of private investors, with a multiplication of MIVs and institutional investors and the increased use of investment banking techniques.

A third CGAP analysis brought the story forward to end-2008. In many countries the return on MFI assets was higher than for commercial banks. Some 75% of MIVs dealt entirely or mainly in fixed interest investments. While some were 'socially focussed' and accepted lower returns, others offered 'structured' products with a range of risk/return options. Overall, the average gross yield on debt held by MIVs was a respectable 9.5%. Other MIVs were private equity funds taking stakes in microcredit operators. This newest class of investors had the highest rate of asset growth among MIVs. More than 100 MIVs held total funds under management of some US$6.6 bn. They recorded asset growth of 72% in 2007 and 31% in 2008, while an industry survey projected 29% growth for 2009. Equity holdings of MIVs were growing even more rapidly (by 47% in 2008). Foreign capital commitments to MFIs from all sources were estimated to total US$14.8bn at end-08, divided almost equally between donors (48%) and investors (52%). Grants made up 17%, debt 63% and equity 11%. Total disbursements in 2008 were about US$3bn (two-thirds by investors).

Foreign investment: Pro and Con

Neither commercialisation nor for-profit foreign investment will necessarily repress financial development or distort MFI operations. Commercialisation is a necessary condition for sustainable grassroots financial services. Since capital shortage is a defining feature of underdevelopment, some level of foreign investment should be welcome. Foreign investment may bring positive technology 'spill-overs', benefiting domestic MFIs. It might discourage domestic investment in MFIs, but could prove to be complementary to it. It is probably too early to judge.

The most telling objections are based on negative consequences for domestic financial development. As previously mentioned, availability of foreign funding tends to repress domestic savings, and to retard domestic financial intermediation and financial deepening. Autonomous financial development at the grassroots is inhibited and the poor continue to be excluded from the financial services of most value to them. Also, MFIs receiving foreign commercial funds will

often experience 'mission drift'. They may be pressed to meet investors' performance benchmarks, causing a focus shift from the poor to middle-income clients, and to consumer durable lending.

Turning to domestic investment in microcredit, some level of funding from domestic institutions should benefit MFIs, in terms of technology spill-overs and mutually beneficial operating linkages. As USAID comments, 'The advantages of local bank lending are many. Loans are typically in local currency and represent banking relationships that can grow deeper over time. Alliances with commercial banks in some cases promise the possibility of offering MFI clients financial services which MFIs often cannot, including savings or ATMs'[5]. Cross-sectoral investment flows might also help reduce capital shortage in poor regions, although experience suggests deposits usually flow in the opposite direction, from periphery to centre. However, if domestic for-profit investment causes mission drift in MFIs, or if it represses personal savings in rural areas or among the poor, there is again good cause to object.

How microcredit became a new 'asset class'

Foreign philanthropy and 'socially responsible' investment helped build the microcredit industry from the 1980s, with a surge in ODA from the 1990s. In the 21st century new forces are at work. The global financial crisis has been attributed to 'imbalances' between trading nations and to risk-taking behaviour of banking executives. The US has been able to sustain a low, or even negative, gross domestic savings rate by virtue of being the issuer of the world's de facto reserve currency. 'Surplus' economies with favourable trade balances vis-à-vis the United States have been willing to hold dollars, or dollar-denominated financial assets, as a large proportion of their foreign currency reserves. Major 'surplus' countries have failed to deploy more than a minor proportion of their external dollar reserves for domestic investment. In China, a very high rate of aggregate savings presents the mirror-reverse image of American over-consumption. The US was confronted by a 'wall of money', directed into its financial markets by trade-surplus economies, and spilling over into other developed economies.

Absorbing this flood of capital required financial innovation to identify new investments (including sub-prime mortgages) and to devise new financial instruments. The imperative of finding new investment outlets drove the search for new 'asset classes' that could be presented to fund managers and in turn recommended to retail investors. This search coincided with interest in 'bottom of the pyramid' investment opportunities, and the rise of 'socially-responsible' or 'ethical' investment criteria for portfolio allocation.

