

Microfinance in Emerging Markets: THE EFFECTS OF THE CURRENT ECONOMIC CRISIS AND THE ROLE OF SECURITIZATION

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I. INTRODUCTION

This past year has boasted the largest global economic recession in recent history. Like falling dominos, many large financial institutions are being forced into bankruptcy, one after another. The United States' government and those abroad, are scrambling for solutions to brace their economies against the resulting financial effects. News circulates daily with somber stories of radical cuts in executive compensation and large-scale corporate layoffs. But, how deep into the global market are the effects of these falling dominos being felt? What have been the consequences to members of the world's lowest income class and what can be done to brace their economic chances at a brighter future?



II. WHAT IS MICROFINANCE?

The term “microfinance” encompasses a large range of banking and financial services provided to low income and underserved communities, most often in developing countries.¹ In contrast to wealthier countries in which financial services are well established and refined, financial services in emerging markets have been comparatively sparse.² The poorest portions of the world's population lack secure places to store the little money they do have and preventative services (including basic life and property insurance) are not accessible.³ Scarce sources of credit which are available, include local pawnshops and moneylenders who charge high interest rates and seek physical redress against clients who fail to pay on time.⁴

The origin of microfinance is often attributed to Muhammad Yunus, the founder of Grameen Bank of Bangladesh, who

began making small loans to the poor in 1976.⁵ He subsequently received the Nobel Peace Prize in 2006 for expanding access to financial services for individuals and communities that traditional financial institutions did not service.⁶

Currently there are four categories of microfinance institutions which are recognized: informal financial service providers, member owned organizations, non-governmental organizations, and formal financial institutions.⁷ This paper will focus on the final category, formal financial institutions, which are generally recognized to be the most expansive of the microfinance institutions in terms of delivering capital.

Formal financial institutions include the world's largest banks and insurers. Their sophisticated systems and global networks enable them to raise large sums of capital in a way that local institutions cannot.⁸ However, all types of microfinance providers interact to satisfy current demands. For example, larger institutional players are able to reduce risks and increase the liquidity of smaller institutions through repackaging and selling their loans.⁹

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III. THE BARRIERS INHIBITING MICROFINANCE

In many developing countries, the pathways for institutions to provide financial services are blocked by non-ideal conditions, such as high inflation rates, incompetent governments, and deficiencies in the legal framework necessary to support such financial services.¹⁰ Most poor families have few assets that can be secured by a bank as collateral, and those who are fortunate enough to own land in the developing world may not have effective title to it.¹¹ Even those who do have legal titles to their land may be inhibited by property laws which make it unfeasible for low income borrowers to use their homes, which are likely their only asset, as collateral to obtain secured loans.¹² Many of the emerging markets are working to improve their current legal frameworks in the interest of attracting foreign investments and financial institutions. However, to ensure investor confidence, it is necessary that these markets effectively implement and enforce such legal reform.¹³

Though well intended, changes to a country's legal framework may be hard to implement because local norms and customs are often deeply rooted within transition economies and date back through many generations.¹⁴ Unfortunately, there had not yet been sufficient research analyzing the extent to which institutionally friendly legal reforms conflict with existing customary laws.¹⁵

One area that traditional customs are known to be in conflict with corporate objectives is within the Islamic culture. In accordance with religious teachings, Islamic law prohibits charging interest rates on loans.¹⁶ Such restraint undermines the profitability of lending money, thereby reducing the supply of loans. Similar limits are also found in non-Islamic emerging economies, such as Venezuela, Brazil, and Columbia. These countries impose interest rate ceilings that discourage new financial firms from entering the microfinance market and push existing firms to seek methods of evading such regulations.¹⁷

An additional barrier within many emerging markets is their lack of government deposit insurance policies similar to those of wealthier countries, such as the Federal Deposit Insurance Corporation in the United States.¹⁸ Thus, when banks in developing countries become bankrupt, depositors are often unable to retrieve any of their savings.¹⁹ The negative result is twofold; the poorest, those with the least to lose, end up suffering the greatest losses, and foreign investors become leery of depositing their money into a system with such high risks when safer alternatives are available.²⁰

