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The Microfinance Collateralized Debt Obligation: A Modern Robin Hood?

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Summary. — The aim of this paper is to highlight a potentially very fruitful link between micro-entrepreneurs and international capital markets. It discusses the role structured finance and credit derivatives could play in extending finance to micro-entrepreneurs on a much larger scale than today's mainly non-commercial microfinance industry. The mechanisms of so-called collateralized debt obligations (CDOs) are described and extended to the microfinance world. Finally, a hypothetical, but realistic, example of such a microfinance CDO (MiCDO) is used to discuss the implications of securitization and tranching of microcredits.

Key words — commercial microfinance, structured finance, collateralized debt obligation, MiCDO, Asia, China

1. INTRODUCTION

Microfinance can be defined as the sustainable supply of small-scale financial services such as credit, savings accounts, and insurance to poor and low-income people (United Nations, 2005). Microfinance institutions (MFIs), in turn, are the banks/organizations providing these financial services and, today, most of them operate on a non-commercial basis. The primary role of the many thousand MFIs, or "banks for the poor," that currently operate worldwide is to support the strong but often untapped entrepreneurial spirit that exists in poor corners around the world through the building of an "inclusive financial system" (UNCDF, 2006). At this stage, however, although the MFIs are estimated to have reached close to 100 million clients (92 million clients by the end of 2004 (Silverman, 2006) and 80 million clients in 2003 (Wine, 2005a)), they are projected to only meet around 4% of the worldwide demand, according to The World Bank (Wardle, 2005). [1]

The total annual demand for microcredit, the most developed sub-discipline of microfinance, is estimated to be $50 billion (de Schrevel, 2005) with a current annual growth rate of 15–30% (Wine, 2005a). Philanthropy and development aid are not capable of meeting this huge demand and a possible answer is commercialization of microlending. Letting profit-oriented institutions enter a scene that is still dominated to a large extent by donation-based institutions, one is more likely to raise the huge amounts of funds needed to meet the demand. In addition to the increased supply of funds, commercialization would also benefit MFIs and microborrowers by providing loans with longer maturities and more diversified funding sources. [2]

The main purpose of this paper is to highlight an alternative link between micro-entrepreneurs and international capital markets. [3] We will discuss the potentially important role played by structured finance and credit derivatives in helping commercial microfinance

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develop faster. While quite a lot has been written about commercial microfinance and credit derivatives, there is only a very limited literature available on the link between the two. Most of it is written by commercial financial institutions with vested interests. As far as we know, not a single objective academic paper has been written on this.

The paper is divided into four parts. The first part discusses the scope for commercial microcredit and how commercialization of this growing market is probably the only way to reach the billions of people in the world who need finance at reasonable terms but lack access to it. Some important steps toward commercialization that have been taken by the microfinance industry, together with future hurdles that need to be overcome, are also taken up. The second part gives an overview of securitization, structured finance, and collateralized debt obligations (CDOs). The third part looks at the role securitization and so-called microfinance CDOs (MiCDOs) could have in the process of providing funding to profitable, but small, microinvestments. Finally, in the fourth part, a hypothetical, but realistic, example is used to discuss the implications of real-world MiCDO deals.

2. COMMERCIAL MICROFINANCE

Why would traditional financial institutions be interested in giving $50 loans to poor women (80% of all microloans are given to women) in rural Nepal or Ethiopia? Why should commercial microfinance loans be treated like any ordinary asset class? Why would microlending be of interest to globally established commercial banks, investment banks, or hedge funds?

There are many compelling reasons why profit-maximizing investors in the City of London or on Wall Street should include poor neighborhoods worldwide in their global investment portfolios. Put differently, there are many reasons why microfinance could give investors the chance to do well by doing good.

1. First, of course, there is the sheer market size. There are currently up to three billion people without access to proper financial services (CGAP, 2006b) and an estimated 500 million micro-entrepreneurs (Cheng, 2005) worldwide. For international investment banks, this means a largely untapped source of microcredits that, for instance, can be pooled together, securitized, and sold to investors all around the world. For local retail banks, a focus on microcredits to the poor could be a first step in building a brand name in a potentially huge future market for ordinary financial services.
2. Second, there is a good chance that the risk-adjusted returns from microlending are higher than returns from corresponding traditional lending. A poor farmer or entrepreneur in the developing world typically generates much higher returns on his or her assets than a corresponding business in the developed world. This means that many of these poor borrowers can afford to pay much for access to capital (or at least value access more than cost). As an example, with "5/6 loans" in the Philippines, a money lender lends five pesos in the morning to be repaid six pesos in the evening (CGAP, 2002a). This is equal to a daily interest rate of 20%, or more than 5000% a year. Now, if one compares this to typical interest rates in the developed world and to documented microfinance default rates in the range of 1–5% one can see the potential for commercial microfinancing. [4] Even if the cost of making microloans is high (the cost of capital plus administrative costs, loan losses, and compulsory equity buildup can reach 20–30% of the borrowed amount), this is a market where arbitrage possibilities remain to be exploited (CGAP, 2002b).
3. Third, one can expect returns from microloans to be largely uncorrelated with returns from most other asset classes (Krauss & Walter, 2006 presents some early evidence supporting this suspicion) and a microloan portfolio would therefore serve as a natural hedge for a typical investment bank, insurance company, or pension fund in, for example, Europe, Japan, or the United States. Furthermore, since diversification is the only real free lunch in the financial world, an asset class that is largely uncorrelated with the major economical and political events in the world should attract the interest of rational investors, big or small.
4. Fourth, commercially viable microlending could be an interesting alternative for private investors who (for altruistic motives as well as for commercially driven "marketing" purposes) want to alleviate poverty. By directly targeting the poor and