Microfinance Meets Macromarkets

A former leftist turned banker hopes capital markets will help the poor help themselves *By James L. Tyson*

ONE MORNING IN MARCH 1997, NORMA FERNÁNDEZ LEFT her street-side vegetable stand and, clutching a loan application, set out for downtown Buenos Aires. She dreamed of starting a backyard carpentry workshop, but she lacked collateral and expected the lender to reject her like a crooked nail. Within days the Emprender Foundation came through with a 500-peso ($500) loan. Since then, it has provided her with 13 more loans. Today she and her family hammer pinewood into shacks at a profit of 20 percent, and they've moved from a one-bedroom shack to a four-bedroom home.

That's microfinance: a worldwide movement to make small loans—as little as $5—available to impoverished workers. Since beginning in Bangladesh in 1976, microbanks have made loans to more than 22 million workers in more than 100 countries. Because more than 95 percent of borrowers repay their loans, some of the banks even make money. Forty return a profit on equity of 30 percent or more.

Now, Emprender is about to take microfinance to the next stage: global capital markets. Working with ACCION International, a trainer of and fund-raiser for microbanks, Emprender plans to bundle small loans into one security with terms that cushion investors against default, much like securities backed by student loans or mortgages. By midyear, Emprender expects to offer the first such security, based on $2.5 million in loans to Fernández and 4,000 other microborrowers. The bond will be marketed to money managers in Argentina and abroad.

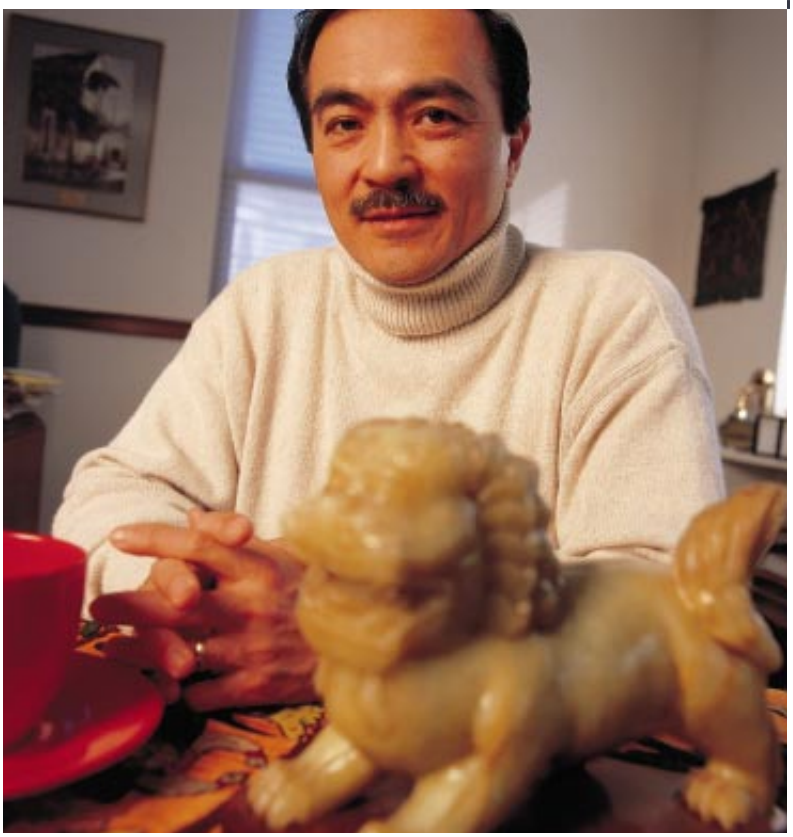
The brain behind the initiative is Michael Chu, a former limited partner at Kohlberg Kravis Roberts & Co. He is chairman of ACCION Capital Markets, an arm of ACCION based in Somerville, Mass., and devoted to raising capital for microlenders through securitization and other methods. Using his connections in the investment banking world, Chu has helped bring together an informal 14-member group from Goldman, Sachs & Co., Lehman Brothers, and Deutsche Bank to give Emprender free advice.

By bringing securitized microloans to market, Chu hopes to reward profitable microbanks with private capital and promote efficiency. If his plan works, streamlined microbanks will be able to reach more of their vast potential customer base: the 3 billion people whom the World Bank says live on less than $2 per day.

"If we succeed, I think at the end of five years, we will unlock for microfinance a market in world capital markets of several billions of dollars," says Chu, who was president of ACCION for six years before launching the capital markets spin-off.

"Securitization will be a tremendous boost for the world's poor," says Muhammad Yunus, widely considered the father of microfinance. His Grameen Bank in Bangladesh serves 39,000 villages and 2.4 million borrowers while registering a repayment rate above 96 percent. "Without securitization, getting enough liquidity pumped into microfinance will be very, very difficult," he says. In the next five years, Yunus and other microbankers estimate, microfinance institutions will need $10 billion–$20 billion to sustain their current pace of growth.

