What Would Leland Stanford Do?

An Editorial Commentary[1]

Submitted to the Microfinance Community

about the Compartamos IPO

Jonathan C. Lewis
Chief Executive Officer[2]
MicroCredit Enterprises[3]

based on a presentation to

Theories of Civil Society, Philanthropy and the Nonprofit Sector

Department of Political Science
Professor Bruce Sievers
Stanford University
Palo Alto, California USA
May 30, 2007
Revised June 12, 2007

[1] The views expressed herein are the personal views of the author and are not intended to reflect the views or opinions of MicroCredit Enterprises or any other person or institution.
[2] The author founded MicroCredit Enterprises in 2005 and serves as CEO/Chair on a pro bono basis.
[3] The MicroCredit Enterprises model takes advantage of private sector economic guarantees in the developed world to provide capital for microloans. MicroCredit Enterprises gives special consideration to microfinance programs that: (a) increase the number of poor clients served, (b) operate comprehensive social service programs, such as women's empowerment, health education or business training, (c) lower interest rates to impoverished client-borrowers and (d) have reliable management and boards of directors. The special focus is sustainable economic development for families living in extreme poverty ($1.00 per day or worse).

It is a pleasure to be with you today, and especially to be on the Stanford campus which, like many American universities, is a living monument to the societal benefits of capitalist wealth.

Leland Stanford --- lawyer, gold miner, Governor of California, United States Senator and president of the Central Pacific Railroad -- hammered the famous golden spike on the nation's transcontinental railway line and with his riches founded this great university. We remember him as a visionary business leader and citizen-politician, a man of greatness and a man of greed. To some, Stanford built a great railroad, economically united a nation and created thousands of jobs in the West; for others, he was a robber baron who exploited Chinese immigrants.

Stanford's career exemplifies the poles of a current and consequential debate within the microfinance community. A recent initial public offering (IPO) by Compartamos, the largest microfinance institution in Mexico and a major industry leader worldwide, is causing many in the microfinance movement to ask:

- Is the Compartamos IPO the oft-remarked "good side of capitalism," a harbinger of a massive private sector infusion of investment in alleviating global poverty? Or, is it the canary in the coal mine, a warning that microfinance is going awry?

- Is microfinance an industry (or emerging asset class, as some would have it) or is it an economic justice movement? Is it about poverty or profits? Can it be about both? Can microfinance serve two masters?

Nowhere are these policy questions more rawly exposed than by the Compartamos IPO.

Commercializing Microfinance: A Case Study from Mexico's Compartamos

Compartamos is without question an impressive, though controversial, bottom line success story, a veritable poster child for commercializing microfinance. Thanks to Compartamos, over 600,000 poor Mexicans have small business loans and the organization is itself sustainable (economic development-speak) or, if you prefer, profitable (marketplace-speak).

Reads a 2005 headline from CGAP, pre-dating the Compartamos IPO: "Donors Succeed by Making Themselves Obsolete: Compartamos Taps Financial Markets in Mexico" and concludes, "Donors looking to support a success story like Compartamos must plan on making themselves obsolete from the outset. Successful MFIs use donor funding to become self-sufficient. Not only has Compartamos become fully integrated into the private financial sector of Mexico, it has proven that it is possible for a financial institution serving poor people to do so profitably and also remain true to its mission."[4]

Compartamos' U.S.-based microfinance network ACCION glowingly adds in 2007, "With the Compartamos IPO, the financial markets have shown the true value created by high-performance, double bottom line-oriented microfinance institutions. We hope that this is the first of many, as it will mean that access to financial services for the poor has truly become a fundamental element of national and international financial systems."[5]

And, from a CGAP Focus Note, "The spectacular success of the IPO was a milestone not only for Compartamos, but for microfinance….The transaction will probably give a significant boost to the credibility of microfinance in commercial capital markets, and accelerate the mobilization of private capital for the business of providing financial services to poor and low-income people." [6]

Impressive stuff indeed. And now to the particulars:

"Compartamos operated from its inception in 1990 until 2000 as a not-for-profit, non-governmental organization (NGO). During this period, it received US$4.3 million…from international development agencies and private Mexican sources. The NGO made tiny loans to poor and lower-income women, mainly in rural areas.

"By 2000 the Compartamos NGO was reaching 60,000 borrowers. In order to tap commercial funds for even faster growth, the NGO and other investors set up a regulated finance company, organized as a for-profit corporation.

"Beginning in 2002, Compartamos was able to issue roughly $70 million in bonds on the Mexican securities exchange; most of these bonds were partially guaranteed by the International Finance Corporation (IFC)…. In addition, the company has raised about $65 million by borrowing from Mexican banks and commercial lenders.

"In June of 2006, the finance company received a full banking license. As a bank, Compartamos is now authorized to take deposits, but had not done so up to the point of the IPO in April of 2007. The company was serving 616,000 borrowers by the end of 2006, and expects to continue its rapid growth.