Furthermore, basic public services (e.g. electrical power) are often unreliable, making it difficult to run computers and perform other basic business functions.²¹ Institutions that would otherwise wish to establish themselves within these developing countries are unable to set up shop without such capabilities.²² Indonesian banks that were willing to establish under these conditions circumvented the electrical shortages by using paper to

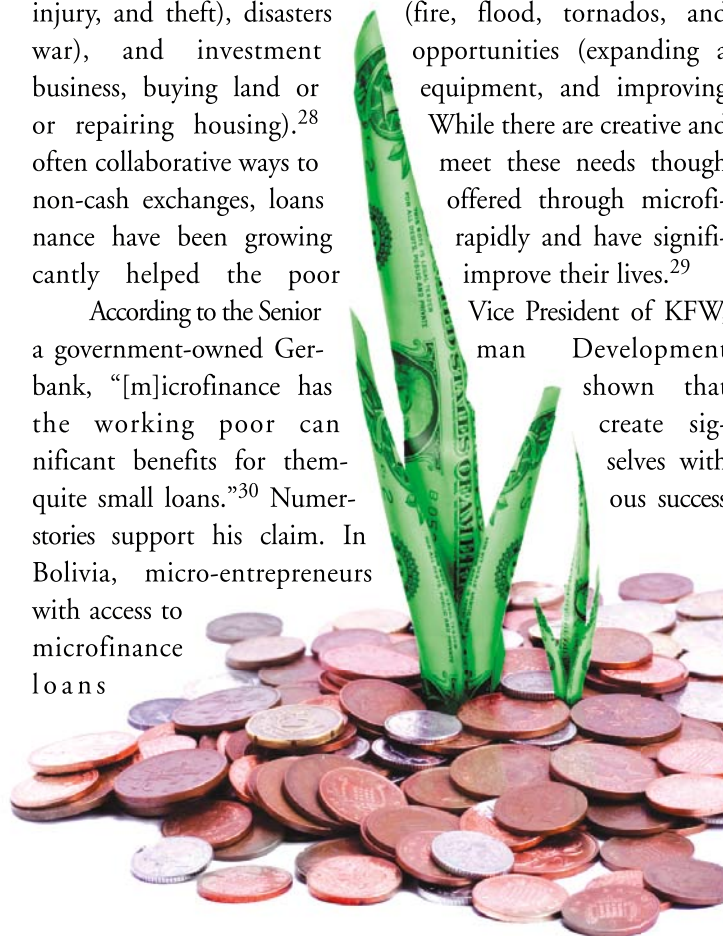
record all of their financial transactions.²³ However, when a tsunami hit Indonesia in December of 2004, all the banks' financial records were permanently destroyed.²⁴

If market hardships, combined with natural forces, do not completely discourage institutional investors away from microfinance, the likelihood of human brutality in response to a change in the status quo may close the deal. In poor countries, injecting available credit can result in social upheavals as the poor begin to have more opportunities. This possibility frightens the elite who fear they will no longer be able to monopolize with power based solely on family ties and inheritances. This turmoil has resulted in Islamic fundamentalists bombing branches of the Grameen Microfinance Bank in Bangladesh and India, and drug lords murdering the head of a large microfinance initiative in Afghanistan.²⁵ The bulk of microfinance borrowers are women, and for radical Muslims, extending credit to the poor enables women to create viable businesses and become independent, thus evading their traditional roles.²⁶ Afghan drug lords fear that credit extensions will enable local farmers, who previously depended on growing poppies to finance their crops, to have alternative options.²⁷

IV. DOES MICROFINANCE WORK?

The monetary needs of the world's lowest income families can be divided into four categories: lifecycle needs (weddings, funerals, and childbirth), personal emergencies (sickness, injury, and theft), disasters (fire, flood, tornados, and war), and investment opportunities (expanding a business, buying land or equipment, and improving or repairing housing).²⁸ While there are creative and often collaborative ways to meet these needs though offered through microfinance have been growing rapidly and have significantly helped the poor improve their lives.²⁹

