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# Evaluating Microfinance

## DO SMALL LOANS FOR POOR ENTREPRENEURS HELP END POVERTY?

Since the 1980s, millions of impoverished people around the world without access to banks have been able to take out tiny loans to start businesses. Nobel Prize-winning economist Muhammad Yunus, who established the first microfinance bank in Bangladesh and launched the modern microlending movement, claims microloans have lifted millions — especially women — out of poverty and spurred economic growth. But recent studies cast doubt on microcredit's effectiveness. Borrowers have been saddled with multiple loans at exorbitant interest rates, often having to borrow from loan sharks to make their microcredit payments. Economists fear overindebtedness could make borrowers even poorer and that a possible credit bubble could burst. Others worry that in recent years, for-profit investors have swarmed to the field, attracted by high returns on investment. Some governments have capped microlenders' interest rates, but the industry hopes to forestall regulation by adopting voluntary consumer protection measures.


A small loan from a microcredit bank in Luanda, Angola, enabled one-time street peddler Ana Helena Domingos to buy goods in bulk and launch a now-flourishing wholesale operation, doubling her income in 10 months.

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# EVALUATING MICROFINANCE

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Cover: AP Photo/Jose Silva Pinto

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# Evaluating Microfinance

**By Sarah Glazer**

## The Issues

Two years ago, Siyawati, a mother of three, lived on a meager income brought in by her husband's work as a construction day laborer in Uttar Pradesh, India's most populous state. Then she got a $212 microfinance loan from SKS India, the country's largest microfinance institution, and invested it in a candle-making machine. That enabled her to increase the number of candles she was making for sale.

Since then, with the help of additional microloans, her small business has become a small factory employing eight people. Her monthly income has risen from $42 to $425, permitting her to send her children to a good school. "She is proud that her expertise could bring her family out of poverty" reports SKS' Web site. [1]

This is the promise of microfinance: helping to end poverty and spur economic development one entrepreneur at a time by offering microloans — typically averaging a few hundred dollars — to help the impoverished, especially women, who lack collateral for a conventional loan. Popular among philanthropists for nearly 30 years, the movement has become increasingly attractive in recent years to equity funds, foreign investors and profit-making banks, drawn by the industry's extraordinary returns on investment, largely due to its high interest and repayment rates of up to 98 percent. [2]

AFP/Getty Images/Yuri Cortez

*Nolberta Melara of San Marcos, El Salvador, sells her homemade embroidered aprons in shops across the country. She got her start with a $30 loan from a nonprofit microlender. Since the first microfinance bank was established in 1983, thousands of banks and credit cooperatives around the world have been created to help small entrepreneurs. Supporters say microloans lift millions out of poverty, but critics say lenders' exorbitant rates lure many borrowers deeper into debt and may even be creating a microcredit bubble.*

Microlenders' high annual interest rates — averaging around 30 percent but sometimes reaching more than 100 percent — result from the added cost of sending an agent to collect weekly payments on very small loans, often to remote villages. However, microloans are generally lower-cost and more reliable than those offered by the moneylenders that many poor villagers and slum-dwellers have depended on for decades.

Countless stories like Siyawati's have attracted billions of dollars in loans — more than $44 billion worldwide in 2008, according to one estimate — creating an average growth rate of 34 percent since 2003. [3]

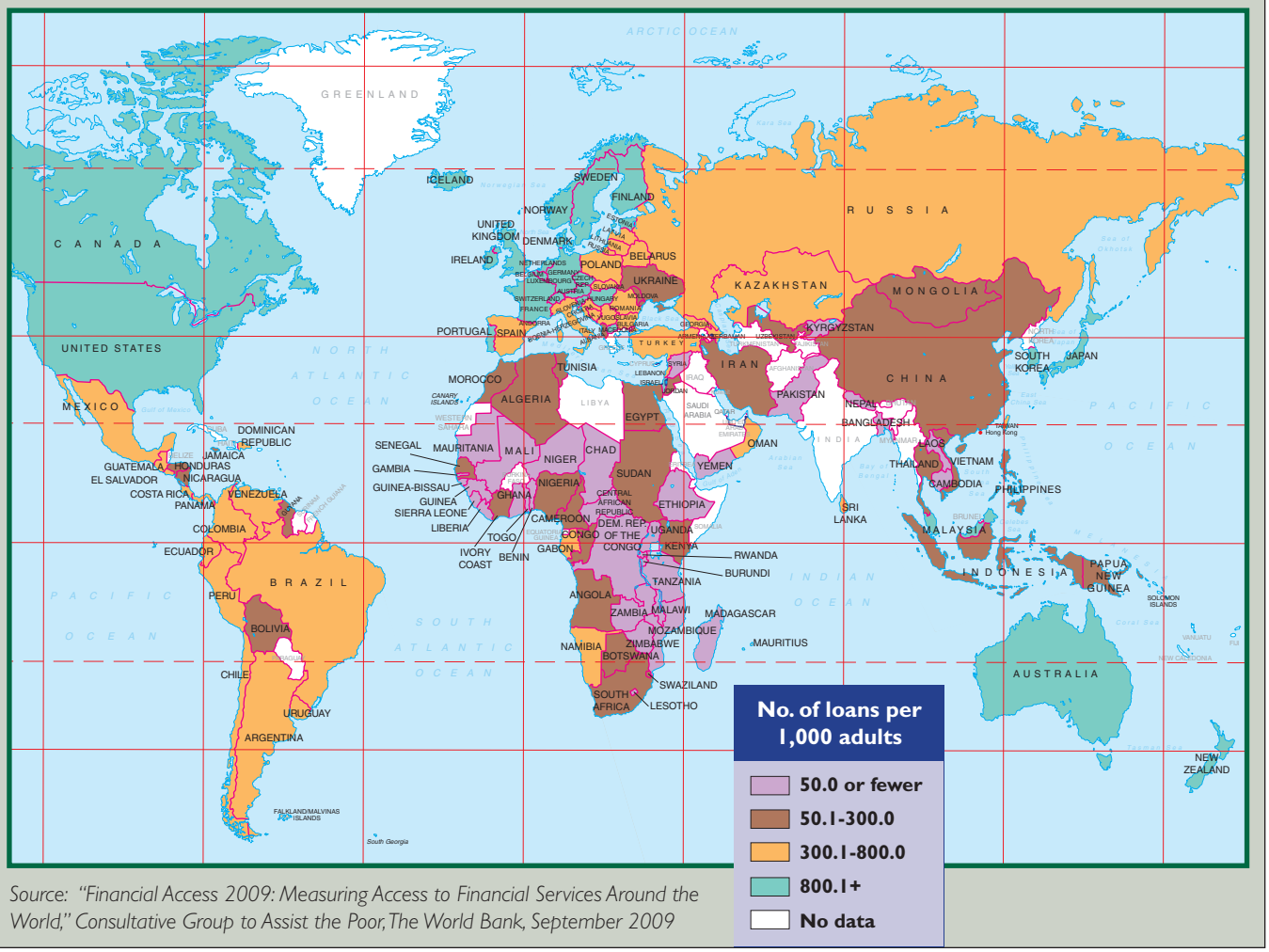
The idea of microcredit finds its roots in Nobel Prize-winning economist Muhammad Yunus' discovery that even very poor people with no collateral, who would never qualify for a bank loan, could be amazingly diligent in repaying loans. The key, according to Yunus, was for borrowers to band together in small groups of neighbors and guarantee one another's loans. So effective was microcredit as an economic engine in improving the livelihoods of the poor, Yunus famously predicted that it would help create a world where "poverty museums" would be the only place to see poverty. [4]

But increasingly, these cheery anecdotes have been mixed with more disturbing tales of exorbitant interest rates and strong-armed debt recovery practices. Some borrowers who can't make their microloan payments resort to extortionist moneylenders who charge even higher interest rates, sending the borrower ever deeper into debt. Even Yunus' renowned peer-pressure approach has its down side: Members of some neighborhood lending clubs have been known to haul off delinquent debtors' property, attack their houses and ostracize them from their communities.

Malcolm Harper, chairman of M-CRIL, an India-based financial rating company for microfinance lenders, tells of an Indian woman he met in a small village east of Hyderabad. Like many microborrowers, she had taken out a small loan, not for business purposes

## Few People in Poor Nations Have Bank Loans

*In the world's poorest nations, largely in sub-Saharan Africa, fewer than 5 percent of adults hold bank loans. Credit is more available in China, India and other African countries, where about one in three adults receives a loan. By contrast eight out of 10 adults in the U.S., Japan, Australia and Western Europe have bank loans.*




*Source: "Financial Access 2009: Measuring Access to Financial Services Around the World," Consultative Group to Assist the Poor, The World Bank, September 2009*

but to pay for her sister's medical care. Then her husband became ill. When she fell behind on her repayments, the other group members locked her and her young daughters out of their hut. After living on the road for days, she despaired and tried to throw herself and her children into the village well. She was stopped just in time when someone pointed out that she had enough savings with the group to pay off her loan. Her debt was cleared but she was expelled from the group. [5]

The rapid growth of the microfinance sector in recent years and its growing attraction to Western investors have awakened fears that microfinance could create a credit "bubble" akin to the recent U.S. subprime loan craze. Some experts fear that as microfinance institutions seek to reach even more borrowers, especially in areas like southern India where numerous microlenders operate, poor people will be encouraged to take out yet more loans, miring them in a cycle of debt they can never repay.

Microfinance "has put hundreds of millions of people into deeper debt than they were," says Harper. "Now that microfinance is becoming fashionable and profitable, a lot more companies are entering the field, and that leads to overborrowing just like it did with house owners in Indianapolis" during the giddy days of subprime mortgages, he maintains. "People are borrowing more than they can afford; it is over-indebting people, and they pay Peter from what they

borrow from Paul" — often the high-priced local moneylender.

