Microfinance Grows Up: Success Brings New Challenges for Investors, Practitioners, in Emerging Economies

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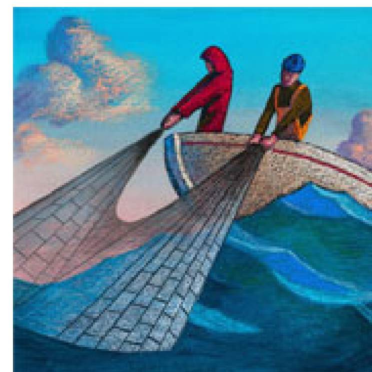

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Nine years ago, Avarzed could not have gotten a small business loan anywhere in her province, even if she had possessed 10 times the value in collateral (which she didn't). She lives in the province of Dornogobi, part of the Gobi Desert in Mongolia, a land-locked country between China and Russia known for harsh winters, arid steppes and nomadic herders. In this country, 2.9 million people are spread out over a land the size of Western Europe, although more than a million of them live in the capital city of Ulaanbaatar.

Avarzed was a single mother with three children in school, barely making ends meet by operating a small kiosk selling food and sundries. Then she got her first loan; she used the US$80 to buy more goods to sell in her kiosk. "I am grateful that someone trusted me, and I have always tried to repay my loans on time because of this," she says.

Today, she is putting one child through university in Ulaanbaatar, lives in a three-room apartment and owns her own shop. She used her latest loan of US$6,000 to expand her stock, buying stationary and beauty products. However, in the provincial capital where she lives, retail is not the only sector seeing growth: There are now six banks operating in this desert town of 19,000 people.

Increasing Competition

Mongolia is just one difficult environment where microfinance -- the business of providing financial services in small transaction amounts to poor, underserved markets -- has taken off in the past five years. But its experience showcases some of the changes now buffeting the industry as microfinance institutions (MFIs) and their markets mature, private investors arrive on the scene in force and traditional microfinance values are questioned.

The Mongolian Central Bank "made some smart reforms in the late 1990s, which helped the banking sector really take off in the ensuing years," says Ganhuyag Ch. Hutagt, CEO of XacBank, a Mongolian microfinance bank. "Consistently high GDP growth, privatization of all state-owned banks, lagging development of local capital markets and foreign investment have all driven rapid expansion."

The precursor to XacBank -- and the source of Avarzed's first loan -- was the Golden Fund for Development, a microcredit project that the United Nations Development Program started in 1998 with US$600,000 in loan capital and four local staff (all of whom are still with XacBank, including Ganhuyag). After registering as Mongolia's first non-bank financial institution in 2000, it quickly merged with another lending organization formed by the international NGO Mercy Corps to become a commercial bank.

Turning a profit from the start, XacBank has become well-known in the microfinance world as a model for transformation and growth. But even as it has expanded to all provincial centers in the country with a wide variety of financial services, XacBank has not been the only microfinance player.

Another is Khan Bank, a former state-run agricultural bank which has become one of Mongolia's most well-regarded institutions and which has a comprehensive presence in rural areas. In 2000, after years of mismanagement and corruption, the agricultural bank was on the verge of being shut down. But the United States Agency for International Development (USAID), active in Mongolia since the peaceful transition from communism to a democratic market economy started in 1990, convinced the Mongolian

government to give the collapsing bank another chance, in large part because it was the only financial institution present in Mongolia's many remote villages. Now privatized, Khan Bank is still headed by the same foreign manager brought in by USAID for the turnaround. After rapid expansion in urban areas and due in part to its inherited nationwide network, Khan Bank is reportedly confident enough to be planning an IPO in London, a first for a Mongolian bank.

But the competition is heating up, especially in the rural areas where Khan Bank once enjoyed a monopoly: its success with small, three-person branches in remote villages is being copied by another privatized bank, Post Bank. Meanwhile, XacBank is pursuing rural customers through branchless banking technologies, including mobile phones.