"The shareholders of Compartamos at the time of the IPO were: Compartamos AC (the NGO)(39.2%); ACCION Gateway fund (18.1%); International Finance Corporation (10.6%); directors and managers (23.7%); other private Mexican

---

[4] Donors Succeed by Making Themselves Obsolete: Compartamos Taps Financial Markets in Mexico, Case Study No 19, CGAP Donor Information Resource Center, 2005 (http://cgap.org/direct/resources/case_studies.php).
[5] See: http://www.accion.org/media_noteworthy.asp_Q_N_E_344.
[6] CGAP Reflections on the Compartamos Initial Public Offering: A Case Study on Microfinance Interest Rates and Profits, CGAP Focus Note 42, June, 2007.

investors (8.5%). The original price these investors paid for their shares in 1998-2000 totaled roughly $6 million. By the end of 2006, the book value of these shares had risen to $126 million, *due to very high profits*.[7]

"The book value of return on shareholders' equity has averaged over 53 percent a year since commercialization in 2000, and over 80 percent of this profit has been retained within the company to fund growth in the number and size of its loans, rather than being paid out in dividends to shareholders. This retention of high earnings produced the massive growth in the book value of the company.

"The profits reflect the high interest rates that Compartamos charges on its loans.[8] Compartamos' interest yield on average loan portfolio was about 86 percent for 2005.

"In the April 20, 2007, IPO, the shareholders sold about 30 percent of their shares to new investors….This initial public offering of shares was a secondary offering—that is, Compartamos did not create and sell new shares, which would have brought additional funding into the bank. Rather, the proceeds of the sale went to existing shareholders who were capturing capital gains by selling off part of their stake in the bank.

"The existing investors received about $450 million for 30 percent of their shares, which represents more than 12 times the book value of those shares. This implies a market valuation of the company at over $1.5 billion, and an internal rate of return on the selling shareholders' original investment (about $6 million) of roughly 100 percent a year compounded over eight years."[9]

Social Entrepreneurship: the Microfinance Way

The common sense belief is that the poor require neither soft-hearted Western charity nor hard-hearted Western capitalism. And, microfinance is the global showcase, a living laboratory, for that economic development viewpoint.

Doing Well by Doing Good, Social Venture Philanthropy, Social Entrepreneurship,[10] Serving the Bottom of the Pyramid, Blended Value Investing, Double and Triple Bottomlines are now capitalized concepts which, taken together, capture a broad and important idea about applying the tools and efficiencies of the marketplace to intractable social problems. As Robert Annibale, Global Director of Microfinance at Citigroup, elegantly puts it, "We are taking microfinance beyond philanthropy."[11]

---

[7] Italics added.
[8] Italics added.
[9] CGAP Reflections on the Compartamos Initial Public Offering: A Case Study on Microfinance Interest Rates and Profits, CGAP Focus Note 42, June, 2007.
[10] The author considers himself a social entrepreneur.
[11] Wall Street Journal, May 15, 2007.

In economic development circles and especially in microfinance, the active application of business principles has been welcomed and even idolized. Acknowledging that microfinance, in essence and in form, is a variation on capitalist banking, it is perfectly understandable that business and bankers would gravitate to it, and be themselves embraced as kindred souls.

But, the animating push for mobilizing private capital and market forces in the service of microfinance is fundamentally one of desperation. To wit, foundation and public dollars are limited, drying up and fickle…..and the poor are many. Notes Ashok Sharma of the Asian Development Bank, "After so many years, there is a bit of donor fatigue and everyone wants microfinance institutions to stand up on their own feet."[12,13]

So, without other funding options, the logic path ends with three rarely challenged suppositions:

- Given a viable infrastructure for investing in microfinance (with its high microloan repayment rates and potential for lucrative interest rates), a cornucopia of seemingly limitless private sector money can and will scale up microfinance programs to reach millions of impoverished people waiting to become entrepreneurs.

- In addition, venture philanthropists and social entrepreneurs will bring not only their wealth, but also the wealth of their market-honed wisdom and managerial knowledge. No longer will microfinance be held back from reaching its full potential by fuzzy-headed non-profits lacking clear management metrics. The marketplace of tough love will work its magic.

- Even more heady, the long term ambition is more and more social investment which will bring about more competition among overseas microfinance programs which, in turn, will improve services for the poor and cause high interest rates to drop. A virtuous circle of economics to be sure.

And, certainly "foreign capital investment in microfinance is surging. Cross-border investment has more than tripled in the last two years to reach US$1.4 billion in 2006,"[14] reports CGAP. Undeniably and very importantly, increasing the number of poor entrepreneurs served by microfinance is manifestly a good thing.

[12] Wall Street Journal, May 15, 2007.
[13] One can't help but remark that the goal of 100% sustainability, which I support, is not applied with rigor to any other social or economic justice program. From sports stadiums to the art museums, from hospitals to transportation, continuing public or charitable subsidies are the norm.
[14] Microfinance Investment Vehicles, CGAP Brief, April, 2007. See: http://www.cgap.org/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Documents/Brief_MFIV.pdf.

Compartamos IPO, an unalloyed peek into the potential trajectory of commercialized microfinance, is a case study of a marketplace rejoinder to global poverty. "The Compartamos NGO received over $100 million from the IPO, which will be used to expand its work, focused mainly on health and nutrition for poor Mexicans. ACCION sold off a larger percentage of its shares and cleared about $135 million, which it will be using to further its work supporting microfinance institutions around the world. When IFC's $40 million is included, about five eighths of the sale proceeds have gone back into organizations whose assets are used for development purposes and are not distributed to private owners….Private individuals captured over $150 million from the sale."[15]

This compelling storyline obscures an underlying "economic development cognitive dissonance." In order to tap into the hoped-for lodestone of investment capital waiting to flow into microloans for the poor, the interest rate charged on microloans to poor borrowers must do more than *merely* alleviate poverty, create sustainable small businesses, empower women and finance microfinance institution operations.[16] It now must also generate profits for investors (mostly foreigners).[17]

Thus, to help desperately poor people help themselves, they are charged extraordinarily high interest rates which, in part, are needed to enrich well-intentioned domestic and foreign investors who require financial returns to justify their doing social good. What?

