Micro-credit Transcript

Date: Thursday, 12 May 2005 - 12:00AM

Location: Barnard's Inn Hall

Micro-Credit: a development miracle or false promise?

Professor Avinash Persaud
with Special Assistance from Dr Stephen Spratt

One of John Maynard Keynes famous dictums – which I have updated the figures to reflect our times - was "if you owe the bank a hundred thousand pounds, you owe the bank a hundred thousand pounds, if you owe the bank a hundred million pounds, you own the bank". So, if you intend to go through you life spending your way into a sizeable stake in the banking sector, micro-credit is not for you. It is for people without normal access to credit on reasonable terms because they only want to borrow small amounts of money and have little collateral or credit history. These are features that would turn a traditional banker away, but proponents of micro-credit argue that are simply missing a trick. The repayment records of many micro-credit institutions are on par with those in large banks in developed countries. Micro-credit could be both good banking and a critical contributor to helping the poor lift themselves out of poverty. Is this too good to be true? We look at micro-credit successes, challenges and limitations. We then look at a novel way of extending the best aspects of micro-credit to more people.

What is micro-credit?

In some circles, like government development agencies or non-governmental organizations in the development sector, micro-credit has become so fashionable that it is used to describe such a broad church of activities, that it is no longer very clear what it means. I hesitate to offer a description of micro-credit, as I am sure it will be discriminate against somebody, somewhere, resolute that what they do is different. But for the purposes of some common understanding let me try. I would say the essence of micro-credit is threefold. First, it is not aid or charity, the lenders expect to get their money back with interest. Secondly, the size of loans and repayments are small. Third, in designing the lending practices of micro-finance institutions, their strong intent, is to alter the initial conditions of poverty – to break the poverty cycle.

To give you some more context to micro-finance institutions, the interest rates charged vary, depending on the type of organization and the underlying cost of money in different countries. In Bangladesh where micro-finance is particularly well entrenched and where large commercial loans carry an interest rate of 10%, micro-credit loans tend to carry interest rates closer to 22%, so we are not talking the cheapest money, though that is still considerably cheaper than your average informal money lender, or credit card company in the UK and in many cases, after discounting for inflation, real interest rates are close to zero or even negative. In terms of size of loans, they can start as low as $10 and, again in Bangladesh, they average around $25. Its small - in the UK you might mistake that for a bank charge – but as the proponents argue, $25 can buy you a lot of seeds.

I have used Bangladesh as an example a couple of times. The most famous micro-credit institution in the world is Bangladesh 's Grameen Bank, which began as a project in the village of Jorba in 1976, led by Professor Muhammad Yunis, Head of the Rural Economics Program of the University of Chittagong. Grameen means village in the Bangla language. Professor Yunis has made the single biggest contribution to the growth of the industry and, to Bangladesh too he would say. Grameen is an inspirational example of how micro-credit goes beyond small loans. 95% of Grameen's, 4.4million borrowers are women, these women borrowers hold the title to the assets purchased with their loans, like land and they own 90% of Grameen bank itself. Grameen has established a number of off-shoots including Grameen Phone, which finances mobile phones to Grameen for Struggling members who are former beggars. So far this sounds like a charity, but - bankers close your ears - the loan repayment rate for Grameen bank is 99% and the bank has made a profit in twenty six out of twenty nine years.

It should not be surprising therefore that micro-credit has caught the imagination of many. It offers the allure of development alchemy – turning the poor into good credit. Consequently, donors tend to trip over themselves in an attempt to help set up micro-credit institutions.

So what holds micro-credit back? Some of you will wonder how I can ask that question. Any Google search would suggest that micro-credit is big business and micro-credit for women is booming. Yet Grameen began in 1976, and was not the first micro-credit institution, yet today less than 2% the world's poor are micro-credit borrowers. Those that are, are concentrated geographically - 75% of micro-credit borrowers in the world are in Asia, there is tiny penetration in Africa or Latin America. It is also interesting that despite the compelling economics we have described above, the vast majority of micro-credit institutions are touched in some way by development agencies and developed country donors. It is very rare to find a micro-credit bank that is purely commercial. Look behind those that promise hard headed finance and you will find donors as sponsors, subsidy providers or investors.