According to the Senior Vice President of KFW, a government-owned German Development bank, "[m]icrofinance has shown that the working poor can create significant benefits for themselves with quite small loans." Numer-ous success stories support his claim. In Bolivia, micro-entrepreneurs with access to microfinance loans



nearly doubled their income within two years while those unable to attain such loans were unable to achieve financial gains remotely close to that extent.³¹ A microfinance institution in Kosovo, ProCredit Bank, helped numerous families survive post-war crises by providing loans to rebuild their homes and businesses after the civil war.³² Finally, clients of BRAC, a microfinance institution in Bangladesh, were able to combat malnutrition in significantly higher numbers than non-clients.³³

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The current market for microfinance institutions is continuing to grow. As many as 400 million potential clients worldwide lack access to financial services, a significantly greater number than the current industry could reasonably serve.³⁴ According to a 2007 report by Morgan Stanley, worldwide loan portfolios of microfinance institutions equaled \$17 billion dollars and have the potential to grow as large as \$300 billion over the next decade.³⁵

Contrary to what many might perceive, microfinance loans have an incredibly high rate of repayment in comparison to loans in other financial sectors.³⁶ Possible explanations for this anomaly include the low risk threshold sought by those with little money, as well as the fact that a majority of microfinance lending focuses on women who statistically default in lower percentages than men.³⁷ However, it should be advised that industry data may have a “survivorship bias;” microfinance institutions with the worst repayment records are those which become bankrupt and take their poor records to the grave with them.³⁸

V. WILL MICROFINANCE ENDURE THE ECONOMIC CRISIS?

Citigroup has been recognized as one of the largest institutional players in the field of microfinance.³⁹ According to the global director of Citigroup’s microfinance division, those with the least amount of money proved to be surprisingly enduring and thus bankable through previous economic crises.⁴⁰ For example, when a financial crisis hit Indonesia in the 1990s, the microfinance sector was not affected nearly to the extent of the formal banking sector.⁴¹ As previously noted, the poor have

a lower threshold for risk as a class, which makes them more resilient to economic cycles and protects them from sudden economic booms and depressions.⁴²

Citigroup’s forecast does not only anticipate microfinance weathering this storm, but further predicts that increasingly available technological options can reduce costs and help microfinance to continue to grow and expand. “By using mobile phones for banking and ATM terminals rather than rolling out bank branches in remote settlements ... [Citigroup predicts it will be able] ... to continue to expand and seek out those previously un-served.”⁴³

In contrast to the silver lining seen by Citigroup, media releases from the World Bank suggest a bleaker outlook for the microfinance field:

Microfinance institutions have proven resilient in times of crisis compared to other financial institutions. They offer the only access to finance for millions of low income people. As a result, customers tend to take their loans seriously and are very reliable payers. But the scale, depth and reach of the current crisis pose a risk, particularly for institutions that depend on financing from local and international banks. Institutions in Eastern Europe, Central Asia, Latin America and the Caribbean are especially feeling the crunch.⁴⁴

The World Bank has begun to see that previously plentiful foreign capital is becoming too expensive or drying up completely as the current financial crisis takes its toll on microfinance institutions along with the other global industries.⁴⁵ Though microfinance investors are largely people and institutions motivated by charity that are willing to accept high risks, charitable giving and aid is also drying up as the economy crumbles.⁴⁶

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During previous financial crises, like those in Mexico, Asia, and Russia during the 1990s, microfinance remained

remarkably resilient.⁴⁷ However, the present financial crisis is worse than those in the recent past, and the microfinance industry has become much more globally interconnected, receiving financing from international banks in addition to local investments.⁴⁸ In the present economic crisis, high food and fuel prices are causing microfinance clients to suffer immensely and, as a result, they are beginning to withdraw savings and are struggling with loan repayments.⁴⁹ Clients are worried about the security of their life savings in banks without government insurance and some believe that hiding money under the mattress would be safer.⁵⁰ To date, only a few isolated deposit runs have occurred. However, there are concerns that rumors of financial insecurity could spread rapidly through the globally connected and wired world in which we live today and shake clients' confidence in the banking system.⁵¹