Success and Its Complications

Even though the high degree of competition present in Mongolia these days is unusual, the phenomenon itself is increasingly common in the microfinance industry.

In Eastern Europe and Central Asia, the number of institutions active in microfinance stood at around 5,800 in 2006, most of them credit unions established after the fall of communism. Grzegorz Galusek, director of the Poland-based Microfinance Centre Network for MFIs in Eastern Europe and the New Independent States, says that a small number of these MFIs have accounted for remarkable growth in the first half of the decade, which is creating increasing competition. Total borrowers served in the region has grown from 1.5 million in 2000 to 5.1 million in 2006 while the total loan portfolio of all MFIs has grown from US$550 million to more than US$12.5 billion.

Indeed, competition will be a theme addressed in this year's 11th annual Microfinance Centre Conference in Ulaanbaatar, Mongolia, on May 29-31. The event will bring together microfinance practitioners, investors, donors, experts, consultants, researchers, IT vendors, policy makers and media to address a number of topics around the theme "Clients and Institutions, Growing Together."

Bosnia and Herzegovina is another small, yet competitive, microfinance market. When the sector first began to develop in 1996, there were around 50 registered microcredit organizations. Now, due to competition, that number has been reduced to about a dozen, says Senad Sinanovic, executive director of Partner, one of the top three microcredit lenders to have emerged in the country. The sector has been further squeezed by established banks reaching down-market and restrictions on loan terms established by the country's Law on Microcredit Organizations.

Yet along with success has come unexpected complications. The traditional microfinance group loan methodology, first popularized by the famous Grameen Bank in Bangladesh, was designed to be used in areas where it was the only loan product available, and where borrowers have very strong ties to their location and community. In the absence of collateral, group members guarantee each other's loans, with the lender threatening, at least in theory, to bar all group members from further loans if they do not cover for each other in the case of missed payments.

But when there is more than one lender in town, such threats lose much of their power, especially when the lenders do not formally or informally share borrower information. And if the competition comes in and offers individual loans, group lenders can lose many of their best clients who would prefer products more tailored to their needs, and who would just as soon not be forced to cover for their riskier group members.

XacBank, which has relied on individual, secured loan products since the very beginning, in part because of the nomadic culture of Mongolia, has felt the effects of other, more universal consequences of competition -- lower prices and tighter margins. According to the Bank's president, Bold Magvan, banking sector average domestic currency loan rates in Mongolia have decreased from 35% in 2000 to 20% in 2007.

"In response to [this] squeezing of profits, we saw the need for new and innovative approaches. Last year, we introduced credit scoring for several loan products, which has improved the efficiency of our credit officers," he says, also noting the planned roll out of a mobile phone banking system using a nationwide network of agents, which he said is projected to reduce transaction costs and increase the bank's customer base and fee income.

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Senad Sinanovic of Partner says his organization has also looked to technology for competitive advantage. Besides beefing up its market research capacity and lowering prices, Partner is utilizing mobile phones to improve service -- including sending greetings on customers' birthdays -- as well as new product offers.

However, no amount of technology can circumvent the need for information on a potential borrower's existing loans and pledged collateral. Lenders must communicate with each other, through a formal or informal credit bureau, in order to avoid double or triple lending to dishonest borrowers.

Mongolia does have a government-run credit bureau, but "there are many obstacles to its successful operation in remote, rural villages," said Enhhuyag Batsukh, the first deputy governor of the Central Bank. Last year, regulators began to worry about the increasing practice in some villages of family members getting two or three loans from two or three different banks, and pledging the same assets as collateral.

While the Central Bank is working to find solutions, banking sector non-performing loan rates remained quite low, standing at 2.7% at the end of 2007. Enhhuyag stresses the positive results that competition has had on the market: "In the past five years, loan rates have been almost cut in half, while loan terms have increased by two or three times, especially for herders," he says. "Banks serving the rural areas have many obstacles to overcome, but their efforts have paid off for Mongolia's rural population."