What, then, could be more intriguing than a new asset class offering gilt-edged ethical credentials, with 'benchmark' returns, tapped from the bottom of the pyramid? This new opportunity was found in a novel and exotic 'sub-prime' finance market, the micro-lending industry.

Financial inclusion and 'distributed' finance

The essential difference between financial inclusion and microfinance is that between goals and instruments. In policy terms, financial inclusion is a goal, while microfinance is currently the most appropriate instrument. In future, as rates of financial inclusion improve and other conditions including technology change, microfinance will become less relevant. That between 30 and 40 million people in the USA still lack access to formal banking services indicates the long-term nature of the task.

'Distributed' financial systems provide strong foundations for improved levels of financial inclusion. Writing in 2009, Elizabeth Rhyne likened the global financial system to 'an overly centralized energy grid that crashes when overloaded'. She suggested 'a more durable approach could resemble a financial microgrid, with self-sufficient local power centers, drawing capital from local communities. These distributed financial centers would not be walled off from each other, but neither would they depend on the mainline current. Microfinance institutions would feature prominently in a financial microgrid'[6].

She also commented that 'the global pullback is sending many MFIs to domestic credit markets and the mobilisation of savings deposits to fund their growth. Savings, in concert with access to responsible lending, provide the working poor with a powerful one-two punch in the struggle to rise above a precarious existence'. Indeed, 'institutions like MFIs that grow through savings accounts and domestic capital markets while offering responsible lending could be the basis for a distributed, diversified and durable financial system'.

The modern drivers of financial inclusion include non-bank agency, M-banking and diversity of service providers. Initiatives directed to clients, including financial identity and consumer protection reforms, will also encourage access to financial services. The list of options is extensive and diverse and includes requirements for private and public investment and regulatory change. In so dynamic an environment, it is not inevitable that small and agile local institutions in close touch with their communities will be outmanoeuvred by larger and better-capitalised competitors.

Conclusion

A striking feature of the microcredit industry is its internationalisation, especially in diffusion of ideas and technology. More problematic is its internationalisation via capital flows, if 'pure-lending' microcredit becomes merely a vent for foreign capital in search of higher returns. Domestic commercial investment in microcredit may be somewhat less problematic, but in any case it is best to avoid jeopardising the financial inclusion of the poor, who would otherwise benefit from financial development founded on extending deposit and other services to low-income households. Adoption of policy and regulatory frameworks supporting financial inclusion, and incentives for institutions and systems to adopt the 'modern drivers' of inclusion, may offer poor societies an escape from contradictions posed by financialised microcredit. Efforts to create distributed financial institutions and systems and to find innovative technological and regulatory solutions for deposit-mobilisation among the poor will also promote sustainable and inclusive financial development.

References

[1] Global regulators are now considering issues of 'depository microfinance'. See *Microfinance activities and the core principles for effective banking supervision* at http://www.bis.org/publ/bcbs167.htm

[2] USAID (2009), 'Will the bottom of the pyramid hit bottom?', page 11, at http://www.microlinks.org/ev_en.php?ID=36865_201&ID2=DO_TOPIC

[3] Calculated from data on the Grameen Bank website at http://www.grameen.com/index2.php?option=com_content&task=view&id=179&pop=1&page=0&Itemid=145

[4] Data in this and the next paragraph are drawn from CGAP Focus Notes, No. 30 (2005) and No. 44 (2008), also CGAP (2009), 'Microfinance funding continued to grow in 2008' at http://www.cgap.org/p/site/c/template.rc/1.11.45737/

[5] USAID (2009) 'Will the bottom of the pyramid hit bottom?' at http://www.microlinks.org/ev_en.php?ID=36865_201&ID2=DO_TOPIC

[6] Rhyne, Elizabeth (2009), 'Toward a distributed global banking grid', NY Times, 27 January at http://dealbook.blogs.nytimes.com/2009/01/27/another-view-a-local-fix-for-a-global-mess/

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