If current trends persist, the World Bank forecasts that microfinance institutions could face a potential refinancing gap upwards of \$1.8 billion within the next year.⁵²

The International Finance Corporation ("IFC"), in partnership with the German development bank KfW, is working to dispel such bleak prospects by creating a new microfinance facility to attract additional funding.⁵³ A World Bank report stated, "[m]icrofinance institutions are doing great work around the world, we cannot allow the global financial and economic crisis to threaten the work of those institutions."⁵⁴ The IFC and KfW hope that the new facility will stimulate growth, create jobs, and enable the continued work of microfinance to overcome poverty in emerging markets.⁵⁵

World Bank Chief Economist and Senior Vice President, Justin Lin, believes that rebuilding the microfinance industry has the potential to stimulate global economic growth and aid in a bottom-up push out of the current economic crisis.⁵⁶ Although he agrees that fiscal resources must be injected into the wealthy countries at the epicenter of the crisis, he believes that channeling investments into the developing world, "can release bottlenecks to growth and quickly restore demand [and] can have an even bigger bang for the buck and [thus] should be a key element to recovery."⁵⁷



VI. WHAT IS SECURITIZATION?

Securitization occurs when assets, such as loans, are transferred from the originator to a special purpose entity, also referred to as a special purpose vehicle ("SPV").⁵⁸ The SPV's only function is to hold the transferred loans and to issue its own securities for which these loans serve as collateral.⁵⁹ These securities are commonly referred to as asset-backed securities ("ABS").⁶⁰ Typically, these securities are liquid and, therefore, very attractive to investors.⁶¹ The SPV sells the ABS to investors and transfers the proceeds of the sale to the loan originator, who no longer owns the original loan.⁶² The transaction is treated as a "true sale," which means that the originator can remove the loan from their balance sheets and can use the cash to offer additional loans.⁶³ The loan originator will continue to pass the principal and interest payments it receives on the securitized loans to the SPV which, in turn, distributes the funds to the investors as a return on their investment.⁶⁴ Today, nearly every type of loan or receivable in the US can be securitized, including microfinance loans.⁶⁵

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VII. SECURITIZATION AND MICROFINANCE

Historically, microfinance institutions have relied on philanthropic funding.⁶⁶ However, the \$20 billion raised through these methods has not been sufficient to meet the current demand, cited to be as high as \$250 billion.⁶⁷ Using securitization transactions would allow microfinance institutions to obtain greater amounts of funding from local and international investors.⁶⁸ Investors prefer securitization transactions because they are rated based on standardized reviews of relevant information through rating agencies.⁶⁹ Thus, highly rated securities require that investors do minimal additional research in order to become comfortable with the investment.⁷⁰ Moreover, issuers who frequently use securitizations as a funding tool often find their profits increasing because the securities generally generate a profit when they are sold.⁷¹

If a microfinance institution is subject to its country's bank regulatory standards, it will be required to maintain a minimum amount of reserve capital to support its loan portfolio.⁷² Some countries require microfinance institutions to hold a greater amount of reserve capital than other banks because microfinance loan portfolios are perceived to be more volatile.⁷³ Securitization provides an opportunity to move these microfinance loans off the microfinance institution's balance sheets, thereby reducing the amount required for their capital reserve.⁷⁴

Arguments against using securitization to fund microfinance include the need for a local legal structure to support this type of financing, which many emerging markets do not have, and the high start up costs. Although these transactions can be profitable, an institution's first securitization transaction can be very time consuming and costly.⁷⁵ The investment banks, rating agencies, and regulatory agencies all require fees, in addition to the cost of lawyers and accountants needed to structure the transaction.⁷⁶ The initial research into the accounting and legal viability, as well as updating servicing and investor reporting capabilities to meet the standards required for a successful securitization, will all require significant investments.⁷⁷