Because borrowers rarely report their outstanding moneylender debts to microfinance lenders, they may look like better credit risks than they are. Some analysts believe the still-thriving moneylender loans are keeping microcredit loans afloat. [6]

"We fear a bubble," Jacques Grivel of Luxembourg-based Finethic, an investment fund that raises money from institutional investors to channel to microfinance lenders in Latin America, Eastern Europe and Asia, recently told *The Wall Street Journal*. "Too much money is chasing too few good candidates." [7]

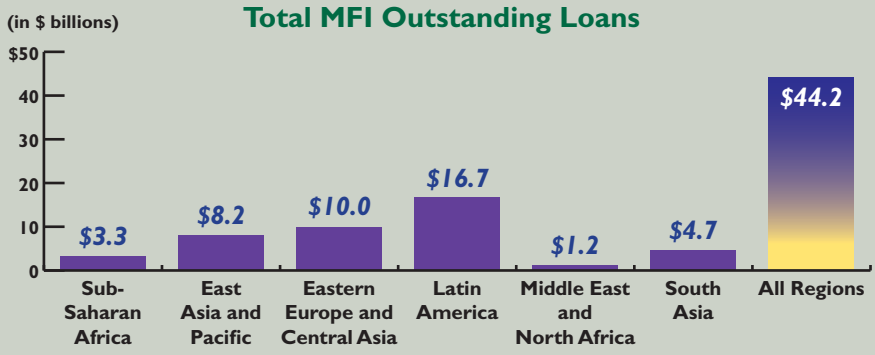
But many experts in the field point out that if there really were a credit bubble, it would have had plenty of time over the past 25 years to burst. Instead, microborrowers have consistently maintained high repayment rates. As abusive as it may get, the borrowing group's collective guarantee — known as "solidarity lending" — usually gets people to repay their loans on time. The borrowers want to maintain access to a highly valued service — reliable loans at lower interest rates than are offered by their local moneylenders.

Yet some fear that for-profit companies will themselves become "microloan sharks," and will charge exorbitant interest, focusing more on profits than on helping the poor, in the words of Jonathan C. Lewis, chair and founder of the nonprofit MicroCredit Enterprises, which makes loans to microlenders.

The commercial industry responds that as more capital and competition enter this market, interest rates will likely come down and more impoverished borrowers can be reached. "There will never be enough donor money to solve the world's ills. We need to find market-driven solutions," says Joan Trant, executive director of the New York-based International Association of Microfinance Investors.

## Microlending Totaled at Least $44 Billion

*At least $44.2 billion was loaned in 2008 to 86 million impoverished borrowers, mainly in Latin America, Eastern Europe and Central Asia. The loans were made by the 1,400 microfinance institutions (MFIs) — nonprofit organizations, regulated financial institutions and commercial banks — that are tracked by the Microfinance Information Exchange (MIX).*




*Source: "Microfinance at a Glance — 2008," Microfinance Information Exchange, Dec. 31, 2009*

Some question the very premise of microcredit — that it offers an escape from poverty — arguing that China-style economic growth and factory jobs offer the better solution. Defenders respond that while microcredit may not lift everybody completely out of poverty, it has been crucial in tiding families over during economic emergencies like health crises.

For the poorest families, "It's a buffer to prevent them from totally collapsing — going into destitution," says Geeta Rao Gupta, president of the International Center for Research on Women, in Washington, D.C. On that score, critics and supporters alike are starting to emphasize ways to help the poor build savings accounts — which may be more appropriate than expensive loans for tiding families over in emergencies.

In 2005, the international charity Catholic Relief Services announced it would divest its holdings in microcredit and focus on savings. Microcredit was making poor borrowers "poor twice" through high interest rates, in the words of Kim Wilson, former director of the organization's microfinance unit. [8]

Wilson, now a lecturer at Tufts University's Fletcher School, says she was disturbed by the "vigilante" enforcement of loan repayments by fellow borrowers. And she was uncomfortable with microcredit's traditional formula of giving borrowers a new loan as soon as they repaid the old one — leading to a "treadmill" of debt, in her view.

Concerns about extortionist interest rates, deceptive information about the interest charged and abusive collection practices have spurred calls for the kind of consumer protection regulation common in the United States but rare in developing countries. The microfinance industry has taken several steps towards self-regulation — including voluntary codes of conduct and more transparent information about interest rates — in an effort to forestall government regulation.

Most economists believe microloans don't necessarily lift people out of poverty but that the loans help them "manage their poverty better," in the words of David Roodman, a research fellow at the Center for Global Development, in Washington, D.C., who is writing a book on microfinance and

maintains a popular blog on the subject (http://blogs.cgdev.org/open_book/).

Microfinance gives the poor "a choice to do something to feed their kids and a chance to have a slightly better life," Lewis says. "We should stop romanticizing it." For the billion people who live on $1 a day, he says, "their economic development question is 'How do I feed my kids today? And do I?' And a lot of days they don't."

Increasingly experts agree that the more than 2 billion people living on less than $2 a day, most without access to banks, deserve access to financial services — not just loans but also savings accounts and insurance, which may help them even more in escaping poverty. [9]

As the industry, academia and the philanthropic world ponder the future of microfinance, here are some of the questions being debated:

### *Does microcredit help the poor, especially women, out of poverty?*

When economist Yunus, the father of microfinance, started giving poor Bangladeshi villagers loans as an experiment in the 1970s, he made some startling discoveries that turned standard economic assumptions on their head. Noticing that even the poorest villages were beehives of small-scale trading, he questioned the conventional wisdom that creating jobs, rather than encouraging entrepreneurial activity, is the best way to help the poor. [10]

"An ever-expanding cycle of economic growth," he predicted, could be created by giving repeat loans to poor borrowers for productive enterprises. [11]

Making loans to women brought more benefits to the family than lending money to men, he discovered. "When men make money they tend to spend it on themselves" for items like drink and cigarettes, he said, "but when women make money they bring benefits to the whole family" by spending it on their children for schooling and better food. [12]

Yunus, who founded the Grameen Bank in 1983 specifically to make microloans, says "64 percent of our borrowers" who have been with the bank for five years or more have left poverty. By his own simple checklist, a family has risen out of poverty when it has a house with a tin roof, clean drinking water, warm clothes for winter and can afford to send all the children to school. [13]

Yet, according to some researchers, the claim that business microloans lift most families out of poverty is, on average, unfounded.

"Few live up to the mythology that their business grows and they climb out of poverty," says researcher Roodman. "The majority don't climb out of poverty but get some assistance in managing their poverty" by taking out loans that permit them to pay for school fees or medical and other household crises.

Two recent studies of microcredit borrowers, conducted by researchers at the Massachusetts Institute of Technology (MIT) and Yale University, found no improvement in household income or consumption — two standard measures of poverty. [14] Moreover, the researchers found, microcredit often helps men's businesses more than women's and is most helpful to those who already have businesses or are better-off to start with. (*See sidebar, p. 92.*)

Indeed, studies question almost every element of the famous Yunus narrative — from the dominant role of women to the focus on entrepreneurship. One study found that about half of loans made by Grameen Bank are not for business purposes at all, even though they were labeled as such, but go instead to household consumption, such as school fees or medical expenses. [15]

That raises the question: What types of desperate measures will impoverished borrowers take to pay the high interest rates, which can range from 20 percent to over 100 percent, if they're earning no profits? Some go to moneylenders, who charge even higher rates but can quickly produce the cash needed for a loan installment, according to *The Wall Street Journal.* The number of moneylenders in India rose 56 percent from 1995-2006, when microfinance was growing rapidly. "Group pressure makes us go to moneylenders," one woman told *The Journal.* "If you lag behind, the rest of the group members can't get new loans." [16]

As for empowering women, loans made to the women who show up at the weekly debt collection meetings often get passed on to the male breadwinners in their families, especially in India and Pakistan, according to Sarita Gupta, vice president for global resources and communications at New York-based Women's World Banking, which works with 40 microfinance providers and banks in 28 countries. That's partly because women may perceive their husbands' businesses as the ones most likely to succeed, she suggests, although women may invest in their own enterprises with later loans.

Yet, even if the loans are used for business, most poor women earn too little from their tiny enterprises to make a significant improvement in their lives, argues Aneel Karnani, associate professor of strategy at the University of Michigan's Ross School of Business. In a typical isolated village in India, he points out, "you see a lot of women sitting next to each other selling the same product — bananas" — to equally impoverished villagers.

"They don't earn enough to get lifted out of poverty. [T]he alternative to microfinance is finding jobs for the poor," he asserts. Rather than making tiny loans to five women, it would be more effective to loan one entrepreneur a large enough sum to start a clothing factory that could provide jobs to those five, he argues. Poor entrepreneurs prefer the same thing most people in rich countries want: the security of a salaried

job, he says. "They're not entrepreneurs by choice but by necessity," he claims.

Some economists also question whether microfinance can be the engine of economic growth it's touted to be. "We know that broad-based economic growth is the most powerful way to reduce poverty," says Jonathan Morduch, professor of public policy and economics at New York University's (NYU) Wagner School, noting that standard-of-living improvements in China, which has little microfinance, and India, which has a lot, have been driven by growth in gross domestic product. "Frankly, we don't have a sense (even if all the loans went to business) of the degree to which microfinance has contributed to economic growth."

As for Yunus' claim that more than half of Grameen borrowers have left poverty, Morduch says, "The question an economist like myself asks is, 'What would have happened without Grameen?' This happened at a time when poverty was falling in Bangladesh generally. What's the net impact?"

Getty Images/Junko Kimura

*Bangladeshi economist Muhammad Yunus was awarded the 2006 Nobel Peace Prize for creating Grameen ("village") Bank, the world's first microcredit bank. The idea grew out of a famine in Bangladesh in the mid-1970s, when Yunus lent $27 of his own money to 42 poor villagers for small enterprises and, to his surprise, all the loans were promptly repaid.*

Microfinance advocates say just because they don't have research evidence that meets the highest standards used by economists doesn't mean microcredit doesn't work. They point to some 25 years of direct experience and growing demand for the loans. "I just think researchers haven't proved it yet," says Alex Counts, president and CEO of the Washington-based Grameen Foundation, which spreads the Grameen philosophy worldwide.