New Money Floods in, but Cautiously

With financial sectors in many developing countries maturing and MFIs themselves growing rapidly, capital markets have been quick to enter the fray. The World Bank's microfinance arm, the Consultative Group to Assist the Poor (CGAP), says that foreign investment in MFIs tripled between 2004 and 2006, reaching US$4 billion, and that half of the more than 80 private microfinance investment funds currently in existence were started after 2005.

This influx of capital is responding not to a new market (since poor people without access to financial services have always been there), but comes mainly from the realization, a long time in the making, that the business itself is sound -- that the poor are, in fact, bankable. According to CGAP, microfinance loan repayment rates are higher, worldwide, than those in the mainstream banking sector in developing countries. And according to the MIX Market (a transparent microfinance data aggregation and analysis organization funded by CGAP, among others), some of the biggest MFIs are also startlingly profitable, showing returns on assets of more than 5% and returns on equity of more than 30%. Such numbers have caught the attention of mainstream capital markets.

In fact, it seems that this profitability is even more secure than that of more traditional sectors in times of macro-economic trouble. A recent article published by economists at the MIX Market suggests that MFI asset quality is uncorrelated with macro-economic events. The study analyzed data from 639 MFIs representing 88 countries between 1999 and 2005, and found no statistically significant relationship between a country's Gross National Income per capita growth level and the asset quality of MFIs in those countries. Some MFIs experienced more late repayments, but default rates were unchanged.

A recent *International Herald Tribune* article by Daniel Altman takes this point further, discussing evidence that MFI profits have been unaffected by the major international credit market crisis. Indeed, they have continued to grow. The article suggests that the lack of integration of both MFI borrowers and local credit markets into the formal, international economy provides insulation from major macro-economic shifts.

Despite the fact that microfinance is getting increasing attention from investors -- including hedge funds such as Sequoia and the Carlyle Group -- many in the industry are wary of all the new money coming in. A recent microfinance profile from the Center for the Study of Financial Innovation, the publishers of the well-known "Banana Skins" banking risk report, provides a list of the anxieties that keep industry players up at night. In the survey of 305 respondents from 74 countries and all groups of stakeholders in the industry, the number-one risk cited was "management quality." In short, it seems that, for the first time in microfinance's history, there could be a danger of too much money pursuing too few quality institutions and managers.

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Gil Crawford, CEO of MicroVest, the first microfinance private investment firm in the United States, sees the problem a different way. "Microfinance has been demonstrated to be a profitable business serving the poor, even in some very difficult environments," he says. "If the equity capital is there in sufficient amounts and is sufficiently patient, and it brings the right incentives, then the management talent will follow."

Both Crawford and Jean-Philippe de Schrevel, a founder of Blue Orchard -- one of the largest private microfinance investment firms in the world, with close to US$800 million under management -- say that there are still bottlenecks in funding for MFIs, but they lie in equity, not debt. "As they expand rapidly, the best MFIs need to recapitalize, and they often need assistance in managing that fast growth," says De Schrevel. This opportunity, along with the chance to participate in the founding of new ventures in large, underserved markets, led him to launch a new, dedicated equity fund. "As an equity investor, we will have the influence necessary to provide the needed guidance, both to start-ups and growth projects," he notes.

However, such equity transactions present complications that are still being worked out. Shawn Murphy, executive director of Morgan Stanley's Microfinance Institutions Group, elaborated on the challenges facing MFI equity investors in a presentation at a microfinance investment conference held in New York in February. In some ways they mirror, on a larger scale, the problems that MFIs themselves face in lending to their own customers. Instead of a lack of enough historical data to feed credit scoring models, investors face a dearth of comparable transactions in comparable environments, and very little consensus on MFI valuation methods. Instead of weak or nonexistent credit bureaus, investors must use an immature rating agency industry and often work without audited financials in unpredictable, weakly regulated environments.