I hope none of my public-sector friends will take offence but the public sector is not an easy shareholder. It is not in the business these days of owning shares in companies so it only does so to pursue a particular

agenda that may have more to do with the sensibilities and priorities of voters back home than poor entrepreneurs. If your venture had commercial returns and you had a choice of investors, a public sector shareholder would not be at the top of your list; which is not to say that the public sector should not be a partner, but that the omnipresence of the public sector in the micro-credit industry is telling us something about the commercial viability of the model. If micro-credit worked, why are the banks not major investors with their economies of scale, long distribution arms and expertise at credit monitoring?

There are of course fine exceptions to this rule. Indeed, this is another feature of micro-credit institutions. The successful like Grameen are often exceptional in some way and despite many attempts their success in one region is not easily transferable to others. Grameen works in rural Bangladesh, arguably it works spectacularly well, but there are few examples of successful migration of the Grameen model to Africa or Latin America. There are pockets of success, but they do not appear scalable.

Why? There is a simple explanation for these two characteristics of micro-credit – the absence of commercial scale the not easily transferable or scalable models of success.

The bank's profit on a loan it has made to you is some percentage of the size of the loan. If a bank borrows money at 5%, and then lends it on to you at 10%, it is making the difference, 5%, on the size of the loan. 5% of a $100 loan is $5, and 5% of a $10,000 loan is $500. The bank's revenues rise with the size of the loan. The cost of assessing the credit worthiness of a borrower, however, is only partially connected with the size of the loan. It costs me the same amount to find out whether you are who you say you are and you live where you say you do, whether you are a millionaire or a pauper. Indeed, it is cheaper, if you are a millionaire because someone has already carried out that due diligence before me and I could use their credit decision as a sign that you are credit worthy or not. This is why it is easier to get credit from a store if you have a whopping big mortgage than if you have no debt at all.

Banks therefore will lend down to amounts where the costs of credit monitoring and account handling equal to expected profit on the loan. Consequently, in general they don't offer micro-loans as a business and those that do, charge very high interest rates. (This incidentally, is the economics of informal money lenders in rural economies: small loans, high interest rates.)

The lower the fixed cost of credit monitoring and delivery the smaller the loans are that the banking sector can offer profitably.

Successful micro-credit organizations are often those where they have found some non-traditional way of lowering credit monitoring costs, often by utilizing social capital – for example Grameen's original lending system was that you had to be part of a small group of four or five to borrow and so this group needed each other and became a supportive network and one of the costs of default was letting your group down.

Social capital is an immensely important concept that does not just reside in the alternative arena. If we were to define it as what, in the absence of physical force, makes people keep their promises, it is one of the most important considerations when the commercial sector make an investment or not. It is all the things that lead you to trust an investor or borrower. If there is trust between you and a borrower – if only because of the deep sense of loss or face if trust is broken, you do not need to know their maiden name or where they live and so credit monitoring costs fall. If a micro-finance institution has found a way to tap into social capital, and as a result it can lower the costs line, it can be a commercially powerful venture.

But there are a couple of challenges with a credit model based on the value of a social network. First, it is not easily scalable or transportable. Social capital is not plentiful everywhere and is often absent in places of strife. More importantly, it takes on a different form in different places. The social context which means that rural Bangladeshi women, in Jorba, collected into groups, do not default is not the prevailing social context amongst urban Bangladeshi women, or women in Kiev or men in Mozambique.

Second, where social capital is leveraged through social networks it is linked to the prevailing social norms and hierarchies. There is some evidence that the main beneficiaries of some micro-finance institutions are those that are perceived to be pillars of the society such as the local landowner or the local boy or girl who did well, got a professional qualification and job, but are not exactly entrepreneurs. Without over-doing the social profiling, entrepreneurs can often be mavericks who do not easily fit into existing social systems. Leaning on social networks should therefore play an important role in the micro-finance industry, but it should not be single solution to unleashing entrepreneurism.

To try and fill in the gaps the public sector often gets involved, sponsoring micro-finance institutions where they may not otherwise spring up on their own. This involvement can have an adverse impact in two ways. First, as we hinted at earlier the public sector is involved to pursue a social agenda. There are often tough lending restrictions in terms of people, communities and activities. But this only increases monitoring costs and guarantees that the only way small loans can be delivered is through subsidy. Speak to some micro-credit institutions and they will complain about the immense paper work and monitoring involved in giving a loan. Many micro-credit institutions have more cash than they have approved loans.