A recent summary of the research from the World Bank-affiliated Consultative Group to Assist the Poor (CGAP), a consortium of government and private development organizations that studies microfinance, concludes the jury is still out as to whether microfinance lifts millions out of poverty. Financial services are, however, "vital tools in helping them to cope with poverty," concluded author Richard Rosenberg, an advisor at CGAP. [17]

Microloans have been used more often to "smooth consumption" over the course of a month of uneven earnings rather than to grow enterprises, studies suggest. But if we find that finding disappointing, it may be because well-to-do Westerners don't have the impoverished person's experience of earning $4 one day and zero the next, Rosenberg suggests. [18]

The microloan can make it possible to eat on that no-earning day. "This is basic survival stuff," says Micro-Credit Enterprises founder Lewis.

### *Will for-profit investors continue to benefit the very poor and women?*

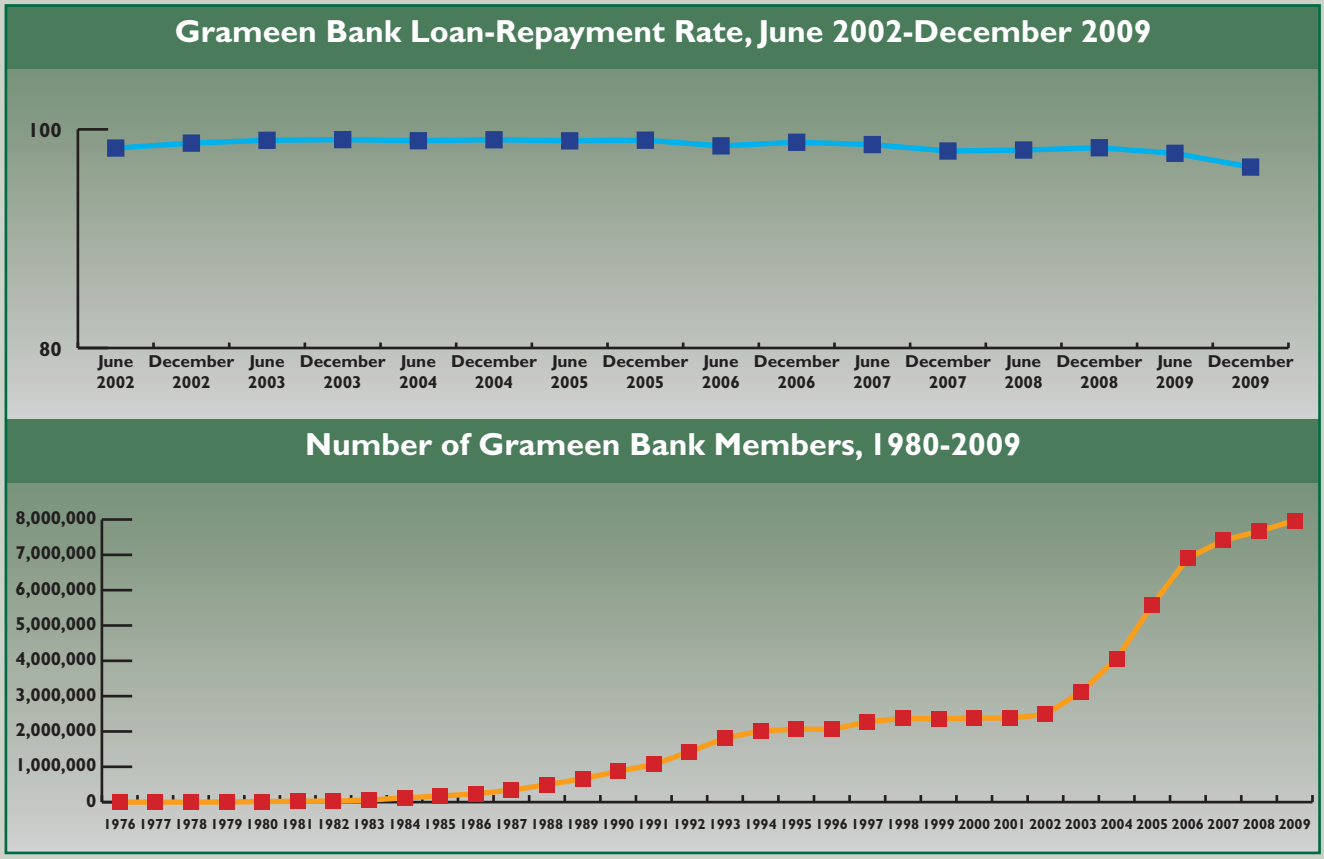
Microfinance suddenly became a hot market for Western investors after Banco Compartamos, the largest microfinance lender in Mexico, went public in 2007. Stock in the former nonprofit was soon valued at more than $1.5 billion, offering a mouth-watering rate of return to investors of more than 50 percent a year. [19]

Even more attention-grabbing was the news that Compartamos routinely charged its impoverished borrowers an astoundingly high annual interest rate of more than 100 percent, in sharp contrast to the 31 percent average annual rate charged by microlending institutions worldwide at the time. [20]

Microfinance godfather Yunus, along with others in the industry, was outraged. "Microcredit was created to fight the moneylender, not to become the moneylender," he said. [21]

## Does Falling Repayment Rate Signal a Loan Bubble?

*Bangladesh-based Grameen Bank, which pioneered providing tiny loans to the poor, is seeing a drop in repayment rates. Founded by Nobel Peace Prize-winner Muhammad Yunus, the bank has nearly doubled its membership rolls since 2004, reaching almost 8 million members in 2009 (bottom). But after the 2008 global recession, the bank reported its collection rate dropped below 97 percent for the first time in recent years, to 96.55 in 2009 (top). Some observers caution this could be a red flag warning that more borrowers will have trouble repaying their loans in the future. But there's been no epidemic of defaults yet in Bangladesh. Even at this new low, repayment rates for microcredit are significantly higher than for American credit card debt, which fell as low as 85.5 percent for Bank of America last year.*




*Source: David Roodman, "Grameen Bank, Which Pioneered Loans for the Poor, Has Hit a Repayment Snag," Center for Global Development, February 2010*

In an article entitled "Microloan Sharks," MicroCredit Enterprises founder Lewis concurred, "[T]he 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." [22]

Yet commercialization boosters say it's just these kinds of highly attractive returns that will draw more capital and more lenders to the sector, permitting it to reach more borrowers. The resulting competition, they say, will ultimately lead to lower interest rates.

Even though Compartamos took a lot of heat for its high returns, "you also saw a rush into the Mexican microfinance sector," says Mary Ellen Iskenderian, president and CEO of Women's World Banking, which supports microfinance institutions converting into for-profit banks. "People thought there was money to be made there, and you've seen some real competition," reports Iskenderian, whose organization is starting an equity fund for investors in microfinance institutions.

Bolivia, a microlending market with vigorous competition, has seen some of the world's steepest declines in interest rates, she points out. (Bolivia's rates have dropped from 50 percent in the mid-1990s to just over 20 percent as their market grew from about

200,000 borrowers to more than 600,000.) [23]

"You have 1.5 billion potential customers who need access to microfinance," estimates Trant, of the International Association of Microfinance Investors. If you multiply them by a typical microloan size (about $200), you'll need about $300 billion to meet the demand, she says. But with only about $44 billion now in microfinance funding portfolios around the world, that leaves a funding gap of more than $250 billion to reach all the unbanked poor. [24]

"Charity's not going to cover that gap. We have to find business solutions," maintains Trant. "People's enlightened self-interest — if they know they can make a buck while doing some good in the world — that's what's driving investment in microfinance."

Yet scaling up microfinance could just as well create monopolies, warns Lewis, especially in small, impoverished regions that may never support more than one microfinance bank. In those cases, he writes, "A poor woman driven by economic adversity has very little power to negotiate interest rates with a microlender." [25]

Some companies say they plow their increased profits into reducing their interest rates. For example, Compartamos has reduced its interest rates by about 30 percent since 2000, when it was charging 115 percent, according to a spokesman. "As we grow and are more efficient, we move that efficiency to our clients" in the form of lower interest rates, said spokesman Jorge Daniel Manrique Barrigan. [26] Critics point out, however, that the bank's average loan size also has increased over the same time, reducing its servicing cost per loan. Considering the 50 percent return Compartamos has consistently given investors over the years, "they are clearly only passing on a small amount to the poor and keeping much more for themselves," says Chuck Waterfield, CEO and founder of MFTransparency, an industry-supported group that reports interest rates.

Lewis says the microfinance sector has split between those who want to commercialize it and his own anti-poverty faction. "We didn't get into this to start banks; we're interested in poverty reduction," he says. "And so we really need to look at the problems the poor have and combine the microfinance services with health, education, financial literacy, malaria bed nets. We need to keep interest rates low; it's not about returns for Western investors."

A recent Women's World Banking study of 25 microfinance institutions seems to confirm his fears. The researchers found that the percentage of women borrowers falls off sharply when nonprofit lenders convert themselves into profit-seeking banks. [27]

That's partly because commercial banks shift to larger loans to improve their profit margins, since they're less costly to administer than very small loans, the report found. And women's loans are typically smaller than men's. Women reinvest less in their businesses than men, because their businesses are smaller, often home-based, with household duties competing for their time. Women also tend to have smaller profit margins than men because they're in highly competitive sectors like food preparation, sewing and beauty salons. [28]

However, the same study also found that more women ended up getting loans from lenders that went commercial, despite being a smaller proportion of the total borrowers — largely because the banks scaled up to serve more people overall, both women and men.

"That's the goal — to reach more people," says Trant. "We want to get economic access to people who haven't had it in the past, whether they're male or female."

The free-enterprise nature of microfinance has attracted millions from investors who see a way to make money while doing good. In 2005, Pierre Omidyar, the billionaire founder of eBay, gave a $100 million donation to Tufts University, specifying it should be invested in microfinance institutions. Omidyar was attracted to microfinance because it demonstrated free-market principles, much like eBay. Omidyar hoped donor funding would become unnecessary once microfinance could raise money in the capital markets, he told *The New Yorker* in 2006. [29]

Yet nonprofits continue to serve poorer borrowers than those sought out by commercial banks, research suggests. Surprisingly, a study of 346 leading microfinance institutions co-authored by NYU economist Morduch found that nonprofit, nongovernmental organizations (NGOs) actually tend to charge higher interest rates — a 25 percent median — compared to banks' 13 percent. That occurs because NGOs' poorer clients take out smaller loans, which are more expensive to administer. "Profit-maximizing investors would have limited interest in most of the institutions that are focusing on the poorest customers and women," the researchers conclude. [30]

"[E]veryone thinks you can do it in a win-win way," helping the poor and maximizing profits at the same time, says Morduch. But in reality, some nonprofits will continue to need donors' help to reach the very poorest. "There's a lot of stuff going on commercially but it can't reach everybody," he says.

