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Big Banks Draw Profits From Microloans to Poor

By NEIL MacFARQUHAR

In recent years, the idea of giving small loans to poor people became the darling of the development world, hailed as the long elusive formula to propel even the most destitute into better lives.

Actors like [Natalie Portman](#) and [Michael Douglas](#) lent their boldface names to the cause. Muhammad Yunus, the economist who pioneered the practice by lending small amounts to basket weavers in Bangladesh, won a Nobel Peace Prize for it in 2006. The idea even got its very own [United Nations](#) year in 2005.

But the phenomenon has grown so popular that some of its biggest proponents are now wringing their hands over the direction it has taken. Drawn by the prospect of hefty profits from even the smallest of loans, a raft of banks and financial institutions now dominate the field, with some charging interest rates of 100 percent or more.

"We created microcredit to fight the loan sharks; we didn't create microcredit to encourage new loan sharks," Mr. Yunus recently said at a gathering of financial officials at the United Nations. "Microcredit should be seen as an opportunity to help people get out of poverty in a business way, but not as an opportunity to make money out of poor people."

The fracas over preserving the field's saintly aura centers on the question of how much interest and profit is acceptable, and what constitutes exploitation. The noisy interest rate fight has even attracted Congressional scrutiny, with the House Financial Services Committee holding hearings this year focused in part on whether some microcredit institutions are scamming the poor.

Rates vary widely across the globe, but the ones that draw the most concern tend to occur in countries like Nigeria and Mexico, where the demand for small loans from a large population cannot be met by existing lenders.

Unlike virtually every Web page trumpeting the accomplishments of microcredit institutions around the world, the page for [Te Creemos](#), a Mexican lender, lacks even one testimonial from a thriving customer — no beaming woman earning her first income by growing a soap business out of her kitchen, for example. Te Creemos has some of the highest interest rates and fees in the world of [microfinance](#), analysts say, a whopping 125 percent average annual rate.

The average in Mexico itself is around 70 percent, compared with a global average of about 37 percent in interest and fees, analysts say. Mexican microfinance institutions charge such high rates simply because they can get away with it, said Emmanuelle Javoy, the managing director of Planet Rating, an independent Paris-based firm that evaluates microlenders.

"They could do better; they could do a lot better," she said. "If the ones that are very big and have the margins don't set the pace, then the rest of the market follows."

Manuel Ramírez, director of risk and internal control at Te Creemos, reached by telephone in Mexico City, initially said there had been some unspecified "misunderstanding" about the numbers and asked for more time to clarify, but then stopped responding.

Unwitting individuals, who can make loans of \$20 or more through Web sites like [Kiva](#) or [Microplace](#), may also end up participating in practices some consider exploitative. These Web sites admit that they cannot guarantee every interest rate they quote. Indeed, the real rate can prove to be markedly higher.

Debating Microloans' Effects

Underlying the issue is a fierce debate over whether microloans actually lift people out of poverty, as their promoters so often claim. The recent conclusion of some researchers is that not every poor person is an entrepreneur waiting to be discovered, but that the loans do help cushion some of the worst blows of poverty.

"The lesson is simply that it didn't save the world," Dean S. Karlan, a professor of economics at [Yale University](#), said about microlending. "It is not the single transformative tool that proponents have been selling it as, but there are positive benefits."

Still, its earliest proponents do not want its reputation tarnished by new investors seeking profits on the backs of the poor, though they recognize that the days of just earning enough to cover costs are over.

"They call it 'social investing,' but nobody has a definition for social investing, nobody is saying, for example, that you have to make less than 10 percent profit," said Chuck Waterfield, who runs mftransparency.org, a Web site that promotes transparency and is financed by big microfinance investors.

Making pots of money from microfinance is certainly not illegal. [CARE](#), the Atlanta-based humanitarian organization, was the force behind a microfinance institution it started in Peru in 1997. The initial investment was around \$3.5 million, including \$450,000 of taxpayer money. But last fall, Banco de Credito, one of Peru's largest banks, bought the business for \$96 million, of which [CARE](#) pocketed \$74 million.