However, the benefits outweigh the costs in many cases and emerging economies are beginning to understand the concepts of securitization as an efficient means of financing.⁷⁸ This understanding is creating a great environment for securitization and these types of transactions are becoming increasingly popular and accepted across the microfinance industry. BRAC is a microfinance bank in Bangladesh who led one of the first and largest securitiza-

tions of retail microfinance loans.⁷⁹ Another microfinance bank, Blue Orchard, lends securitized wholesale loans to microfinance institutions through collateralized loan obligations.⁸⁰ In April 2006, Blue Orchard executed the largest single commercial investment transaction in the history of microfinance.⁸¹ The transaction raised \$99 million for twenty-one microfinance institutions in thirteen different countries and five different currencies.⁸² This was the first microfinance transaction rated by a major rating agency and a significant milestone for the microfinance industry.⁸³

VIII. SECURITIZATION'S ROLE IN THE CURRENT RECESSION

As shown, there are many benefits which can be realized through the use of securitization. However, as the subprime mortgage crisis continues to unfold, negative aspects created by this mode of financing have come to the surface and must be recognized. Of great present concern is the ability for securitized loans to be transferred off the balance sheets of those who securitized them.⁸⁴ After loan originators sell their loans, they are no longer adversely affected by repayment rates. This creates a lack of incentive for the originators to set and enforce a minimum standard for risk management and prudent lending.⁸⁵ Originators cut back on screening and monitoring borrowers which contributed to the systematic deterioration of lending and collateral standards, and played a large role in the current economic recession.⁸⁶ Though it is important to learn from the pitfalls securitization has created, the diversification of risk, increased liquidity, and the ability to attract funding from foreign investors are all advantages which make securitization prime for the microfinance industry and should not be overlooked.

IX. CONCLUSION

Though there are many different opinions on the current and future status of the microfinance industry, it appears that there is enough institutional support for the current work being done in order to carry the industry through the presently tumultuous economic times. Future capital can become more widely available through methods of securitization. Securitization can provide viable and lower risk investment opportunities for microfinance institutions which may be the answer to the desperately needed funding they currently require. Thus, securitization can enable microfinance institutions to continue providing life-changing credit products to the world's lowest income earners within emerging markets.⁸⁷

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¹ Joanna Ledgerwood, *Microfinance Handbook: An Institutional and Financial Perspective*, WORLD BANK, 2000, at 1.

² Tom Easton, *A Survey of Microfinance: The Hidden Wealth of the Poor*, THE ECONOMIST, Nov. 5, 2005, at 3.

³ *Id.*

⁴ Lenders in the Philippines request six pesos in return for every five they lend which translates into an annual interest rate of over 1000% on a one-month loan. *Id.*

⁵ Citigroup.com, Citi Microfinance, Microfinance Initiatives, <http://www.citigroup.com/citi/microfinance/data/initiatives.pdf>.

⁶ *Id.*

⁷ Brigit Helms, *Access for All: Building Inclusive Financial Systems*, CGAP/WORLD BANK, 2006, at 35-57.

⁸ Easton, *supra* note 2, at 10.

⁹ *Id.*

¹⁰ *Id.* at 3.

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¹² *Id.*

¹³ Ali Adnan Ibrahim, *Developing Governance and Regulation for Emerging Capital and Securities Markets*, 39 RUTGERS L. J. 111, 118-19 (2007).

¹⁴ *Id.* at 122.

¹⁵ *Id.* at 123.

¹⁶ "This prohibition is based on arguments of social justice, equality, and property rights. Islam encourages the earning of profits but forbids the charging of interest because profits, determined ex post, symbolize successful entrepreneurship and creation of additional wealth whereas interest, determined ex ante, is a cost that is accrued irrespective of the outcome of business operations and may not create wealth if there are business losses. Social justice demands that borrowers and lenders share rewards as well as losses in an equitable fashion and that the process of wealth accumulation and distribution in the economy be fair and representative of true productivity." WorldBank.org, Islamic Financial Systems, <http://www.worldbank.org/fandd/english/0697/articles/0140697.htm>.