### *Should microfinance lenders be more tightly regulated?*

The astoundingly high interest rates charged by some microlenders have prompted calls for mandated caps on interest rates.

For instance, a populist debtors' rebellion in Nicaragua — the "No Pago" (I Won't Pay) movement — has spurred mass demonstrations protesting high rates and demanding a legal rate ceiling. [31] Part of the outrage stems from the fact

## The Poor Are Active Money Managers

*Financial diaries clarify how the poor manage their money.*

People living on $2 a day or less — like Bangladeshi rickshaw driver Hamid and his wife Khadeja — have something in common with the rich: They are also active money managers.

The couple live with their child in one room in the slums of Dhaka, sharing a toilet with seven other families. They survive on an average of 78 cents a day per person. But some days Hamid gets no work and no earnings. To ensure cash flow, they've built up reserves in six different instruments — from money saved at home to a life-insurance policy. [1]

They also have six debts outstanding to lenders ranging from a microlender to the grocer. Between the money they've pushed into savings ($451) and pulled out by taking loans or withdrawing savings ($514), their total turnover ($965) is $125 more than their total income for the year. As a result they have managed to extend each dollar of income earned to $1.15 through a combination of savings, loans and guarding money for others for a fee.

Hamid's story is just one of the 250 portraits gleaned from financial diaries kept by borrowers in Bangladesh, India and South Africa and described by a team of economists in a ground-breaking book last year — changing the way experts think about the "unbanked" poor.

The book, *Portfolios of the Poor*, revealed that while microfinance is often touted as replacing expensive moneylenders for the poor, 88 percent of the loans made actually were taken out through an informal network of friends, relatives and moneylenders — even in Bangladesh where most of the families had access to microfinance banks.

Informal loans, the authors found, sometimes are interest-free, in the cases of relatives, or more flexible, in the case of moneylenders. And loans from microfinance lenders, ostensibly for business enterprises, were frequently used for household needs. Khadeja used part of her microloan to buy gold — a form of secure savings.

Another Bangladeshi rickshaw driver decided that spending his loan to buy his own rickshaw was too risky, because the vehicle could be stolen. Instead, he used the loan to stock up on rice and to buy a cupboard; then he loaned $20 of it to a fellow rickshaw driver for 17.5 percent interest per month, permitting him to make some money.

Moneylenders are often thought to be the main predators on the poor, charging exorbitant interest rates. But the authors were surprised to discover that some of the highest rates in South Africa, for example, were charged by savings clubs. These groups of conservative ladies pool their savings together and then lend a portion of it out at 30 percent per month — over 2,000 percent on an annual basis. That should have yielded hedge-fund sized profits, but because so many loans were not repaid or partly forgiven, the yield came to only about 1 percent a month.

Still, how are poor people able to pay such enormous interest rates? Whether to moneylenders or microfinance banks, interest rates can range from 20 percent to more than 100 percent a year. The authors suggest a 25-cent fee charged for a moneylender loan of $10 for a week may seem reasonable to Hamid, who earns just $2.33 a day as a rickshaw driver, even though on an annual basis, such a loan costs 261 percent per year. That $10 may be the difference between buying new clothes for the Muslim holiday of Eid and going to the mosque in rags.

"It can be a few pennies a week; they're repaying in small bits," explains Jonathan Morduch, a coauthor of *Portfolios* and a professor of public policy and economics at New York University's Wagner School of Business. "Very expensive loans are out for a few weeks, and it's a fee for service — not big." Most microfinance loans made by Bangladesh-based Grameen Bank, a pioneer in microlending, "are 20-40 percent for a year; it's a big chunk of cash you pay back in dribs and drabs."

Many of the diarists also were found to be paying a fee to accumulate their savings in a safe place but earned no interest on their deposits — something a Westerner would find difficult to understand. The fees might be paid to a woman who comes to the village once a week to collect or to a neighbor to act as "money guard," keeping the money out of temptation from a spouse. These savers may not see loans as very different from savings — in each case they are paying a fee each week to procure a large lump sum, the authors note.

But even these nest eggs can disappear. Similarly, informal lenders may not come up with the cash when it's promised. And there can be cheating even among friends.

Having reliable financial tools — whether savings or loans — would make a big difference to those with such low incomes, according to the authors, who find it surprising that cash-flow management has received little attention from the microfinance sector. Although microfinance loans historically have been oriented towards business, the diaries show that households need to borrow for a wide range of needs and "are prepared to find ways of repaying loans from ordinary household cash flow."

***— Sarah Glazer***

[1] Information from this story comes from Daryl Collins, *et al.*, *Portfolios of the Poor: How the World's Poor Live on $2 a Day* (2009).

that for nearly three decades many microlenders have presented interest rates to illiterate borrowers in a way that makes them look deceptively low.

Until recently, Compartamos charged an annual interest rate of 129 percent, including all up-front fees and taxes, according to a 2008 calculation by MFTransparency's Waterfield. [32] But "Compartamos didn't actually say, 'We charge 129 percent a year.' . . . They said to the borrowers,

'We charge 4 percent a month,' " according to Waterfield. [33]

That 4 percent is deceptively low because it is based on a so-called "flat" rate. Many microfinance lenders charge such flat rates on the entire amount borrowed, but flat fees turn out to be nearly double the annual percentage rate (APR) — the standard used on loans in the United States, which calculates the interest on a declining balance over the life of the loan. For instance, a loan advertised at 36 percent "flat" actually works out to 65.7 percent APR, according to Waterfield. [34] That rate is even higher when up-front fees like security deposits and insurance fees are factored in. [35]

"As soon as some [microlenders] start lying, you've created an environment where everyone else has to lie" within the same regional market, Waterfield says, in order to look as (deceptively) cheap as their competitors. He hopes to break that syndrome by persuading all lenders in a country to submit their interest rates to him in a sealed envelope; then his Web site will disclose all annual rates on the same day.

Compartamos now charges 78.7 percent annually for its core microcredit loan, according to a company spokesman. But Waterfield says even that number is deceptive. Adding taxes and a mandatory 10 percent security deposit brings the rate up to 110 percent annually, he calculates, lower than the 129 percent of two years ago but still breathtakingly high. [36]

"Compartamos has made serious efforts in order to reduce our rates," spokesman Barrigan said in an e-mail. In fact, he notes, the company has lowered its rates "more than 30 percent" since 2000, when it was charging 115 percent annually according to its own calculation, not including tax or up-front fees.

Citing misleading — and sometimes deceptive — practices, Karnani of Michigan's Ross School of Business wants governments to cap the rates microlenders can charge, prohibit abusive debt collection practices and require interest rate disclosure according to a standardized method. [37] (*See "At Issue," p. 97.*)

Such legal protections are virtually nonexistent for microborrowers overseas, according to Wilson at Tufts' Fletcher School. By contrast, in the United States, usury laws at the state level limit interest rates, and federal truth-in-lending rules stipulate a consistent method of disclosing rates. The Fair Debt Collection Practices Act attempts to limit harassment of debtors. [38]

Getty Images/Shamik Banerjee

*A microcredit borrowers' group in Kolkata, India, meets to make payments on loans. Peer pressure ensures that the poor pay loans promptly. Weekly payments typically are made in public in the village "center," and everyone in the group can be denied subsequent loans if one member defaults.*

But mandated interest rate caps are almost universally opposed by the microfinance industry. If politicians were to set caps too low to cover lenders' costs, microfinance organizations would be forced out of business, Grameen Foundation's Counts contends, and borrowers would be driven into the jaws of unregulated loan sharks.

Nonprofits that offer assistance in health, education and training along with loans would be hit hardest, because those extra program costs would no longer be covered, Counts predicts, "The most vulnerable isolated communities would be driven off the map," he says.

Karnani says these kinds of objections assume that free-market competition is keeping interest rates reasonable. That may be true in a rich country like the United States, where numerous banks compete to drive rates down. But in poor villages "there may be [only] one or two [lenders], so there is no competition," he asserts. "So the tendency is to charge above what would be a competitive rate."

Calls to require transparent disclosure of interest rates find some support among industry practitioners like Waterfield. But he believes his voluntary experiment, launched in 2008, will get the job done faster.

"It will take us a decade to get transparency regulation" in all 100 countries that have microfinance, he says. "But in

a couple of weeks I can go to India, we can go to the microfinance institutions and say, 'Why wait for government to tell us to do the right thing? Why don't we ourselves do the right thing?' "

In Cambodia and Bosnia and Herzegovina, the first two countries his organization approached, all lenders agreed to disclose their APR's on his Web site, www.mftransparency.org. However, he concedes, this doesn't necessarily mean their loan officers tell new borrowers the true rate — though he hopes they eventually will.

AFP/Getty Images/Francisco Leong

*Tattoo artist Filipe Gil started his parlor in Lisbon, Portugal, after receiving a small loan from a private microcredit bank. Unsecured microcredit loans appeal to the poor, who lack the collateral required by commercial banks. High interest rates charged by microlenders are attracting many private investors to the field, and critics say some microcredit lenders use strong-armed collection tactics.*

However, even that information may be insufficient in places like India, where 39 percent of adults are illiterate. [39]

"I want to tell people, 'Here's exactly what you'll pay' in dollars and cents [and] let them figure out that's three meals of food on the table," says Wilson, who points out interest rates may be a hard concept for an illiterate person to grasp.