"Here was a sale that was good for Peru, that was good for our broad social mission and advertising the price of the sale wasn't the point of the announcement," Helene Gayle, CARE's president, said. Ms. Gayle described the new owners as committed to the same social mission of alleviating poverty and said CARE expected to use the money to extend its own reach in other countries.

The microfinance industry, with over \$60 billion in assets, has unquestionably outgrown its charitable roots. Elisabeth Rhyne, who runs the Center for Financial Inclusion, said in Congressional testimony this year that banks and finance firms served 60 percent of all clients. Nongovernmental organizations served 35 percent of the clients, she said, while credit unions and rural banks had 5 percent of the clients.

Private capital first began entering the microfinance arena about a decade ago, but it was not until Compartamos, a Mexican firm that began life as a tiny nonprofit organization, generated \$458 million through a public stock sale in 2007, that investors fully recognized the potential for a windfall, experts said.

Although the Compartamos founders pledged to plow the money back into development, analysts say the high interest rates and healthy profits of Compartamos, the largest microfinance institution in the Western Hemisphere with 1.2 million active borrowers, push up interest rates all across Mexico.

According to the Microfinance Information Exchange, a Web site known as the Mix, where more than 1,000 microfinance companies worldwide report their own numbers, Compartamos charges an average of nearly 82 percent in interest and fees. The site's global data comes from 2008.

But poor borrowers are often too inexperienced and too harried to understand what they are being charged, experts said. In Mexico City, Maria Vargas has borrowed larger and larger amounts from Compartamos over 20 years to expand her T-shirt factory to 25 sewing machines from 5. She is hazy about what interest rate she actually pays, though she considers it high.

"The interest rate is important, but to be honest, you can get so caught up in work that there is no time to go fill out paperwork in another place," she said. After several loans, now a simple phone call to Compartamos gets her a check the next day, she said. Occasionally, interest rates spur political intervention. In Nicaragua, President [Daniel Ortega](#), outraged that interest rates there were hovering around 35 percent in 2008, announced that he would back a microfinance institution that would charge 8 to 10 percent, using Venezuelan money.

There were scattered episodes of setting aflame microfinance branches before a national "We're not paying" campaign erupted, which was widely believed to be mounted secretly by the Sandinista government. After the courts stopped forcing small borrowers to repay, making international financial institutions hesitant to work with Nicaragua, the campaign evaporated.

A Push for More Transparency

The microfinance industry is pushing for greater transparency among its members, but says that most microlenders are honest, with experts putting the number of dubious institutions anywhere from less than 1 percent to more than 10 percent. Given that competition has a pattern of lowering interest rates worldwide, the industry prefers that approach to government intervention. Part of the problem, however, is that all kinds of institutions making loans plaster them with the "microfinance" label because of its do-good reputation.

Damian von Stauffenberg, who founded an independent rating agency called [Microrate](#), said that local conditions had to be taken into account, but that any firm charging 20 to 30 percent above the market was "unconscionable" and that profit rates above 30 percent should be considered high.

Mr. Yunus says interest rates should be 10 to 15 percent above the cost of raising the money, with anything beyond a "red zone" of loan sharking. "We need to draw a line between genuine and abuse," he said. "You will never see the situation of poor people if you look at it through the glasses of profit-making."

Yet by that measure, 75 percent of microfinance institutions would fall into Mr. Yunus's "red zone," according to a March analysis of 1,008 microlenders by Adrian Gonzalez, lead researcher at the Mix. His study found that much of the money from interest rates was used to cover operating expenses, and argued that tackling costs, as opposed to profits, could prove the most efficient way to lower interest rates.

Many experts label Mr. Yunus's formula overly simplistic and too low, a route to certain bankruptcy in countries with high operating expenses. Costs of doing business in Asia and the sheer size of the Grameen Bank he founded in Bangladesh allow for economies of scale that keep costs down, analysts say. "Globally interest rates have been going down as a general trend," said Ms. Javoy of Planet Rating.