Microloan Sharking: Why Not?

We in microfinance accept and uphold the market reality which demands that interest rates sustainably cover a local microfinance institution's expenses,[18] and I wholeheartedly subscribe to that balance sheet truth. No margin, no mission.

---

[15] CGAP Reflections on the Compartamos Initial Public Offering: A Case Study on Microfinance Interest Rates and Profits, CGAP Focus Note 42, June, 2007.

[16] As the literature widely documents, many microfinance institutions, especially startups and smaller organizations serving tough markets, experience high transaction costs associated with servicing many tiny loans.

[17] A look at the attitudinal divergence between profit-maximizing capital and philanthropic capital about exit strategies is particularly instructive. (a) Before the advent of social venture philanthropy (or blended value investing, if you prefer), it was basically unnecessary to offer an exit strategy to a benefactor. Now, a planned-for exit, that is, returning principal with a profit (albeit sometimes an anemic one), can include repaying a loan, selling off shares to another party, a management buy-out or issuing an IPO ala Compartamos. Whatever, for the investor the intent from the onset is to get in and get out. (b) Philanthropic capital (charitable donations in some cases) is less concerned with financial exits. Philanthropists presumably are motivated principally by social and economic justice outcomes and, once working with an effective microfinance program, will look for deeper engagement opportunities, not mission-limiting exits. After all, if one's goal is poverty reduction and a program is successful, what is the moral imperative for exiting? The author's comments are informed by "If Pigs Had Wings: The Appeals and Limits of Venture Philanthropy," an address to the Waldemar A. Nielsen Issues in Philanthropy Seminar, Georgetown University, November 12, 2001, by Professor Bruce Sievers, Stanford University.

[18] For a short summary discussion of this topic, see Making Sense of Microcredit Interest Rates, CGAP Donor Brief #6, September, 2002 (reissued January, 2004).

CGAP's Key Principles of Microfinance states with common sense and conviction, "Interest rate ceilings hurt poor people by making it harder for them to get credit. It costs much more to make many small loans than a few large loans. Unless microlenders can charge interest rates that are well above average bank loan rates, they cannot cover their costs….At the same time, a microlender should not use high interest rates to make borrowers cover the cost of its own inefficiency."[19]

That stipulated, with respect to the Compartamos IPO two important policy judgments present themselves for discussion:

- CGAP reports the average yearly drop between 2000-2005 in microcredit interest rates worldwide was 3.6% when weighted by microfinance institution loan portfolio amount (and 2.8% when weighted by number of borrowers).[20] This is good news for the poor today, but will the impact of more and more private, profit-maximizing investors make this trend less likely tomorrow? Should high interest rates be used to "make borrowers cover the cost of" generating lucrative financial returns for investors? Is there is a qualitative difference between foreign investors and domestic investors? Between pure financial investors and social investors (presumably, accepting somewhat concessionary rates of return)?

- Is Compartamos inefficient? Presumably, the Compartamos management did not willfully prefer to torment the poor with unnecessarily usurious interest rates, so why did management fail to lower interest rates commensurate with excess revenues (even considering reserves for expansion)? Should high interest rates for larger, well-established microfinance organizations be considered a leading indicator of poor management judgment (along with high portfolio-at-risk numbers, shaky balance sheets, high staff turnover, etc.)?

Considering local economic conditions, the actual operating costs of the local microfinance organization and all the other arrayed business factors, the fundamental questions microfinance cannot and should not avoid are: <u>What is a fair, appropriate and just interest rate for a microloan?</u> <u>When does micro-lending morph into microloan-sharking?</u>

Good people on all sides of the question are weighing in with viewpoints ranging from the practical to the principled.[21] Sometimes the debate has been more

[19] Key Principles of Microfinance, Consultative Group to Assist the Poor, 2004. See: http://www.cgap.org/keyprinciples.html.
[20] Interest Rates Dropping Globally, CGAP, April, 2007. See: http://www.cgap.org/portal/site/portfolio/Apr2007/Data/.
[21] In large measure the opinion factions seem to loosely fall into these groupings: (a) The Bankers. An articulate, industrious thought leadership promoting a broad range of needed financial services for the poor, accessing private sector capital markets to reach ever greater numbers of poor people and firmly committed to mainstreaming microfinance into the financial services industry. Loosely

ideologically rooted than altruistically framed or fact-based, but all are sincerely motivated. Some favor a pure, unfettered invisible hand; others (to paraphrase Nobel Laureate Joseph Stiglitz) think the invisible hand is invisible.

Competition Cometh

The most orthodox, and compelling, rationale for free-floating, seemingly high-priced interest rates is that they are a temporary necessity required to stimulate investment and eventually create the competition that will bring down interest rates. The argument, in a nutshell, is that markets achieve equilibrium over time and, thus, are inherently and perpetually allocating capital efficiently. No matter how soaring the interest rate, it is "just right" to attract competition, more investment and eventually better consumer pricing.