Media coverage of Indian and Mexican lenders who hired thugs to collect debts has recently drawn attention to abusive debt collection, the other area Karnani wants regulated. [40]

More than 900 microfinance lenders and other organizations have signed an industry code of conduct, dubbed the Smart Campaign, promising neither to engage in "abusive or coercive" debt collection, nor to market loans to people who can't afford them. They also pledge to present their interest rates in a form understandable to clients. [41]

"The main reason for starting the campaign was watching the U.S. subprime meltdown and recognizing that it arose from a failure of consumer protection — and seeing that regulation hadn't stopped it," says Elisabeth Rhyne, managing director of the Center for Financial Inclusion, the Washington-based industry group that initiated the campaign.

Borrowing from the organic and fair trade labeling movements, Grameen Foundation's Counts has proposed a "certification" for those lenders who agree to abide by an ethical code — including disclosing their interest rates and eschewing unethical debt collection. [42]

Karnani is skeptical, especially in the absence of a government enforcer to assure compliance. "Vague and platitudinous appeals for self-restraint by companies and self-regulation by the industry are not effective at protecting microclients," he has charged. [43] ■

# BACKGROUND

## Early Beginnings

Efforts to organize financial services for the poor stretch back to rural credit cooperatives organized in Europe in the 19th century. By 1910, there were more than 15,000 such institutions operating in small communities in Germany alone. [44]

Members contributed savings to the cooperatives, which then allocated loans to members who needed money for investments or living expenses. Participants, whether borrowers or savers, were all shareholders in the cooperative and made key decisions democratically about interest rates and loan sizes.

The modern microfinance movement's roots date back to 1974 when Yunus, then an economics professor in Bangladesh, became dissatisfied with the free-market theories he was teaching in the classroom as a solution to ending poverty. Since the 1950s, foreign aid had been based on the theory that the route to economic development in poor countries like Bangladesh was technical assistance in modernizing their agriculture and industry.

But Yunus noticed that the poorest of the poor in Jobra, where he was helping farmers improve their crop

*Continued on p. 92*

# Chronology

## 1860s-1940s

***Credit cooperatives offering savings and low-cost loans to the poor spread from Europe to India, Senegal and the U.S.***

***1864***
German village mayor Freidrich Raiffeissen pioneers lending to poor farmers through cooperatives.

***1904***
In British-ruled India, Cooperative Credit Societies Act creates co-ops that lend to poor farmers.

***1946***
Indian co-ops have 9 million members.

## 1950s-1970s

***Foreign aid focuses on economic development in the Third World.***

***1970s***
Bangladeshi professor Muhammad Yunus begins experimenting with loans to poor villagers.

***1974-75***
Bangladesh famine leaves many families destitute.

***1976***
Yunus lends $27 to 42 villagers, launching his lending experiments with the poor; all loans are repaid.

## 1980s

***Bangladeshi banks begin lending to the poor to start tiny businesses; the idea spreads to Latin America, Asia and Africa.***

***1983***
Yunus creates Grameen Bank in Bangladesh, first bank devoted to making microfinance loans to poor people with no collateral.

## 1990s

***Microfinance lending grows rapidly; Grameen eases lending rules, microfinance becomes more professional.***

***1991***
Grameen hits millionth member, growing 40 percent per year.

***1995***
Consultative Group to Assist the Poor, a group of major donors and agencies, created at World Bank.

***1997***
Microcredit Summit Campaign — a coalition of lenders, donors and advocates — sets goal of reaching 100 million families with microloans.

***1998***
Worst flood in Bangladesh's history leaves over 30 million homeless, killing over 1,000.

***1999***
Grameen suffers large-scale defaults.

## 2000s

***Grameen Bank makes microlending more flexible; profit-seeking investors take stakes in microfinance; worldwide credit crisis begins to affect microfinance. Reports of over-indebted microborrowers raise specter of loan "bubble"; microfinance industry initiates consumer-protection efforts to avoid regulation.***

***2001***
"Grameen II" is introduced, making loan terms more flexible.

***2004***
Grameen's savings deposits exceed its loans for the first time.

***2005***
U.N. declares it the Year of Microcredit.

***2006***
Yunus receives Nobel Peace Prize for bringing microcredit to the poor.

***2007***
California venture capital firm Sequoia Capital's $11.5 million equity investment in giant microlender SKS India signals attraction to purely profit-seeking investors.

***2008***
Worldwide credit crisis erupts (March 17). . . . By year-end, growth of new borrowings slows and delinquency rates rise.

***2009***
First randomized study finds microlending has no impact on poverty (July). . . . *Wall Street Journal* reports poor residents of southern India get "carpet-bombed" with offers of multiple microloans, raising fear of a credit bubble (August). . . . Microlenders criticized for concealing high interest rates with deceptive marketing; industry responds by disclosing true price of microlenders' loans in three countries, at www.mftransparency.org (Oct. 19).

***2010***
Bill & Melinda Gates Foundation announces $38 million grant to microfinance lenders in 12 countries in Asia, Africa and Latin America to create savings accounts for the very poor — signaling new focus on savings.

*Continued from p. 90*

yields, received no benefit from his assistance. They owned no land and eked out a daily living as day laborers, craft workers or beggars. A village woman, Sufiya Begum, told Yunus that she relied on a local moneylender for the cash to make the bamboo stools she sold. But the moneylender would only give her the cash if she agreed to sell him what she produced at a price he set. Together with the high interest on her loan, this left her only two pennies a day as income. [45]

In an experiment starting in 1976, Yunus decided to lend $27 of his own money to 42 villagers who were beholden to moneylenders. When he asked a local bank to make more such loans, they objected that the borrowers had no property to offer as collateral and no credit histories.

Yunus persuaded the bank to make the loans by offering to act as guarantor. He was "stunned" when the poor paid back their loans "on time, every time." Unable to persuade local banks to expand this program further, he created the now world-renowned Grameen ("village") Bank in 1983, to lend money to the poor without requiring collateral. [46]

## Power of Peer Pressure

The bank grew explosively, largely credited to its innovative group lending, in which poor borrowers acted as guarantors for one another. Each group consisted of five friends, all of whom had to approve of a new loan; if a member defaulted and fellow group members did not pay off the debt, everyone in the group could be denied subsequent loans. [47]

This so-called "joint liability" became the most celebrated feature of the Grameen contract, according to

# Do Microcredit Loans Alleviate Poverty?

*New studies question old assumptions.*

Many impoverished borrowers rise above the poverty level after receiving a microfinance loan. But was the loan the crucial factor, as advocates have claimed?

Not necessarily, economists have argued. Since people who take small loans tend to be entrepreneurs with drive and ambition, they could have found some other way besides microfinance to better their situation — through social networks, other loans or business aptitude. Dean Karlan, a professor of economics at Yale University, argues that the better question is: "How would their lives have been different had they not received the loan?" [1]

Karlan and economist Jonathan Zinman of Dartmouth College are two of the first researchers to employ the randomized control trial — the gold standard of scientific research — to determine the effectiveness of microfinance. In this approach, one group of people is randomly assigned to receive a loan, and another group gets no loan. Last year, in one of two studies that appear to overturn widely held beliefs about microcredit's power to alleviate poverty, they compared two such groups in the Philippines. [2]

The results were surprising. They found no evidence that household income improved among those who got a loan. Although women are the traditional recipients of microcredit, male borrowers were more likely to increase their small-business profit as a result of their loan. Men also tended to spend their profits on their children's education — in contrast to the conventional wisdom that it's mainly women who can be counted on to do so.

A second study using randomized groups in the slums of urban Hyderabad, India, did see some benefit: Borrowers who already had a business saw some increase in profit. Conducted by economists Abhijat Banerjee and Esther Duflo at the Massachusetts Institute of Technology (MIT), the study found that overall household spending — a crucial sign of financial health — stayed about the same. The authors found "no impact on health, education or women's decision-making" power in the family — three benefits often claimed for microfinance. For example, households that took a loan were no more likely to have children in school than those that did not. [3]

In at least half the Hyderabad cases, borrowers said they planned to use their loan for a nonbusiness purpose, such as repaying another loan, buying a TV or meeting household expenses. The authors conclude that those borrowers who didn't start a business but increased their consumption when they got a loan "may eventually become poorer" because they are "borrowing against the future."

However, critics said both studies measured a period of time — up to 18 months — that was too short to determine whether poverty would be overcome. "You need about two-and-a-half years worth of loans to see a real impact," says Mary Ellen Iskendarian, CEO of Women's World Banking, which works with 40 microfinance lenders in 28 countries. In Pakistan, she says, that's when "you start to see a substantial improvement in the house: The tin roof goes on or the mud floor becomes wood, or another child is registered for school."

Leading microfinance advocates say the studies can't disprove improvements in people's lives that they've seen with their own eyes. "We don't have the evidence in the sense academics want to have it," partly because randomized trials are expensive, says Susan Davis, president and CEO of BRAC USA, a New York-based nonprofit that supports the leading microlender BRAC. In addition, Bangladesh now has so many microlenders that it's hard to find people who have never received a loan to use as a control group, she points out.

"If I hadn't talked to hundreds and hundreds of microfinance borrowers directly, maybe I wouldn't be such a supporter," says Davis, who lived in Bangladesh for four years. "I'm not worried about what the research says. I could see the difference

between a mom who got access to finance in the size of their children," who weren't stunted with malnourishment, she recalls. "We have way too many people who have seen the stories. And the fact that millions want access to the service is an indication of the demand."

Jonathan Morduch, a professor of public policy and economics at New York University's Wagner Graduate School of Public Service, is a longtime skeptic about the traditional claims for microfinance. "The boldest claim for microfinance — that it can single-handedly eliminate a large share of world poverty — outpaces by a long distance the evidence accumulated to date," he said in 2006. [4]

That conclusion is "even more true now," with the release of last year's randomized studies from Yale and MIT, he says. But surprisingly, he also insists that "microfinance could be good in its own right without poverty reduction" by giving poor people the kinds of banking services that permit them to send a child to school or deal with a health problem. Something as simple as having money on hand to go to the hospital for childbirth could have a big impact on infant mortality, he says.