¹⁷ Easton, *supra* note 2, at 13.

¹⁸ *Id.* at 4.

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² *Id.*

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.* at 6.

²⁶ *Id.*

²⁷ *Id.*

²⁸ See Stuart Rutherford, *The Poor and Their Money* 4 (Oxford U. Press 2000); see also Microfinance, <http://en.wikipedia.org/wiki/Microfinance> (May 1, 2009, 16:29 UTC).

²⁹ Ingrid Matthaus-Maier, *New Partnership for Innovation in Micro-finance VIII* (Springer Pub. Co.) [hereinafter NEW PARTNERSHIP].

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³² *Id.*

³³ *Id.*

³⁴ *Id.*

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³⁶ *\$500 Million Microfinance Facility Backs Lenders to the Poor*, WORLD BANK, Feb. 12, 2009, <http://go.worldbank.org/WT35DEKUV0> [hereinafter *Backs Lenders to the Poor*].

³⁷ "A recent study of microentrepreneurs from Sri Lanka published by the World Bank found that the return on capital for male owned businesses averaged 11% while the return for women owned businesses was 0%." *Microfinance Information Exchange*, 15 MICROBANKING BULLETIN 46, 49 (2007).

³⁸ Easton, *supra* note 2, at 12.

³⁹ Peter Apps, *Citi Sees Microfinance Growth Even in Downturn*, REUTERS, Dec. 21, 2007, <http://www.reuters.com/article/email/idUSL2157748820071221?sp=true>.

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Backs Lenders to the Poor*, *supra* note 36.

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⁴⁶ Scott Everett, *Microcapital Story: The Global Financial Crisis and Micro-finance*, MICROCAPITAL, Oct. 8, 2008, <http://www.microcapital.org/micro-capital-story-the-global-financial-crisis-and-microfinance/>.

⁴⁷ Elizabeth Littlefield, *Microfinance and the Financial Crisis*, WORLD BANK, Nov. 18, 2008, <http://crisistalk.worldbank.org/2008/11/microfinance-an.html>.

⁴⁸ *Id.*

⁴⁹ *Backs Lenders to the Poor*, *supra* note 36.

⁵⁰ Littlefield, *supra* note 47.

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ David M. Theis, *Crisis Reveals Growing Finance Gaps for Developing Countries: Research Shows Poorer Countries are short of \$270-\$700 Billion for 2009*, WORLD BANK, Mar. 8, 2009, <http://go.worldbank.org/U05NMJJNZ0>.

⁵⁷ *Id.*

⁵⁸ Sharon Stieber, *Is Securitization Right for Microfinance?*, INNOVATIONS, Winter/Spring 2007, at 202.

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.* at 203-04.

⁶⁴ *Id.* at 202.

⁶⁵ *Id.* at 205.

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ Sudipto Basu, *Securitization and the Challenges Faced in Mico Finance 4* (Center for Microfinance Research, Working Paper Series Apr. 2005).

⁷⁰ *Id.*

⁷¹ Stieber, *supra* note 59, at 207.

⁷² *Id.* at 205.

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.* at 206.

⁷⁶ *Id.* at 209.

⁷⁷ *Id.*

⁷⁸ Andreas A. Jobst, *Sovereign Securitization in Emerging Markets*, 12 J. STRUCTURED FIN. 2 (2006).

⁷⁹ Susan Davis and Rod Dubitsky, *Microfinance Meets Wall Street*, FORBES, Mar. 26, 2008, http://www.forbes.com/2008/03/22/brac-microfinance-creditsuisse-oped-cx_sdrd_0326brac.html.

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

⁸⁴ Andreas Jobst, *What is Securitization?*, FINANCE AND DEVELOPMENT, Sept. 2008, at 48.

⁸⁵ *Id.*

⁸⁶ *Id.*