

FT REPORT - SUSTAINABLE BANKING: Big business in small loans

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When in 1990 Carlos Danel and Carlos Labarthe headed south with a group of other young Mexicans to explore the possibility of building "social enterprises" in the poor states of Oaxaca and Chiapas they had little idea of what they were starting.

"We simply said there were thousands of people who knew how to do things but they lacked the access to capital," says Mr Danel, who now - seventeen years on - sits alongside his co-director Mr Labarthe atop Compartamos, the western hemisphere's biggest, fastest growing and most profitable micro-finance initiative (MFI).

Compartamos now provides small loans to more than 600,000 poor Mexicans and has a portfolio of \$275m. Originally backed by grants and low-interest loans it now draws most of its capital from institutional investors and recently completed a successful share offer on the Mexico City and New York stock markets. The deal - in which Compartamos raised \$467m - has highlighted the growing connection between micro-finance and the world of capital markets.

Compartamos is still the only IPO - two other MFIs that have raised money on the stock market, Equity Bank of Kenya in 2006 and BRK of Indonesia in 2003, started life as more orthodox banks.

But in recent weeks private capital group Legatum and Aavishkaar Goodwell have partnered to invest \$25m capital in one Indian micro-finance group, Share, while California-based venture capital group Sequoia and Unitus, the Seattle-based "accelerator" which supports, lends to and invests in MFIs, have ploughed \$11.5m into another Indian operator, SKS Microfinance. In a fourth deal Morgan Stanley and Switzerland-based Blue Orchard raised \$108m from the issue of a securitised bond backed by repayments from micro-finance loans. They plan to use the money to put money into 21 MFIs in 13 countries.

The flurry of activity demonstrates the geographical reach of micro-finance. The vast population of South Asia, the home of Bangladesh's Grameen Bank, set up by Nobel Prize winner Muhammad Yunus, provides the world's biggest micro-finance market in terms of pure numbers, but MFIs have achieved the greatest level of market penetration in Latin America.

Maria Otero, president of Acción Internacional, the US-based non-government organisation which invests and lends in MFIs internationally, points to rapid expansion in the region, partly on the back of regulatory changes that recognise MFI activity as very different in nature to conventional banking.

She says that her organisation took 20 years to win its first million clients, but only three years to obtain its second million.

The recent deals, however, also reflect a more profound change. In some ways, micro-finance is coming of age, completing a transition from a business funded by NGOs and development banks and subsidies to one that is fully commercial. In turn this change reflects the increasing commercial acceptance of the MFI business model, which centres on very low default rates, the relatively high cost of administering loans and high interest rates.

Typically it costs mainstream commercial banks less than 4 cents to administer every dollar of lending to customers. Micro-finance institutions operate with much higher expense ratios, paying at least 10 cents and sometimes more than 20 per cents per dollar they lend out.

The reason is that micro-finance institutions need to keep much closer tabs on their customers who are usually new to the financial system and often work in the informal economy.

According to Ms Otero, at Acción, which sold half its 18 per cent stake in Compartamos in the recent IPO, the Mexican bank employs 2,000 loans officers to administer a portfolio of \$275m. A traditional bank would manage the same value of loans with only ten to fifteen people.

MFI's also tend to charge their customers higher interest rates in order to compensate higher costs. These rates vary enormously according to local conditions but though more expensive than conventional loans they are generally much lower than rates charged by usurers, effectively the only other source of capital for many borrowers.

Even so, the scale of rates charged by the more commercial MFI's such as Compartamos - between 4 and 6 per cent a month - have been a source of some controversy, with critics saying the bank should do more to get lending rates down. In any event most practitioners agree that competition, technology and the introduction of more professional management will bring these rates lower. Geoff Davis, chief executive of Unitus, says that the introduction of smart cards, mobile phone payment facilities and more efficient credit assessment will all help reduce rates.

If MFI's are able to market new kinds of products over this more streamlined distribution network, costs will fall even further.