Many companies say the highest rates reflect the costs of reaching the poorest, most inaccessible borrowers. It costs more to handle 10 loans of \$100 than one loan of \$1,000. Some analysts fear that a pronounced backlash against high interest rates will prompt lenders to retreat from the poorest customers.

But experts also acknowledge that banks and others who dominate the industry are slow to address problems.

Added Scrutiny for Lenders

Like Mexico, Nigeria attracts scrutiny for high interest rates. One firm, LAPO, Lift Above Poverty Organization, has raised questions, particularly since it was backed by prominent investors like [Deutsche Bank](#) and the Calvert Foundation.

LAPO, considered the leading microfinance institution in Nigeria, engages in a contentious industry practice sometimes referred to as "forced savings." Under it, the lender keeps a portion of the loan. Proponents argue that it helps the poor learn to save, while critics call it exploitation since borrowers do not get the entire amount up front but pay interest on the full loan.

LAPO collected these so-called savings from its borrowers without a legal permit to do so, according to a Planet Rating report. "It was known to everybody that they did not have the right license," Ms. Javoy said.

Under outside pressure, LAPO announced in 2009 that it was decreasing its monthly interest rate, Planet Rating noted, but at the same time compulsory savings were quietly raised to 20 percent of the loan from 10 percent. So, the effective interest rate for some clients actually leapt to nearly 126 percent annually from 114 percent, the report said. The average for all LAPO clients was nearly 74 percent in interest and fees, the report found.

Anita Edward says she has borrowed money three times from LAPO for her hair salon, Amazing Collections, in Benin City, Nigeria. The money comes

cheaper than other microloans, and commercial banks are virtually impossible, she said, but she resents the fact that LAPO demanded that she keep \$100 of her roughly \$666 10-month loan in a savings account while she paid interest on the full amount.

"That is not O.K. by me," she said. "It is not fair. They should give you the full money."

The loans from LAPO helped her expand from one shop to two, but when she started she thought she would have more money to put into the business.

"It has improved my life, but not changed it," said Ms. Edward, 30.

Godwin Ehigiamusoe, LAPO's founding executive director, defended his company's high interest rates, saying they reflected the high cost of doing business in Nigeria. For example, he said, each of the company's more than 200 branches needed its own generator and fuel to run it.

Until recently, Microplace, which is part of [eBay](#), was promoting LAPO to individual investors, even though the Web site says the lenders it features have interest rates between 18 and 60 percent, considerably less than what LAPO customers typically pay.

As recently as February, Microplace also said that LAPO had a strong rating from Microrate, yet the rating agency had suspended LAPO the previous August, six months earlier. Microplace then removed the rating after The New York Times called to inquire why it was still being used and has since taken LAPO investments off the Web site.

At Kiva, which promises on its Web site that it "will not partner with an organization that charges exorbitant interest rates," the interest rate and fees for LAPO was recently advertised as 57 percent, the average rate from 2007. After The Times called to inquire, Kiva changed it to 83 percent.

Premal Shah, Kiva's president, said it was a question of outdated information rather than deception. "I would argue that the information is stale as opposed to misleading," he said. "It could have been a tad better."

While analysts characterize such microfinance Web sites as well-meaning, they question whether the sites sufficiently vetted the organizations they promoted.

Questions had already been raised about Kiva because the Web site once promised that loans would go to specific borrowers identified on the site, but later backtracked, clarifying that the money went to organizations rather than individuals.

Promotion aside, the overriding question facing the industry, analysts say, remains how much money investors should make from lending to poor people, mostly women, often at interest rates that are hidden.

"You can make money from the poorest people in the world — is that a bad thing, or is that just a business?" asked Mr. Waterfield of [mftransparency.org](#). "At what point do we say we have gone too far?"

Elisabeth Malkin contributed reporting from Mexico City.