This optimistic line of argumentation in my view is more faith-based than fact-grounded. Indeed, an informed social investor is hard pressed to ignore any number of countervailing, practical realities:

One, a CGAP Focus Note about competition and microfinance interest rates begins, "In many countries…microfinance has become more competitive in recent years. Competition is generally expected to benefit consumers by offering a wider choice of appropriate products and providers, better service and lower prices. However, in some countries where microfinance is considered competitive, interest rates on microloans have remained stubbornly high."[22] The article goes on to dissect various explanations, but the end result remains discouraging for those who would place the fate of the poor at the mercies of the market.

Two, even under the most favorable scenarios, microfinance competition in many countries and regions is a long, long way off. In significant parts of the world, microfinance has yet to establish even a toehold. Interestingly, the same CGAP analysis about microfinance market competition could report, just last year, on only three countries (Uganda, Bangladesh and Bolivia) with sufficiently developed microfinance industries to warrant review.[23] And, while the poor wait, should the borrower of today pay unnecessarily high interest in order to attract private capital

---

tagged, this group is called "commercializing microfinance." (b) The Skeptics. A respected, mission-driven cadre of veteran practitioners questioning whether or not private capital, including private social capital, will reduce microfinance's focus on the very poor ("mission drift"), instead of promoting microfinance as a platform or distribution channel for anti-poverty tactics (e.g., health education, anti-malaria bednet distribution, health products, etc.). They are firmly committed to evaluating microfinance in terms of poverty reduction, not financial returns. (c) The Peacekeepers. An open-minded, informed contingent of activists and donors encouraging a big tent "encompassing all approaches," promoting more market experimentation and innovation (with controlled pilot projects to test the theory) and seeking balanced, non-ideological solutions.

[22] Competition and Microcredit Interest Rates, CGAP Focus Note No. 33, February, 2006. See: http://www.cgap.org/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Documents/FocusNote_33.pdf.

[23] Ibid.

so the borrower of tomorrow will have the same opportunity to pay usurious interest rates?

Three, scaling up microfinance, we assume, will produce competition, but it might as readily produce monopoly or cartels.[24] Leland Stanford might make this very point. In some sub-national regions, there will always be insufficient demand (for any number of reasons) to support two or more local microfinance institutions. What to do?

Four, in the global heartland of capitalism, competition has not lowered prices on basic necessities for the American poor. Indeed, it seems the poor pay higher prices for most items because they are geographically and educationally isolated, trapped by circumstance and condition. By inference, it would seem rural villagers and urban slum dwellers in the developing world might well confront the same burdens. The point is financial markets won't always reliably function on behalf of borrowers.[25]

A responsible social investor, even one firmly committed to market solutions, needs in my opinion to consider a critical point of differentiation between normal markets and microfinance markets. In microfinance markets *all* costs are directly borne by poor people; thus, microfinance investment decisions should be made with careful due diligence which needs to include a clear-eyed, practical, realistic and factual understanding of local market conditions which have traditionally operated feebly, if at all. This is not a place for testing classroom economic theories.

Size Doesn't Matter

A persistent case for scaling up larger and larger microfinance institutions is that economies of scale will ensue, operating costs will drop and interest rates can and will be lowered. What does Compartamos' history reveal on this question?

"The largest share of (Compartamos') income goes to cover *administrative costs*. Compartamos' 36.4% operating expense ratio might look inefficient in comparison with the 15.0% median for MFIs worldwide in 2005. But this measure ignores the impact of Compartamos' loan sizes, which are very small in the Mexican context. A better metric is the operating expense per borrower over the course of a year. Such an analysis provides no suggestion that inefficiency on the part of management is contributing to Compartamos' high interest rates."[26]

[24] In the American experience, the steel, oil, football and baseball, telecommunications and aircraft industries are troubled examples. And, of course, most countries in the developed world have antitrust laws of some form.
[25] For example, given vigorous American credit card company competition, why don't consumer loan interest rates in the United States drop, and keep dropping?
[26] CGAP Reflections on the Compartamos Initial Public Offering: A Case Study on Microfinance Interest Rates and Profits, CGAP Focus Note 42, June, 2007.

Unfortunately, this answer is not very comforting for social investors. What the CGAP Compartamos analysis sidesteps is: For a microfinance institution of such size and global leadership stature, subject to marketplace discipline, with access to modern technologies and run by well-trained Western-style executives,[27] why hasn't it achieved *greater* operating efficiencies?[28]

Is this a failure of the market or of management? Regardless, social investors concerned about interest rates are warned that size alone does not assure fair interest rates or, by implication, other pro-poor policies.

In my view, an important allowance can and should be made for smaller microfinance institutions (which are still the large majority) confronted with considerable diseconomies of scale. They need and deserve space to grow and strengthen financially in order to overcome the desperate poverty which afflicts the poor who have been abandoned by the market. But, the aspirational endpoint cannot be profits at the expense of the poor. Over time, microfinance institutions, if well-managed and committed to their mission, should not convert an expedient requirement of business survival, that is, usurious interest rates, into a self-proclaimed business virtue.

It Could Be Worse

An oft-heard argument in defense of high interest rates is that microloans are better than the clutches of the rapacious neighborhood loan shark. And, of course, a microloan is unsecured debt. And, most certainly, where gender discrimination is rampant, microloans combat that evil. All true.