However, the underlying question remains: Would governments and aid agencies make a bigger dent in poverty by spending their money on something else? A year of primary schooling probably helps poor people more than a year of microfinance lending, some experts say. But microfinance costs much less in subsidies. [5]

"What interventions do we have that have even repaid 1 percent of the investment?" asks Jonathan C. Lewis, founder and CEO of the nonprofit MicroCredit Enterprises, which makes loans to microlenders. "Do we have vaccination programs or schools that provide self-financing?"

As for the recent studies, he concludes, "Every single value that you hold dear you don't measure with a spread sheet. We don't say, 'Before you start school, we need to know what benefit society will get.' We have a general sense this is the way it's going to work."

***— Sarah Glazer***

AFP/Getty Images/Farjana K. Godhuly

*Carpenter Anil Sutradhr works in the backyard shop he opened in Manikganj, Bangladesh, with a microloan from Grameen Bank. Recent studies have shown that microloans are less effective at decreasing poverty than was widely thought.*

[1] Dean Karlan, "Measuring Microfinance," *Stanford Social Innovation Review*, Summer 2008, p. 53.

[2] Dean Karlan and Jonathan Zinman, "Expanding Microenterprise Credit Access: Using Randomized Supply Decisions to Estimate the Impacts in Manila," July 2009, http://financialaccess.org/sites/default/files/Expanding%20Credit%20Access%20Manila.pdf.

[3] Abhijit Banerjee, *et al.*, "The Miracle of Microfinance? Evidence from a Randomized Evaluation," October 2009.

[4] Connie Bruck, "A Reporter at Large: Millions for Millions," *The New Yorker*, Oct. 30, 2006.

[5] Richard Rosenberg, "Does Microcredit Really Help Poor People?" January 2010, Focus Note No. 59, Consultative Group to Assist the Poor, www.cgap.org.

economist Morduch. For many years, microfinance was linked inextricably to the idea of group lending. It gave customers incentives to pay promptly, to monitor their neighbors and to select responsible acquaintances when forming the groups. The requirement that weekly payments be made in public in the village "center" in the presence of 10 or 12 such groups, placed even more peer pressure on timely repayment. To many economists, it was the linchpin that explained why loans to poor people without collateral worked. [48]

Today Grameen has branches covering virtually all villages in Bangladesh, according to Grameen's Web site. The Grameen bank gives loans to more than 8 million poor people, 97 percent of whom are women. Grameen has long boasted an impressive 98 percent repayment rate, but it recently reported a surprising drop to just 96.55 percent of loans paid on time at the end of last year. (*See graph, p. 86.*) [49]

## The 'Debt Treadmill'

Grameen's group lending model has been widely imitated by microfinance institutions around the world. By June 2009, microlending had spread to 100 countries, where more than 1,400 microfinance institutions were making loans to more than 86 million borrowers, according to the Microfinance Information Exchange (MIX).

But the model has been criticized in recent years for putting some borrowers into more debt than they could repay and abusively pressuring those who can't repay in time. Loan officers, paid according to how many loans they collect, have sometimes insisted that everyone be held at the village meeting until defaulters paid up. In some cases that meant a rushed visit to an expensive moneylender to come up with the money. In other cases, loan

AP Photo/Esteban Felix

AP Photo

**Desperate Microfinance Borrowers**

*Riot police arrest a farmer in San Benito, Nicaragua, during a January 2009 demonstration in which hundreds of farmers blocked the Pan-American Highway to protest high interest rates charged by microfinance firms (top). Demonstrators associated with Nicaragua's populist "No Pago" (I Won't Pay) rebellion have held mass protests across the country demanding a legal cap on interest rates. In an Indian village in Andhra Pradesh state, family members grieve the suicide death of a 26-year-old farmer, who had been despondent about his debts. In 2006 more than 200 people in the state reportedly committed suicide because of intimidation by microfinance institutions. The government closed down 50 branches of two major microlenders and charged them with extortionate interest rates and intimidating borrowers with strong-armed debt recovery.*

officers harassed borrowers, sometimes refusing to leave someone's house until they came up with the money, according to Anton Simanowitz, a socioeconomist at the University of Sussex Institute of Development Studies in England.

Most microfinance institutions pay cash incentives to loan officers based on how many new clients they bring in and how much money they lend, according to Simanowitz. "It doesn't matter if you're not careful about assessing [the borrower's] ability to repay and their business capacity" when recruiting new clients, he says.

As a result of how they're paid, some loan officers put excessive pressure on borrowers to pay their loans — even in desperate situations. For example, says Simanowitz, a group of women in Kenya had fallen behind in their payments because of a drought. Despite being on the verge of starvation, they sold one of their last chickens to pay their loans. [50]

"That's irresponsible lending . . . accepting money from people selling food when they're starving," says Simanowitz. Theoretically, the business supported by a microloan is expected to generate enough income to repay the loan. But the longer a borrower is with the lender, he says, the more likely are microfinance lenders to "give bigger and bigger loans, so the gap between business and loan size gets bigger until people are extremely vulnerable."

The common practice of pressuring members to take a new loan as soon as they've repaid their last loan also disturbed Wilson, the former director of microfinance for Catholic Relief Services. In 2005, the organization announced that it was withdrawing from the business as a direct investor and lender, citing a fundamental conflict between seeking financial profits and its mission of serving the poor. [51] (The organization still lends technical assistance to microlenders but has shifted emphasis to encouraging savings.) Wil-

son believes savings, rather than loans, meet the kinds of emergency health and household needs poor families have most often.

"The problem I've seen with most microcredit is they have a formula: once you get a customer hooked, you don't want them to graduate [out of indebtedness] because it's expensive to get that first customer — you've got to do organizing and outreach. Now you've got a live one and don't want to let them go, so you keep selling them more loans. That's a treadmill" of debt, Wilson says.

## After the Flood

In 1998 Grameen itself recognized problems with its group lending approach after being hit with large-scale loan defaults following Bangladesh's worst flood in history. When the bank studied which borrowers were defaulting in 1999, it discovered many of them had been struggling to repay for years before the flood. [52]

Recognizing underlying flaws in its approach, Grameen made some radical changes. It began offering more flexible loans — not just for business but also for family needs like student fees — allowing borrowers to change the rigid weekly payment schedule and putting less emphasis on the group to enforce loans. [53]

In 2001 Yunus introduced "Grameen II," which shifted away from the previous inflexible lending system in which every loan term was one year and repayments had to be in weekly installments even if that didn't match the cash flows of many poor households. The new approach removed the requirement that a member borrow continuously. Grameen II also stepped back from the group approach, outlawing an arrangement that makes borrowers responsible for repaying each other's loans. [54]

In addition, the bank intensified its collection of villagers' savings. By the end of 2004, savings deposits amounted to more than its loans for the first time and have continued growing faster than loans.

In 2006, Yunus received the Nobel Peace Prize for his work in microfinance. ■


AP Photo/Hussein Malla

*A Jordanian woman who obtained a microloan from the private Microfund for Women displays her embroidered wares at a microfinance conference in Amman. Studies show that when nonprofit lenders convert themselves into profit-seeking banks, the percentage of female borrowers declines sharply. Commercial banks seek higher profit margins, but women generally operate in highly competitive sectors like food preparation, sewing and beauty salons, which have smaller profit margins.*

# Current Situation

## Rising Delinquencies

Having grown from a small philanthropic movement in the 1970s, microfinance institutions (MFIs) today provide financial services to 86.2 million borrowers and nearly 100 million savers in the developing world. [55] And while dozens of banks in the developed world met their demise during the world financial crisis in mid-2008, the MFIs appeared to be surprisingly nimble.

"No microfinance bank has gone under yet," according to Trant, of the International Association of Microfinance Investors. "We've seen some show stress in repaying loans; but we haven't had a bankruptcy or liquidation."

Iskenderian of Women's World Banking attributes the industry's adaptability to the fact that the microborrowers tend to have small, short-term loans that they can get out of quickly and maintain small inventories so they can shift easily to a new business.

While the industry may have been resilient at first, the most recent reports suggest it is not impervious. By the end of 2008, the rapid 25 percent annual growth rate in borrowers worldwide had slowed to 15 percent, according to the MIX. A major reason: Rising delinquency rates in some areas forced loan officers to focus on getting current clients to pay their debts rather than attracting new borrowers. [56]

Delinquency rates rose particularly in high-growth markets; Morocco and Bosnia and Herzegovina saw their unpaid loan rate double, though defaults still represented less than 5 percent of their loans. [57]

Contrary to early hopes that they would be insulated from broader economic shocks, microlenders now see themselves as "vulnerable to them through financial markets, credit conditions and the fortunes of their customers," the London-based Centre for the Study of Financial Innovation recently reported. Indeed, a survey of 430 lenders and investors showed that they were most worried about borrowers being unable to repay their loans — a radical change from its last survey in early 2008, when many lenders were growing at double-digit rates. [58]

Fear of growing overindebtedness — borrowers who've taken on more debt than they can repay — dominated the list of concerns. In disturbing echoes of the subprime mortgage market collapse, many lenders worried that in high-competition regions like Latin America and Asia, where growing numbers of lenders are jockeying for market share, standards for determining the credit-worthiness of borrowers are declining, and more borrowers are defaulting. [59]

In Bosnia and Herzegovina, loan officers are being forced to fill "crazy" monthly quotas of new borrowers, one survey respondent said, based on this come-on: "Just take a loan, you'll pay it back some way." [60]

AP Photo/Sayyid Azim

*Members of the Fikina Kibiashara ("think business") borrowers' group in Nairobi, Kenya, gather to make payments on their microloans. The group's tailors, vegetable and grain vendors and used clothing and wastepaper dealers are just the kind of small entrepreneurs the microfinance movement targets.*

## Looming Crisis?

Even before the international credit crisis hit, there had been growing concern in the industry about regions where borrowers seemed to be over their head in microfinance debt, with rising delinquency rates. A potential repayment crisis is brewing in several "hotspots" — South India, Morocco, Nicaragua and Bosnia and Herzegovina, according to industry experts. [61]

Experts say borrowers owing multiple debts to several microlenders are driving the problem. Typically, microfinance borrowers don't develop individual credit histories. "Group lending . . . the very thing that makes it possible to reach poorer people, means the institution knows less about each individual client," says Rhyne, of the Center for Financial Inclusion.