Many of these problems are familiar to any investor working in rapidly developing countries. But one of the more contentious issues has evolved out of the very characteristic that brought so much attention to microfinance in the first place from people unsatisfied with traditional models of philanthropy and development -- the seductive combination of doing good and doing well at the same time.

Doing Good, Doing Well, Doing Enough?

From the development perspective, microfinance is all about giving poor people a chance to work themselves out of poverty, to be treated as responsible, productive agents with the capacity to improve their own lives if given the same chances that are afforded better-off people in more developed countries.

These were the founding values of the industry. As the economic development community was searching for a more grassroots approach in the face of the mostly failed structural reform policies of the IMF and World Bank, microfinance became increasingly popular for the tangible impact it had on poor clients while at least partially, if not fully, covering operating costs.

As the industry slowly grew, cost-covering turned into profitability and the donor projects began to transform into regulated financial institutions. Facing limited and uncertain donor funding, the increasingly professional staff were often eager to access deposits and capital markets to finance expansion, as well as meet the non-loan financial needs of their customers. The greater focus on profitability and market discipline was often encouraged by a new wave of former bankers providing technical assistance to the MFIs. The result has sometimes been increasing trade-offs with social missions and shifts within organizational cultures.

The transformation process also placed the founding donors in often uncomfortable positions as shareholders and board members. The donors' new colleagues in MFI funding initially came from the socially responsible investment community, which, in theory, shares the same founding values. But as more mainstream players get involved, with their talk of astronomical growth and relatively quick exit strategies, accusations of "mission drift" are becoming louder and more frequent.

The second largest risk facing the industry, according to the Banana Skins report, is "corporate governance." This refers not only to a perceived lack of skills and experience, but to the potential for conflict that is arising through the diversification of so many MFI boardrooms. In the case of transformed donor projects, new, more commercial players are often brought in at the instigation of ambitious local

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management.

This conflict was brought sharply into focus by the IPO of a Mexican MFI, Compartamos, in the spring of 2007. The IPO, a secondary offering, was a wild financial success. Investors valued the company so highly that Accion, a non-profit microfinance network that put US$1 million of equity into the MFI through its subsidiary investment fund in 2000, sold half of its shares for US$140 million. The senior management and directors, who together held the largest single stake in the bank, received US$91 million through selling only 7.4% of the total outstanding shares.

Through online forums, newsletters and conferences, many in the industry applauded the IPO as an important milestone in the quest for greater investment from private capital, which they say is necessary to finance the massive expansion needed to reach the estimated billion-plus people still without access to basic financial services. But others argue that the near-100% effective annual interest rate charged by the bank to poor women, while competitive in the market, was more than excessive, as were the high salaries paid to management. Many such people saw Compartamos as an example of the hijacking of the microfinance concept by profit-seeking wolves wearing the sheep's clothing of poverty reduction to attract subsidized support and justify their high interest rates. "Microfinance has lost its innocence," declared Damian von Stauffenberg, executive director of the microfinance rating agency MicroRate and an industry veteran, in a microfinance newsletter following the IPO.

Mary Ellen Iskenderian is president of a global MFI network called Women's World Banking which assists its members to both scale up their operations and to deepen their commitment to serving women. In response to a recent article in the *New York Times* about the Compartamos IPO, she focused on its future implications for the industry: "If the Compartamos deal leads to more competition and services, then we will eventually be better off. But if it prompts others to enter microfinance solely to make a profit, then we all lose."

Women's World Banking has tracked the development of 25 MFIs from all corners of the globe over the last five years, and finds that while growth and formalization have doubled the total number of women served by these MFIs, the percentage of women borrowers in the total portfolio has dropped. "We cannot let microfinance's profitability overshadow its power as a poverty alleviation and empowerment tool," she argues.