Moreover, it is practical to note that, because poor entrepreneurs have little or no other costs (taxes, transportation, labor, electricity or rent, general business expenses are small or non-existent), loan repayment interest rates are bearable and even reasonable. Indeed, the worldwide microloan repayment rate of 97%[29] suggests that in the daily rough and tumble of the market, microloans are affordably priced. This is even truer for Compartamos which proudly boasts close to a 99% microloan repayment rate.[30]

---

[27] "Compartamos management attend(ed) the microfinance training course at the Economics Institute in Boulder, Colorado….Since then, 90 percent of the Compartamos management team has attended the training course, deepening the skill base of its team. Source: Donors Succeed by Making Themselves Obsolete: Compartamos Taps Financial Markets in Mexico, Case Study No 19, CGAP Donor Information Resource Center, 2005

[28] By comparison, started in 2002, "Pro Mujer Mexico is a relatively new, small organization; its size, extra services, and the high cost of operating in Mexico result in an annual interest rate (including taxes and other fees) of about eighty-four per cent." Source: Bruck, Connie, Millions for Millions, The New Yorker, October 30, 2006.

[29] By comparison, U.S credit card companies experience a 5% default rate (Wall Street Journal, May 15, 2007).

[30] See: http://www.accion.org/about_where_we_work_program.asp_Q_T_E_11.

Without a doubt, microfinance *even with* high interest rates is good. But, is it good enough?

Even free marketers might blanch at a microfinance institution charging 600% interest to poor people. Is there a microfinance institution charging 600% interest? Not yet. But, is there a social investor prepared to realize a return on investment from microloans at 300% interest? How about 150% interest? Compartamos' 100+%? There are limits, one would hope.

For microfinance institutions that can sustainably afford to do so, why not offer lower rates for customer-borrowers, instead of profiteering on behalf of shareholders or investors? In the view of Nobel Laureate Muhammad Yunus, as interviewed in the New Yorker, "Yunus…certainly wants to reach all the world's poor, but he is convinced that the traditional goal of business—maximization of profit—is inappropriate when dealing with the poor….'Why do you want to make money off the poor people? You make money somewhere else. Here, you come to help them. When they have enough flesh and blood in their bodies, go and suck them, no problem. But, until then, don't do that. Whatever money you are taking away, keep it with them instead, so they can come out more quickly from poverty.'"[31]

In Leland Stanford's time, robber barons charged what the market would bear, employed questionable business practices and monopolistically manipulated markets. Today, the microfinance industry should not, as a matter of principled commitment to free and fair markets, defend a microfinance institution's "right" to charge exorbitant interest rates just because it can.

Caveat Emptor (Let the "Social Investor" Beware)

As every investor knows, markets without transparency cannot function either efficiently or honestly. The Compartamos IPO brings into focus a disturbing lack of transparency for social investors and industry watchers.

As anyone who has spoken publicly about microfinance knows, interest rates that can reasonably be called usurious (whatever their theoretical and/or practical justification) are a deterrent to charitable donors, social investors and philanthropic guarantors. To the point, many socially responsible investors (motivated by heartwarming stories about impoverished entrepreneurs feeding their kids) have undoubtedly been assuming their investment returns are profitable at appreciably lower microloan interest rates than the 100%+ effective annual rate charged by Compartamos.[32]

Social investors can and do hold two ideas simultaneously in our collective mind. We generally favor free markets; we also have a moral compass.

[31] Bruck, Connie, Millions for Millions, The New Yorker, October 30, 2006.
[32] CGAP Reflections on the Compartamos Initial Public Offering: A Case Study on Microfinance Interest Rates and Profits, CGAP Focus Note 42, June, 2007.

The general public – unaware of local economic conditions and black market alternatives -- finds seemingly usurious interest rates confusing, if not outright repugnant, when applied to the desperately poor. Unquestionably, the interest rates charged by most microfinance institutions are justifiable because they are necessary to stimulate and finance smaller startups, transaction costs are expensive, smaller microfinance programs serving rural areas cannot achieve economies of scale, etc., but only a precious few are enduringly convinced by the industry's explanations.

Presumably that explains why most microfinance organizations pitching investors don't mention microloan interest rates at all. Spend time in microfinance cyberspace -- from web sites and flashy annual reports to fundraising appeals and poignant videos, you name it – and one is unlikely to find a microfinance organization touting a mission statement which includes generating lucrative profits from usurious interest rates charged to impoverished borrowers.

As an illustration, consider the respected and very successful ACCION microfinance organization. ACCION's home page[33] asks visitors to "Donate Now," right above "Invest Now." But donate or invest, the reader is hard-pressed to learn the interest rate charged poor borrowers by ACCION affiliates in other countries.

Lending methodologies, countries of operation, vital statistics, heartwarming stories, investment options, donor learning trips and the like are all there….no analysis of interest rates, trends, etc. This dearth of disclosure stands in stark contrast to other available data. For example, at ACCION's web report on Compartamos the interested donor or investor can learn that in 2001 the active portfolio was $25,434,759.00 or that in 2006 the portfolio at-risk was 1.11%.[34]

The website reports "Compartamos is also one of the most profitable microfinance institutions in Latin America," but not a word about interest rates hovering around 100%. At the ACCION vital statistics page,[35] "ACCION recognizes that financial transparency is critical for microfinance institutions, not only as a moral imperative, but also to ensure the long-term availability of financial services for the poor," but on the congratulatory webpage "applauding" the Compartamos IPO there is silence[36] about the interest rates that underpin the IPO beyond "…for Compartamos to expand and cover costs, it charges interest rates above the commercial Mexican

[33] See: http://www.accion.org/about_our_mission.asp.
[34] See: http://www.accion.org/about_where_we_work_program.asp_Q_T_E_11.
[35] See: http://www.accion.org/about_key_stats.asp.
[36] Of paradoxical interest, while the Compartamos IPO is much-heralded as its "success is also the success of the entire industry, and a model for the type of microfinance that accesses the capital markets to achieve scale" and similar laudatory statements, Compartamos' proud partner, ACCION, does not reveal its own profits from the IPO, however, CGAP's Focus Note #42 provides some analytics on the question.

rate, a practice common in high-touch, relationship-based microfinance worldwide."[37]

As responsible consumers, we have learned to consider if our rugs are woven by the hands of children, our shoes are cobbled in sweatshops, our coffee harvested by workers paid a living wage and our diamonds bought with blood. In microfinance, we social investors have a similar obligation to determine if our investments are being repaid with predatory interest rates or if our donations are supporting questionable policies.