Could this overlending lead to a bubble like the U.S. subprime crisis? "We should be worried," says the Center for Global Development's Roodman. Since credit bureaus are rare in these countries, "No one except the borrower has the whole picture," Roodman observes.

In Karnataka, one of the Indian states worst-hit by defaults, the four largest microfinance lenders recently pooled their data to determine how many of their borrowers had multiple loans. They found less of a problem than many imagined. Only 11 percent of borrowers said they were getting loans from two or more institutions, according to the Grameen Foundation's Counts.

Yet, more and more the industry and trade press are asking if a subprime-size bubble could develop. Some argue that a bubble already exists in three states of southern India that account for nearly half of all Indian microclients — Andhra Pradesh, Karnataka and Tamil Nadu — yet are also

*Continued on p. 98*

# Should governments cap microloan interest rates?

**ANEEL KARNANI**
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**WRITTEN FOR *CQ GLOBAL RESEARCHER*, APRIL 2010**

## Yes

The microcredit industry resists regulation on the grounds that microcredit is an open and competitive market. I disagree. The industry is characterized by a lack of competition, imperfect information and vulnerable consumers. In an ironic twist on the original microcredit mission, microfinance institutions (MFIs) are making a fortune in microcredit — by exploiting the poor! The government should impose an interest rate ceiling to protect the poor.

Microcredit interest rates are very high. Grameen Bank founder Muhammad Yunus argues that if the interest rate is more than 15 percent above the cost of funds, then it is "too high…. You are moving into the loan shark zone." A study by the Consultative Group to Assist the Poor (CGAP), (a consortium dedicated to promoting microcredit) showed MFIs charge a median interest rate of 28 percent per year, and 5 percent of MFIs charge rates above 50 percent. Generously allowing 10 percent for cost of funds implies that more than half of MFIs charge interest rates that Yunus would consider too high.

High interest rates have made many MFIs very profitable. In the CGAP study, MFIs earned an average 2.1 percent return on assets annually, well above the 1.4 percent earned by banks in the same countries. In 2006 10 percent of MFIs earned a return on equity above 35 percent. These are high profits by any business criteria. Even the CGAP study concludes that MFI profits are high because "the microcredit market is still immature . . . and [has] little competition so far."

The industry responds that the high interest rates are due to high costs. But empirical analysis shows that costs (and prices) vary widely across MFIs in a country. Since this analysis holds the loan size and the environment constant, the cost differential is likely due to some MFIs having unreasonably high controllable costs. In a competitive industry, such wide differentials in costs would not persist, and firms with inefficient operations and high prices would be penalized.

Financial literacy is a major problem for microcredit clients, who are poor, ill-informed and often illiterate and innumerate. The volatile combination of profit-seeking companies, minimal competition and vulnerable borrowers has opened up a dangerous potential for exploiting the poor. MFIs have much market power and can earn monopoly rents. Expecting microcredit organizations to exercise self-restraint and self-regulation is naively optimistic. Regulating interest rates is the only feasible solution. This does not mean that all, or even most, MFIs abuse monopoly power; but enough of them do exploit the poor to warrant regulation.

**ALEX COUNTS**
***President, Grameen Foundation***

**WRITTEN FOR *CQ GLOBAL RESEARCHER*, APRIL 2010**

## No

When we hear about poor microfinance clients paying interest rates well above the rates paid by businesses and middle-class consumers, in the same country, it is tempting to argue for government-imposed interest rate caps on microfinance institutions. But I am convinced it would be counterproductive in practice.

Caps might spur some needed innovation and cost-cutting in a few markets if the imposed rate was within striking distance of the rates currently being charged. But in most cases, it would drive microfinance lenders out of business and force their former clients to increase their dependence on moneylenders who can charge rates well above 100 percent annually (as we saw happen in India in 2006).

And the MFIs that survive would likely suspend outreach to the poorest and most isolated clients (where initial transaction costs are highest); cut back on social-empowerment services (mostly related to health and education) that often magnify the poverty-reduction impact of microfinance; and attempt to circumvent the interest rate caps by charging additional fees (effectively negating the cost savings to clients).

Rather than take this crude though possibly popular approach, a more subtle strategy would be preferable. First of all, let competition on a level playing field — rather than government mandates — drive reductions in pricing (as has occurred in Bangladesh and Bolivia, two mature and highly efficient markets where there have been no government-imposed rates). Second, have donors and others invest in industry-wide initiatives that could bring widespread efficiency gains, such as documenting and driving adoption of best practices in (a) low-cost capital mobilization (especially from deposits), (b) optimization of human resources and (c) cutting-edge technology applications.

Grameen Foundation has made significant commitments to all these areas. Governments can play a role by helping to ensure a level playing field by, among other actions, defining price transparency in a way that helps clients find the lowest cost for particular products and requiring microfinance providers to implement consumer protection measures.

Rather than impose interest rates set by bureaucrats and politicians, it would be safer and more in the interests of the poor for governments to work with microfinance stakeholders to accelerate a market-based process that has been under way for years — which is bringing down rates 2-3 percent on an annual basis thanks to competition, media scrutiny, efficiency-enhancing innovation and price transparency.

AFP/Getty Images/Roberto Schmidt

*Women seeking loans in Sauir, Kenya, rest in the shade of an Albizia tree as they wait to speak with a representative from a microcredit lender.*

*Continued from p. 96*

experiencing some of the fastest growth. [62]

In August *The Wall Street Journal* reported that poor neighborhoods in southern India were being "carpet-bombed" with offers of loans. The reporter found two aspects reminiscent of the subprime bubble: loan officers paid on commission and undocumented loans. [63]

Industry defenders are quick to point out the sector's admirable history of on-time repayment by 98 percent of borrowers. But people living on $2 a day typically have many unreported loans in the informal sector — from moneylenders, storekeepers, friends and family — in addition to one or more microfinance loans. [64]

This is only one of the reasons why Trant, of the International Association of Microfinance Investors, says, "The general consensus is the 98 percent repayment rate is probably not 100 percent realistic." A study by her organization discovered that microfinance organizations often restructured loans — giving borrowers who can't pay extra time — but counted that as part of their renowned 98 percent repayment rate.

Nevertheless, industry experts say, even the highest default rates among microlenders — about 5 to 10 percent of their portfolios — are less than American credit card defaults in the past year, which rose as high as 14.5 percent for Bank of America customers. [65]

## Government Crackdowns

As the specter of overindebtedness looms, several governments have introduced consumer protection measures. Some countries in West Africa are encouraging the creation of credit bureaus. Nigeria has imposed interest rate caps on microlenders. And India has clamped down on what it considers exorbitant rates and abusive debt-collection policies by microlenders. [66]

Such "political interference" worries Latin American microfinance industry leaders, according to a recent survey, some of whom complain that interest rate caps in Colombia and Venezuela are stunting the growth of the market. [67]

In Nicaragua, the "No Pago" movement, supported by thousands of angry borrowers, scored a major victory last October when legislators recommended a bill capping interest rates at 12 percent and giving debtors up to five years to repay loans. [68] The movement in Nicaragua, first sparked by inflammatory remarks against microfinance lenders by President Daniel Ortega, has the industry worried about measures that populist governments might take.

Indeed, according to MFTransparency's Waterfield, fear of government caps is one reason why the industry "lied for three decades" about the interest rates they charge. "If the Ortegas of the world knew what we were really charging, they would freak out and put a limit on interest rates," he says.

India also has cracked down on microfinance organizations over exorbitant rates and abusive debt collection. In Andhra Pradesh more than 200 people committed suicide in 2006 allegedly because of intimidation by microfinance institutions. Government authorities closed down 50 branches of two major microlenders and charged them with extortionist interest rates and intimidating borrowers with strong-armed debt recovery. [69]

Last month, Bangladesh Finance Minister AMA Muhith charged that high interest rates and charges were forcing borrowers to sign up with several microlenders simultaneously to pay back their loans, placing them in a "debt trap." [70] Yunus called on the Bangladesh Microcredit Regulatory Authority to come up with standardized interest rates to establish transparency and remove suspicion among borrowers about interest rates. [71] The authority has announced that it plans to publish microlenders' interest rates regularly and to frame a policy to make rates more transparent. [72]

Other than these scattered official efforts, Counts says, no big government backlash has occurred. "There are more threats than outright laws," he says.

Have the recent government actions been effective? "The problem is there's very little ability to enforce regulation in most of the countries in which microfinance operates," says Rhyne. "Most of the time you have a few scattered laws here and there and a very weak regulatory apparatus; it's not clear who is responsible for consumer protection in the financial industry." ■

# OUTLOOK

## Soaring Needs

To many in the banking world, microcredit offers enormous opportunity as 2010 marks the beginning of a demographic window in which the developing world's working-age population will surge to its highest point relative to the nonworking old and young. Millions of the "unbanked" will join the formal banking system, and "the need for microfinance will also soar," predicted HSBC Chairman Stephen Green. If all the working-age adults earning $2 a day or less are counted, some estimate the demand for microfinance is already 10 times the current supply. [73]

But many uncertainties hang in the balance, including worries about exploiting the poor to pay Western investors and questions about whether governments will clamp down on the industry.

Revealing microlenders' true interest rates is particularly important now that more profit-oriented investors are getting into the act. "We all agreed to lie [about interest rates] to help the poor, and now we've created the perfect environment for new people to come in and say, 'We can make a lot of money,' " Waterfield, of MFTransparency, says bluntly about his industry. "We're working to rapidly correct that before the damage gets out of control."

Meanwhile, the industry has "a long way to go" before attracting for-profit investors in a big way, according to Tryfan Evans, director of the Omidyar-Tufts Microfinance Fund. Illiterate borrowers placing their thumbprint on a hand-written receipt are a long way from providing Western-style credit ratings. The industry must become far more sophisticated to attract private investors on a large scale.