Microbankers are watching the Emprender bond carefully



Marnie Crawford-Samuelson; Rafael Wollman/Liaison Agency

By securitizing loans from borrowers like Fernández (top), ACCION's Chu (bottom left) hopes to increase the attractiveness of microfinance loans to capital markets investors

as a test case. If investors embrace such issues, bankers could use them to cut their reliance on donations. Most of the estimated 7,000 banks depend on aid from private foundations and international organizations like the United Nations and the World Bank and operate in the red as charities. With more capital, they say, they could help more people and get on a sound financial footing.

Emprender, started by a group of Argentine business executives in 1992, operates at just below breakeven and usually can obtain a bank loan for no longer than 30 days. So it lacks the capital to reach Argentina's estimated 400,000 potential microborrowers—100 times its current clientele. With more capital, it could turn a profit by reaching many more borrowers at a marginally higher cost, says Executive Director Carlos Medina.

The one-year Emprender bond will yield 14.5 percent, or about 1.1 percentage points above the typical one-year Argentine corporate bond. It provides safeguards for holders of the senior tranche, or those paid after four months. In a default, Emprender and other holders of the middle and final portions of the bond would suffer losses first.

"The senior tranche is incredibly attractive on a risk-return basis," says Harry Krensky, founder and manager of Discovery Capital Management, a hedge fund based in Westport, Conn., that focuses on emerging markets. "The beauty of the microfinance sector is that theoretically over time, it should be attractive to all institutional investors, not only to those with a specific humanitarian goal in mind," adds Tim Kingston, a managing director of Goldman Sachs.

During the next few years, Chu plans many bonds similar to the Emprender paper in both Argentina and Bolivia, which last decade deregulated their securities industries in line with leading developed countries. Among the possible issuers of securitized debt is Banco Solidario, which has grown into one of Bolivia's biggest, most profitable banks, with $82.2 million in assets. ACCION is affiliated with 20 other microbanks scattered among 14 Latin American countries.

This is not the first time a microlender has made a foray into the financial markets. During the 1990s, microbanks marketed certificates of deposit, corporate bonds, and equity. Many private-sector investors shied away from such issues because they were concerned about lending to the poor and the volatility of Third World markets.

By securitizing their loans, microbanks will be able to compete for capital in global markets on the same footing as other issuers of debt. "Securitization means that investors can ignore what's below the surface of the bond, size up a standardized product, and just worry about the rate, maturity, and risk," says Tom Coleman, founder of Microenterprise Finance Consulting and former vice president of new product development at the Chicago Board of Trade.

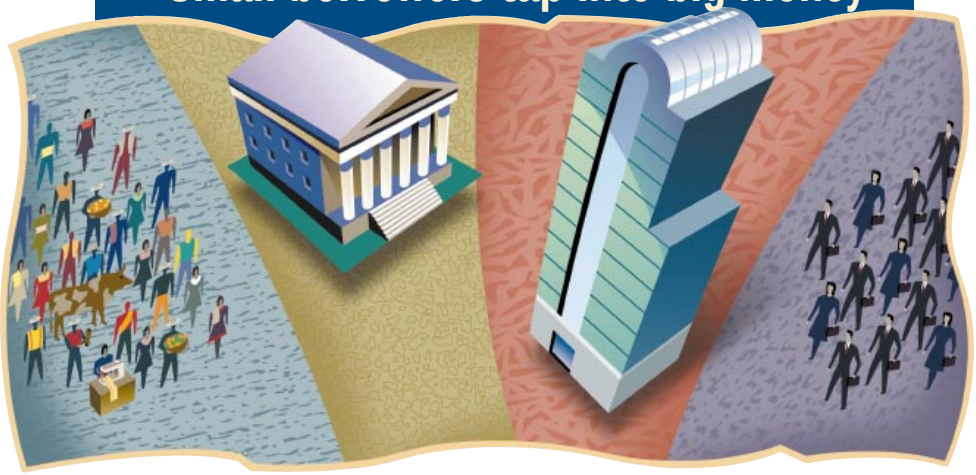
"Through the Emprender bond, we'll educate people about microfinance and build confidence in the sector," Chu says.

Before microfinance securitizations can become an established part of emerging-markets debt, more bankers must embrace the goal of profitability. Although few in number, profitable microbanks currently provide about 80 percent of microloans. Many microbankers, however, resist the idea of profiting from the poor. They fear that pressure for profits could force them to raise interest rates or make fewer, bigger loans to better-off borrowers.