Social Enterprise Redlining

Manifestly, the Compartamos IPO has raised the bar for financial investment in microfinance. As remarked on by CGAP, "Even people who favor a commercial approach to most microfinance have to scratch their heads when they see shareholders making annual returns of 100 percent on their investments, compounded for eight years running."[38]

Of course, some will welcome those high investment returns, others will decry them. But, indisputably, the Compartamos IPO cements in place a new dilemma for microfinance institutions, namely, without an affirmative policy to do otherwise microfinance funds and intermediaries may inescapably slide into de facto redlining against microfinance institutions that integrate comprehensive social services with microloans.

Microfinance institutions that, as a matter of mission and policy design, dilute profits to provide free or subsidized educational services, business training and healthcare for impoverished borrowers inevitably will fare worse in the hunt for private sector capital. Since markets, as normally defined, are constrained to measure and reward maximum profits in the short- to medium-term, factoring in non-monetary metrics is difficult. Indeed, institutional investors may have a legal and fiduciary obligation to evaluate only financial returns.

Some microfinance policy analysts fret that combining microfinance and life survival educational programs or products is unwise. The rudiments of this view are summarized:

- A microfinance institution's basic sustainability is undercut. By definition, a microfinance institution spending money on non-financial extras is less profitable.

- Local in-country microfinance organizations less optimally operate local banking operations because educational programs divert management

[37] See: http://www.accion.org/media_noteworthy.asp_Q_N_E_344.
[38] CGAP Reflections on the Compartamos Initial Public Offering: A Case Study on Microfinance Interest Rates and Profits, CGAP Focus Note 42, June, 2007.

expertise or, in the business management phrase, microfinance should stick to its core competency.

- Diverting resources into social services detracts from the primary goal which is reaching more poor communities with financial services. In this view, achieving scale is priority one.

- The education of poor women is not a microfinance responsibility; microfinance exists purely to provide financial services, broadly-defined. Non-financial services should be provided independently by government or non-profit institutions.

Carlos Labarthe, Compartamos' co-CEO, captures the debate succinctly in an interview with the New Yorker, "'Muhammad Yunus always has said that credit is a human right,' Labarthe said, his voice tinged with sarcasm. 'Well, I don't believe that. Opportunity is a human right, education — but credit is for the one that has an opportunity to make something productive with that. This is in a way creating wealth, more than wiping out poverty. Not bringing up the destitute.'" [39]

In counterpoint, advocates of a multi-disciplinary strategy have concluded the business case for merging banking and social services is compelling:[40]

- Like all businesses, local microfinance institutions must remain competitive, creating ever higher degrees of consumer satisfaction. Health education, business training, etc. are value-added services which strengthen the microfinance institution-client relationship, giving women an even greater incentive to join the program, repay loans, etc.

- To renovate a cliché, local microfinance managers are perfectly capable of banking and educating at the same time. In numerous countries, microfinance institutions have demonstrated sustainability is not hampered or hindered by combining microfinance with other programs.

- Business training creates stronger business owners. A key necessity for every enterprise, and self-owned microfinance businesses are no different, is healthy workers. Healthy women borrowers stay productive in the marketplace, preventively take care of their families (a sick child being the classic career/business distraction, as every woman knows), etc.

- To reduce the human misery index, the virtually universal understanding is an empowered, educated woman is a critical building block for civil society formation, public health improvement, business growth, gender equality, behavior change, societal progress of all types. If the primary mission of

[39] Bruck, Connie, Millions for Millions, The New Yorker, October 30, 2006.
[40] For a more comprehensive discussion, see Magner, Marge, Microfinance: A Platform for Social Change, Grameen Foundation Publication Series, March 2007.

> microfinance is poverty reduction, disaggregating micro-banking and education is self-defeating. Moreover, economic opportunity without empowerment, business training, improved health, better child-rearing or other quality of life skills merely monetizes women into more productive economic household units (more profitable chattel?) without respecting their minds, family values and so on.

Carmen Velasco, president of Pro Mujer, sums up the real-life experience of the poor, "If you give them a loan and don't see that their other needs are met, perhaps they are worse off. They have a debt to repay, but still they have no sanitation, no health care, no education."[41] Or, as Muhammad Yunus notes, "…we continue to interpret capitalism too narrowly….we create a one-dimensional human being to play the role of entrepreneur. We insulate him from other dimensions of life, such as religious, emotional, political dimensions."[42] Indeed, village banking with its solidarity model depends on multi-dimensional entrepreneurs who can compete and cooperate at the same time.