Despite all the excitement about high profits, average investor returns for microfinance banks overall fall well below the returns for either a commercial bank like Citibank or high-flying Compartamos, according to a recent study. Thus, for the immediate future, the industry probably will continue to depend on "social investors" — those willing to settle for a lower return in exchange for the knowledge they are helping the poor. [74]

And subsidies will continue to be important — perhaps even more so as microlenders struggle with the effects of the worldwide recession. About half of the foreign investment in microfinance in 2008 still came from donors and aid agencies, according to CGAP. [75]

The growing trend of MFIs providing savings accounts to the poor could address concerns that microloans are often used for emergency household needs, rather than entrepreneurial investment. Financial diaries reveal that those living on $2 a day are willing to pay neighbors to guard their savings for emergencies. Citing that finding, the Bill & Melinda Gates Foundation recently provided a $38 million grant to microcredit institutions in 12 countries to encourage them to offer savings accounts for the very poor. [76]

New technology — such as banking via cell phones, which is already widely used in Kenya and the Philippines — could help spread financial services to the poor, potentially offering more flexibility to borrowers than microcredit, with its group attendance requirements and lack of privacy.

Whatever the contributions and faults of the microcredit system, almost everyone agrees that the poor should have access to the same kinds of financial services — whether for credit or savings — that those in the West take for granted. ■

## Notes

[1] See www.sksindia.com.

[2] See "Microfinance at a Glance-2008," updated Dec. 31, 2009, Microfinance Information Exchange. www.themix.org/publications/microfinance=glance. The average loan balance per borrower reported by almost 1,400 microlenders is $1,588 — heavily influenced by higher average loans in Eastern Europe and Central Asia. Average loan balances reported by region were Africa: $626; East Asia and Pacific: $684; Eastern Europe and Central Asia: $4,008; Latin America: $1,341; Middle East and North Africa: $746; south Asia: $912.

[3] This is the compound average annual growth rate according to "Microfinance at a Glance-2008," Updated Dec. 31, 2009. The $44 billion gross loan portfolio is based on reporting from 1,395 microfinance lenders to the Microfinance Information Exchange, *op. cit.*

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[5] Malcolm Harper, "Some Final Thoughts," in Thomas Dichter and Malcolm Harper, eds., *What's Wrong with Microfinance?* (2008), p. 257.

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[8] Kim Wilson, "The Moneylender's Dilemma," in Dichter and Harper, *op. cit.*, p. 97.

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[10] Muhammad Yunus, *Creating a World Without Poverty* (2007), p. 54.

[11] *Ibid.*, p. 56.

[12] *Ibid.*, p. 55.

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[14] For a summary of the studies, See Richard Rosenberg, "Does Microcredit Really Help the Poor?" Focus Note 59, Consultative Group to Assist the Poor, January 2010, www.cgap.org/p/site/c/template.rc/1.9.41443/.

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[19] Jonathan C. Lewis, "Microloan Sharks," *Stanford Social Innovation Review*, Summer 2008, pp. 55-59, www.mcenterprises.org/uploadimages/file/microloan_sharks_lewis_stanford_social_innovation_review_2008.pdf.

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[21] "Online Extra: Yunus Blasts Compartamos," *Business Week*, Dec. 13, 2007, www.businessweek.com/magazine/content/07_52/b4064045920958.htm.

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[32] Chuck Waterfield, "Explanation of Compartamos Interest Rates," May 19, 2008, www.microfin.com/aprcalculations.htm. This rate is the annual percentage rate (APR) — the standard used in the United States.

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[34] See "Slideshow" at www.mftransparency.org.

[35] Aneel Karnani, "Regulate Microcredit to Protect Borrowers," Ross School of Business Working Paper No. 1113, September 2009, http://papers.ssm.com/sol3/cf_dev/AbsByAuth.cfm?per_id=561150.

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[38] Wilson, *op. cit.*, p. 105.

[39] Karnani, *op. cit.*, p. 6.

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## About the Author

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## FOR MORE INFORMATION

**Center for Financial Inclusion**, 1401 New York Ave., N.W., Suite 500, Washington, DC 20005; (202) 393-5113; www.centerforfinancialinclusion.org. An initiative launched by microfinance lender Accion International that has initiated a consumer protection pledge for the industry known as the Smart Campaign.

**Consultative Group to Assist the Poor (CGAP)**, 900 19th St., N.W., Suite 300, Washington, DC 20006; (202) 473-9594; www.cgap.org. A coalition of development agencies and private foundations promoting microfinance, housed at the World Bank.

**David Roodman's Microfinance Open Book blog**, http://blogs.cgdev.org/open_book/2010. One of the best sources of information about ongoing debates in microfinance, written by a fellow at the Center for Global Development, a Washington think tank, who posts chapters of a book he is writing on microfinance and seeks comments.

**Grameen Foundation**, 50 F St., N.W., 8th Floor, Washington, DC 20001; (202) 628-3560; www.grameenfoundation.org. Supports microlenders worldwide and promotes the philosophy of the first microfinance bank, Grameen Bank, founded by economist Muhammad Yunus in Bangladesh.

**MFTransparency**, 325 N. West End Ave., Lancaster, PA 17603; (717) 475-6733; www.mftransparency.org. A new industry-led effort to disclose the true cost of loans by posting interest rates, country by country.

**Microcredit Summit Campaign**, Results Educational Fund, 750 First St., N.E., Suite 1040, Washington, DC 20002; (202) 637-9600; www.microcreditsummit.org. A coalition of microfinance practitioners, donors and advocates seeking to provide microcredit to 175 million of the world's poorest families.

**Microfinance Information Exchange (MIX)**, 1901 Pennsylvania Ave., N.W., #307, Washington, DC 20006; (202) 659-9094; www.themix.org. A nonprofit founded by CGAP that receives data from over 1,400 microfinance lenders.

**Microfinance Insights**, 512, Palm Spring, Link Road, Malad West, Mumbai 400064, India; +91-22-4035 9222; www.microfinanceinsights.com. A widely read trade publication that focuses on the latest trends in microfinance and offers expert opinions and global viewpoints.

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# The Next Step:

## *Additional Articles from Current Periodicals*

### *Criticisms*

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### Citing *CQ Global Researcher*

Sample formats for citing these reports in a bibliography include the ones listed below. Preferred styles and formats vary, so please check with your instructor or professor.

MLA Style

Flamini, Roland. "Nuclear Proliferation." CQ Global Researcher 1 Apr. 2007: 1-24.

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# Voices From Abroad:

## Godwin Ehigiamusoe
### Executive Director, Lift Above Poverty, Nigeria

***Empowering women and the poor***

"Conscious of this reality [that poverty has many root causes], the organisation has over the years evolved into a group of system[s] of robust and viable institutions well-equipped with systems and structures that can effectively deliver sound economic, social and health services for fighting poverty and empowering the poor, especially women, in the society."

*Daily Champion (Nigeria)*
*March 2010*

## Vikram Akula
### Founder and Chairman, SKS Microfinance, India

***Absolute profitability***

"Do we believe that microfinance can be profitable? Absolutely. Do we believe profits have to come at the expense of clients? Absolutely not."

*The Times (England)*
*October 2009*

## Dean Karlan
### Professor of Economics, Yale University

***In reality, microfinance's effect is weak***

"Microcredit is not a transformational panacea that is going to lift people out of poverty. There might be little pockets of people who are made better off, but the average effect is weak, if not nonexistent."

*The Australian, October 2009*

## Monique Nsanzabaganwa
### Minister of Trade and Commerce, Rwanda

***Lenders lack necessary information***

"The fact that there are high non-performing loans in the banking and microfinance institutions is proof that lenders lack credible, comprehensive, easy to obtain and inexpensive credit information."

*The New Times (Rwanda)*
*March 2010*

## Xavier Reille
### Lead Microfinance Specialist, Consultative Group to Assist the Poor The World Bank

***Focus should be on sustainable growth***

"Experience shows that microfinance can maintain asset quality, and pay impressive returns, both in terms of profits to investors and as well as improvements in people's lives. Nevertheless, a few countries do show signs of stress and remind us of the need for a much stronger focus on sustainable growth and re-commitment to asset quality."

*TechWeb (United States)*
*February 2010*

## Malachi Kongude
### Chief Executive Officer, Tangale Microfinance Nigeria Limited, Nigeria

***Microfinance is a path to business and education***

"We have been able to disburse loans to farmers to boost their farming business; we give loans to parents to cater for their wards in schools at all levels. . . . Some parents who cannot afford money to send their wards to school at the beginning of the term/semesters have come to us to get loans, and we are always at their beck and call."

*Daily Independent (Nigeria)*
*February 2010*

## Prashant Thakker
### Global Head of Microfinance, Standard Chartered Bank, England

***Microfinance's many benefits***

"Asia is the birthplace of microfinance and the largest market for microfinance, whether in terms of potential clients, the number of people near the poverty line or asset size. . . . [Microfinance] offers attractive returns and a reasonable risk, and I'm not even talking about quantifying the social impact of those investments."

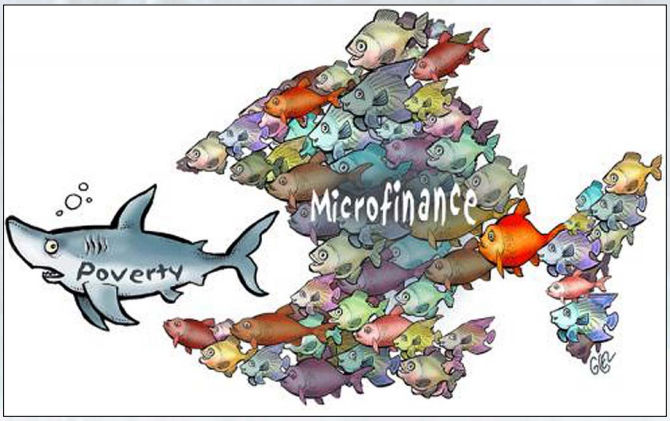
*The Business Times (Singapore)*
*February 2010*

## Muhammad Yunus
### Founder, Grameen Bank, Bangladesh

***A different kind of bank***

"In a traditional bank, the richer you are, the more important you are. With Grameen Bank, the poorer you are, the more important you are. In fact, if you have absolutely nothing — well, you're our best customer! . . . Banks spend a lot of time looking at people's credit history. Our bank is more interested in your future."

*Hobart Mercury (Australia)*
*March 2010*

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