"The challenge is how to become professional without losing one's soul," says Jacques Attali, president of PlanetFinance, a Paris-based microfinance organization that plans to launch this year a bank that will extend lines of credit and loan guarantees to microbanks. Attali led the European Bank for Reconstruction and Development from its launch in 1991 until he resigned in 1993 over criticism for extravagances, including decorating the interior of the bank's London headquarters with expensive Italian marble. He has plunged into microfinance partly for the challenge of building a new institution, he says.

Attali and Chu argue that the profit motive will spur competition, reward efficiency, and weed out unwise lenders. Ultimately, they say, the poor will profit from access to credit flowing from world capital markets.

Small borrowers tap into big money



BORROWERS
In the developing world, entrepreneurs with little or no collateral get loans as small as $5 to help finance their own businesses.

MICROLENDERS
Financial institutions such as Argentina's Emprender make thousands of tiny loans. They can earn profits because repayment rates are so high and labor costs are lower than in the First World.

LARGE BANKS
International banks help Emprender bundle the loans together into a competitively priced bond that cushions investors against risk.

INVESTORS
The Emprender bond is floated on the Argentine market. It appeals especially to the growing number of "socially responsible" investors backing enterprises that help the poor.

Don Baker

Concern for the poor has been important to Chu since boyhood. Just months after Michael was born in 1948, his father, a textile mill owner, was jailed and tortured by agents of the Nationalist Party government in the southwestern Chinese city of Kunming. Chu Chienfei's provocation: giving his 5,000 workers housing, education, health care, and profit sharing, something that won him acclaim and a legislative seat but also the hostility of the autocratic government. The Chus fled to Montevideo, Uruguay.

After graduating from Dartmouth College in 1968, Michael Chu returned to Uruguay and joined the leftist Broad Front, inspired by Chile's Allende government of idealistic Marxists seeking to instill progressive change. The failure of Salvador Allende Gossens's government and its overthrow in 1973 blindsided Chu's idealism and affirmed a lesson from his fledgling business career: Lasting social progress comes not from above but by helping people prosper at the grass roots.

Chu shelved his leftist convictions and attended Harvard Business School. After graduating in 1976, he was with the Boston Consulting Group, City Investing Co., and Pace Industries before joining Kohlberg Kravis Roberts. He delved into mergers and acquisitions until 1989, when he joined ACCION.

"Microfinance means a lot more to me than doing a leveraged buyout deal because of its impact on poverty," says Chu. Under Chu, ACCION and its affiliates in Latin America and 10 U.S. cities have lent $2.2 billion to 1.6 million seamstresses, cobblers, taxi drivers, street vendors, and other entrepreneurs.

"Michael has made ACCION the McKinsey of microfinance," says John Scott, a retired vice president of CPC International and Chu's former boss in Uruguay. "Michael's ideas shifted from establishing socialism to establishing people's capitalism through microfinance."

That aim appeals to a growing number of investors backing enterprises that help the poor or protect the environment. Capital that's managed in a "socially responsible" way has grown 50-fold since 1984 to reach $2.16 trillion in 1999, according to the Social Investment Forum in Washington, D.C.

Boosters of microfinance pitch it as an alternative to the traditional top-down model of Third World development. Among microfinance borrowers, household output rises by half, according to a 1998 World Bank study on microfinance in Bangladesh. Yet development experts warn that grassroots lending shouldn't be a substitute for direct aid to the poor, particularly in the areas of health and education.

"It is dangerous to see microfinance as an alternative model for development," says Ben Rogaly, a lecturer in development studies at the University of East Anglia in Norwich, England. Overseas development assistance by industrialized countries fell 21 percent from 1992 to 1997, according to the Organization for Economic Cooperation and Development.

"Microfinance is the flavor of the week for a lot of people, and they see it as a miracle tool," says Gary Hattem, managing director of community development at Deutsche Bank. "There is always a risk microfinance will fall out of fashion, donations will fall, and a lot of microbanks on the ground could disappear overnight."

Meanwhile, millions of street-side entrepreneurs like Fernández find in microbanks their only alternative to loan sharks. Since Fernández, 43, turned to Emprender, her husband, Manuel, has stopped criticizing her business and begun helping her. She is currently paying off a four-month, 4,000-peso debt at 15 percent interest. She has bought a refrigerator, furniture, and a 1974 Ford Falcon. And now Fernández, educated only up to seventh grade, can send her two teenage sons to a private school. "My dream," she says, smiling and standing amid wood scraps and sawdust, "is to open locations in many places throughout the city."

The attempt to link Fernández with Wall Street bond buyers tests whether globalization can pay off for the poor as well as the rich. If microfinance can harness the profit motive to help the poor help themselves, the payoff in prosperity could be as sure as the bang from Fernández's hammer.

▶For a graph of the 30-day Argentine prime rate in pesos, type ARPM30AP <Index> GP.

James L. Tyson is a senior writer at Bloomberg News in Washington. With reporting by Peter Wilson in Buenos Aires and Miguel de Figueiredo in Washington