Microfinance faces the horns of a dilemma: an inadequate trickle of charitable and public monies for integrated microfinance programs (and microfinance expansion generally) versus a torrent of private sector funding for commercial microfinance institutions and their economic development backers. What seems certain is that to the extent microfinance institutions depend on private market financing they will be under pressure to de-emphasize holistic, all-inclusive anti-poverty microfinance programs.

Capital Market Challenges

The Compartamos IPO showcases other important, and emerging, challenges for the microfinance industry. By aggressively entering the capital markets (to shed dependency on philanthropic money), microfinance joins a globalized system of capital inflows and outflows. As the private sectors in Thailand (1997) and Argentina (2002) learned, mobile capital markets can be capricious.

As microfinance has ruefully experienced in its dealings with foundations and donor agencies, funders are fickle and faddish. Concentration on social solutions come and go; focus on a particular nation or region ebbs and flows; new is better than old, even if old is more effective; and so on.

As there is donor herd mentality, so can there be investor herd mentality. Capital flight happens. Thus, to foreign currency risk, microfinance institutions can now add volatile capital markets.

---

[41] Bruck, Connie, Millions for Millions, The New Yorker, October 30, 2006.
[42] Yunus, Muhammad, Social Business Entrepreneurs are the Solution, Grameen Foundation USA Publication Series, 2005. See: http://www.grameenfoundation.org/pubdownload/~pubid=26.

A second capital market challenge concerns the thousands of promising microfinance institutions who are not yet ready for private sector capital (debt or equity). Currently, most of microfinance is tax-subsidized, enjoying government support or foundation/donor tax-sheltered funding. If well-established, high-flyer microfinance institutions continue to achieve extraordinary profits, will a foundation and donor backlash desiccate funds for struggling startups in the nascent stages of development?

The market answer is creative destruction, as best explained by Tryfan Evans, director of investments, Omidyar-Tufts University Fund.[43] "One of the things (microfinance) need(s), and we will get, is a cycle of creative destruction. If you're inefficient, you will get overtaken by competitors."[44] Taking a less Darwinian perspective, one might ask who suffers when a microfinance program collapses for lack of financing (either from private, commercial money or from soft philanthropic subsidies, no matter). Not the students at Tufts, presumably.

Carlos Labarthe, Compartamos' co-CEO, predicts in five years "eighty to ninety per cent of all microfinance institutions will be for-profit institutions."[45] If true, privatizing the financing of microfinance will create new conundrums with far-reaching implications: Volatile capital market funding replacing finicky foundation funding and ample resources for profitable microfinance programs and "creative destruction" for the rest.

Money is Power

Microloan interest rate pricing, in theory, should be determined voluntarily between a willing buyer (the poor borrower) and a willing seller (the local microfinance institution). Of course, for the poor woman borrower without any other economic options, the construct is a farce.

Most microloan borrowers operate their businesses in the informal economy, free of both governmental regulation *and* governmental protection. There are no enforceable usury laws, no consumer rights lawyers, no small claims courts and no better business bureau to promote or monitor ethical lending. Add to the mix, functional illiteracy, financial illiteracy and language diversity.[46]

Poor people are in no position to speak truth to money any more than they can speak truth to power. A poor woman is driven by the duality of economic adversity and aspirations for her children; the microfinance lender holds all the power.

---

[43] The fund, founded in 2005, will "invest $100 million in international microfinance initiatives" with a hoped-for nine percent return. See: http://www.tufts.edu/microfinancefund/. Source: Bruck, Connie, Millions for Millions, The New Yorker, October 30, 2006.
[44] Bruck, Connie, Millions for Millions, The New Yorker, October 30, 2006.
[45] Ibid.
[46] Protecting Microfinance Borrowers, CGAP Focus Note No. 27, May, 2005. See: http://www.cgap.org/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Documents/FocusNote_27.pdf.

Recognizing this power imbalance, the respected international Microfinance Network[47] and its individual members, including Compartamos (and ACCION, its network partner and a key investor) sign a fair pricing pledge which states "…members will price their services at fair rates. Their rates will not provide excessive profits, but will be sufficient to ensure that the business can survive and grow to reach more people."[48] As the Compartamos IPO deal reveals, enforcement is voluntary and, unsurprisingly, a definition for "excessive profits" is left to the imagination.

Reflecting on alleged microfinance abuses in India just last year, Alex Counts, president of the Grameen Foundation, presciently raised a concern: "I fear that the recent events in India could be a window to our future, where the profitability figures that (microfinance) brags about among international donor and ratings agencies are turned against them by local politicians with a variety of motives, not all of them bad."[49]

A lesson can be drawn on this topic from the most robust, open, free and vibrant capital market in the world where the law – not the marketplace -- regulates consumer affairs. In the U.S., the federal Fair Debt Collection Practices Act, the Fair Credit Reporting Act, Truth in Lending Act, Fair Credit Billing Act all protect consumers from unfair business practices. It is well worth noting and remembering that not one of these consumer protection acts was enacted *before* predatory practices occurred; all were a policy reaction to marketplace abuses.

Storyline: Non-profit microfinance institutions originally funded with start-up capital from taxpayers, public charities and foundations convert to for-profit ventures and then, fueled by excessive interest rates on our nation's poor, issue IPOs which enrich management and well-heeled, foreign investors. As more Compartamos-like deals hit the newsstands, can potentially damaging governmental oversight, regulation and legislation be far away?[50]

Thus, a social investor might reasonably conclude that a looming and real challenge for (and caused by?) commercializing microfinance is intrusive governmental regulation. Whatever the case against market-defeating "restraint of trade" in the

---

[47] An international association of 37 leading microfinance institutions from 31 countries.