Secondly, this subsidy may be addressing the inefficiencies of the micro-finance institution not a market

failure and so it prices private sector and commercial organizations out of the sector. These factors may explain why micro-credit has not caught on, why generally, though not always so, a public sector attempt to kick start a micro-credit industry has often led to a large number of small micro-credit organizations, some more successful than others but all with limited scale.

My colleague, Dr Stephen Spratt, and I have developed a more scalable model. The challenge is to come up with innovative ways to lower the non-money cost of initiating, monitoring and processing a loan, not to burden those costs further with public sector priorities. Not to price out the commercial sector but to encourage it, because it alone can deliver the necessary scale, and not to rely on models of social capital imported from elsewhere.

An alternative and new way of using social capital that is not dependent on social networks is to leverage off existing working networks. For example, where there is a private utility company with extensive coverage and strong payment histories, micro-credit could be delivered via the utility company. Initiating, monitoring and processing costs can be kept down to a bare minimum by determining loan agreements and size based on the payments data.

Critics will say first that this will not get to the poor and that you know very little about the borrower. There is clearly legitimacy to these concerns but utility coverage in developing countries had changed over the past twenty years through the privatization of electricity and telephone systems and more recently, the contracting out of payment systems. Today electricity coverage in rural Brazil is 90% and in urban Brazil is 99%. Many of these users are poor and without bank accounts. Rural electricity coverage is 80% in North Africa and East Asia, and 99% in urban Latin America, North Africa and East Asia. This idea would not work in rural sub-Sahara Africa, and South Asia where utility coverage is particularly low. And yes, you would not know much about these borrowers, but that is the point of social capital, you are relying on something else than individual credit information. In this case their regular payment of electricity reveals a disciplined “payer” and we are lending on that basis and hoping to further reduce risk through a portfolio of loans.

There are a couple other matters that need addressing before we close. First, the best and most complicated way of breaking the cycle of poverty is not through a $10 loan but providing access to collateral which in most cases is land. Lease purchase arrangements where families can purchase land through long-term payment facilities which allow for temporary periods of difficulty, will have the biggest impact on rural poverty. The revolution that is required here is not so much micro-credit but agents which buy the land for the poor and have them pay back these larger loans through long-term, high-frequency, micro-payments, like paying the electricity meter weekly.

Second, as a result of the achievements of the micro-credit providers, Bangladesh now has an hour glass

shaped banking market in which credit and other limited financial services are valuable to both very large and very small businesses and very wealthy and very poor individuals. While there is well – known informal system that provides credit to businesses, virtually nothing is available from either banks or micro finance provider to the millions of the middle class businesses and individuals- who are severely constrained in their ability to produce and save for lack of access to financial resources and services. Until modern, competitive financial services are readily available – including credit in amounts, terms and conditions that small can access, Bangladesh will not be able to create the large middle class. We may feel less urgent about this sector, they are materially less desperate, but they are the both engine of an economy and the glue of social stability.

We think both of these issues can be addressed by the scalable feature of our model, across both geography and size of loan.

In conclusion, the key to scaling up micro-finance so that it becomes a motor to economic development and touches not the fringes of the poor in Asia but the poor everywhere is to find innovative ways to reduce the costs of initiating, monitoring and processing small loans. Public sector involvement in micro-credit often though by no means always, serves to do the opposite. In order to satisfy the public sector shareholders sensibilities and priorities loan monitoring costs are higher than otherwise. Relying on social capital rather than traditional collateral or credit checks is a promising route. However, measuring social capital through social networks has its limits. It may not easily find the entrepreneurial mavericks, it may be biased to the leaders of the social system and it will not be easily scalable or transportable.

There may be alternative ways to tap social capital; one we suggest is to use the effectiveness of other networks to measure the presence of social capital. Utility coverage is one example and coverage has become extensive enough for this to be a practical solution in Latin America, North and South Africa and East Asia. Using utilities as agents of micro-credit may also help to support the small and medium enterprises that are the engine of most economies. Finally though, the poor are a good investment and $25 can sustain a farmer, but to break her out of the cycle of poverty she needs to own her land. This is one of the reasons why land is such an emotive issue in Southern Africa today. We need to turn the attention of the industry towards facilitating the purchase of land through large loans, not micro-loans, but then to serve these loans with easy micro payments linked to the performance of the land. We believe the utility model can address this challenge.

We have not touched on development issues much in this lecture series, but at the end of the day this remains humanity's biggest challenge. In some ways finance can, and I hope will, play a significant part in overcoming it.

© Professor Avinash Persaud, Gresham College, 12 May 2005