Still, Iskenderian believes that commercial capital is necessary for microfinance to reach all those who need it. At a recent conference in New York on microfinance and capital markets, co-sponsored by Women's World Banking and Morgan Stanley, the buzz about the IPO focused on the double take done by Wall Street at the return on investment. On the other hand, Iskenderian noted, the IPO was also a warning for MFIs that would follow in Compartamos' footsteps: If you access the public markets, you had better be prepared for the scrutiny that comes with your financials being aired in the required public filings.

Onwards, Upwards ... Eastward?

Despite the conflicts in doing well and doing good at the same time, there seems to be plenty of momentum in microfinance for both growth and social impact.

"Investment facilitation has definitely been a focus of our conference in previous years," says Galusek of the Microfinance Centre Network for MFIs. "Last year, around 40 different investors participated in the conference's Investor Fair. With all of the new entrants into the market and the increasing complexity of the instruments offered, we expect more interest than ever." As microfinance expands in Eastern Europe and Central Asia, "competition will bring pressure on margins, while social performance management techniques will evolve to become one of a number of sophisticated tools and products that MFIs utilize in pursuit of their goals."

Just as growth and competition have been good for Mongolian herders, the increased pool of investor money has benefited the top-tier MFIs. "We have seen an astonishing growth in interest from the investment community in recent years," says Ganhuyag of XacBank. "The terms of our external loans have greatly improved and we have even sold some of our mortgage loans to be securitized. Another consequence is that investors are stepping up to provide funding for us to take our expertise across our

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borders to less developed markets, where we can manage the same rapid growth that XacBank saw in our early years."

China is one market that microfinance investors have been closely watching. If official statistics are to be believed, only 4.6% of the world's most populous nation still live in poverty in rural areas, but many experts believe the real number is substantially higher. In any case, the government has traditionally been agonizingly slow in removing barriers to microfinance development.

Mario Fischel, general manager of the Private Enterprise-Partnership Program implemented by the International Finance Corporation in China, says this is changing: "Microfinance development has seriously started in the country thanks to the two separate pilot initiatives of the People's Bank of China and the China Banking Regulatory Commission. Overall, the operating environment for microfinance is improving." He noted, however, that continued regulatory reforms are required, mainly in further developing the framework for credit-only institutions, providing greater operating flexibility and allowing better access to sustainable sources of funding.

Joohwan Cheon, Executive Director of PATRA, a Chinese microcredit NGO run by Mercy Corps and operating in Jilin province, close to the North Korean border, agrees that regulations need to be clarified and more microfinance-friendly policies adopted. "According to the Chinese Financial Law, registered NGOs cannot provide financial services, but according to the Chinese Poverty Alleviation Law, they can," he states. Cheon also notes that while the Chinese Banking Regulatory Commission recently changed its policies to allow private investors to establish rural financial institutions, the qualification process is very demanding and the tax rate is quite high. "These things have made the international microfinance community hesitant [to make] further investments."

The momentum of MFIs is, of course, ultimately driven by their customers. As the Mongolian economy grows and diversifies, and the "transition" period fades into history, many small and medium-sized businesses face competitive pressures, lack of information and challenging regulatory environments.

Eight years ago, Lhagvasuren was living in a small, semi-nomadic felt tent -- called a "ger" -- with his wife and two children, working as a mechanic for the government in the Gobi Desert province of Dundgobi. His used his first loan of US$500 to rent a table and buy spare parts to sell on it. Having worked for the government his whole life, like many Mongolians at the time, he had no experience running a business or even knowledge of basic market principles. He encountered numerous difficulties when he tried to expand his business.

Today, Lhagvasuren is the proprietor of the "Buyantchandmani" repair and trade company, employing five people in his six-room garage and materials shop. He has built a brick house for his family, and one of his sons has married and moved out. When reached by mobile phone at the Mongolian-Chinese border, he echoed Mario Fischel and Joohwan Cheon: "The biggest problems I have now concern crossing the border -- all the forms I need to fill out, the high taxes and so many restrictions." When your company supplies 70% of all construction materials in your province, such is the price of success.

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