[48] See: http://www.mfnetwork.org/images/stories/workinggroups/proconsumer/MFN%20Pro-consumer%20Pledge%20English.pdf.

[49] Thoughts from Alex Counts, President, Grameen Foundation USA, Microfinance Gateway, Fall, 2006. See: http://microfinancegateway.org/resource_centers/socialperformance/article/36054/.

[50] For many reasons (some practical, some ideological, some self-aggrandizing), the microfinance industry – like so many other industries before it – may react defensively in the face of governmental investigation or criticism, come to view government as an enemy, not an ally, and, fatally, proceed from institutional self-interest, not the public interest. As smart business leaders know, one can trust the marketplace to allocate resources efficiently and still respect government limits on profiteering, monopoly and unfair business practices. For example, fraud is a government-enforced boundary on market operations; intellectual property protection is another. It is a question of balance and respective public-private roles.

matter of microfinance interest rates, outrageous marketplace behavior invites outrageous governmental intervention.

Vigorous markets can usually be trusted to determine prices including loan interest rates. But some prices and interest rates are offensively predatory. This is a matter of degree and circumstance, and fair-minded people can differ. For my part, I think the microfinance interest rates charged by Compartamos are dangerously comparable to price gouging.

A Matter of Business Values

Microfinance lending – like all money and budget decisions – is a reflection of values, mine and yours. The mission matters. In the end, the values-goal is making a difference in the life of a poor woman and her family.

A common business valuation includes many non-balance sheet intangibles, such as goodwill, location, brand reputation, trademark recognition, management competence and community permission to operate. The analogous intangible in the world of microfinance, and its most compelling valuation, is the social return on investment.

Given poor borrowers are solid credit risks with extraordinary repayment rates, the practical argument for microfinance usury is that charging high interest rates will catalyze both the private social investor and, even more assertively, the private, profit-maximizing investor. The ends (scaling up microfinance) justify the means (excessive interest rates) is advanced.

By this logic, conceptually at least, there are many ways to sustainably, even lucratively, serve the bottom of the economic pyramid, generate employment and foster economic development. Some self-evidently preposterous microfinance business opportunities:

- A microfinance institution might diversify its revenue base by selling cigarettes to poor people. Too unhealthy?

- Microloans could be used to finance prostitution (low overhead, low cost of goods). Offend your values?

- In countries where it is legal and popular, microfinance institutions might be encouraged to sponsor cockfights to attract new borrowers. A problematic brand tactic?

- Microfinance organizations could reduce capital costs by partnering with pre-existing, well-established, cost-effective and very profitable in-country financial services, such as loan sharks and pawn shops. Other considerations need addressing?

As the above examples highlight, there is more to microfinance than making money. To my mind, there is something unseemly about wealthy individuals and institutions earning excessive returns off the unbearably poor. It is hard to comprehend the moral justification.

We in microfinance are painfully aware of the sad fact that every four seconds, someone, somewhere, dies of hunger.[51] Eleven million children die each year from preventable causes like malaria, diarrhea and pneumonia.[52]

So then, a modest thought experiment: A child is drowning ten feet from shore. The parents, who cannot swim, are frantically shouting for help. You are walking along the seafront, carrying a life preserver. What do you do?

- Immediately and without hesitation throw your life preserver to the child?

- Keep your life preserver because, after all, if these desperate situations (which, of course, we all deplore) are ever to be solved on a sustainable basis the parents need to learn to swim, save their own kids and not become dependent upon charitable life preservers?

- Rent your life preserver at a fair market rate, factoring in the risk of losing it in the waves, wear and tear and lost opportunity costs?

My favorite Washington, DC walk is from the Jefferson Memorial past the Lincoln Memorial and on to the National Archives. Enshrined in these structures are words and ideas that inspire, educate and cajole us to nobler purposes. Big concepts, like freedom, liberty, justice, courage, commitment and sacrifice, permeate every document. One can look into the farthest corners of those massive buildings and never find a ledger or a balance sheet. Our most important life values are not often measured by profit and loss.

What Would Leland Stanford Do?

In 2006 a CGAP Focus Note asked, “How can the international community – public and private -- contribute to the greatest possible increase in financial service access for underserved people?”[53] In 2007, the answer is Compartamos.

---

[51] Source: United Against Hunger (http://www.unitedagainsthunger.org/facts/facts.htm).
[52] Source: NetAid (http://www.netaid.org/global_poverty/global-poverty/global-poverty-fact-sheet.html)
[53] Littlefield, E., Helms, B. & Porteous, D., Financial Inclusion 2015: Four Scenarios for the Future of Microfinance (Focus Note No. 39), 2006. See: http://www.microfinancegateway.org/content/article/detail/36552.

Microfinance has before it a defining moment. As the Compartamos IPO dramatizes, this is not leisurely mission drift; it is a radical departure in core purpose, objective and intention.

Imagine for a moment, if the problem statement were “How can the international community – public and private -- contribute to the greatest possible decrease in poverty by using financial services?” Humbly considered, financial services for the poor are merely a tool in the larger campaign against poverty.

What would Leland Stanford do? Who knows, but what really matters is what <u>we</u> will do.

We each come to microfinance with different life perspectives, but all of us do so with a deep and abiding concern for the poor. In our shared judgment microfinance is the most promising platform for wiping out the scourge of poverty.

Let it remain so.