Statement of

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Mr Chairman, Members of the Subcommittee,

MicroRate is the first rating agency dedicated to measuring the performance of microfinance institutions ("MFIs"). MicroRate's rating teams visit MFIs and "kick their tires". We have been doing this since 1996 and we have by now rated many hundreds of MFIs. When you see so many of these institutions, certain patterns begin to emerge. I will describe some of these patterns, which are relevant to the question you are considering: what are the appropriate roles of public and private funding of microfinance? Before I started MicroRate, I worked for 25 years in the World Bank and (mostly) in its private sector affiliate, the International Finance Corporation.

Let me just mention that MicroRate is financially independent. We receive no donor money. I therefore feel free – with your permission – to speak openly not just about what works in microfinance, but also – and especially – about what doesn't work.

Yes, microfinance is a development success story. It really is! That is remarkable in itself, and it is all the more remarkable, because development is not noted for its successes. But let me immediately inject an element of caution. Your invitation for this hearing refers to microfinance as "*one of the great success stories of US foreign aid*". That, Mr. Chairman, is overstating things. Microfinance is a success, but whether US aid for microfinance has been equally successful is not so obvious. Our experience tells us that there are some notable successes, but there are also a great many failures. I would trace many of those failures back to two factors:

(i) <u>Donor money often harms MFIs</u>

When dealing with financial institutions, donations are a two-edged sword. They tend to have the unintended consequence of dulling the institution's entrepreneurial drive, of promoting inefficiency and of generally lowering the quality of operations. In our ratings we have seen a fairly consistent link between the degree of dependence on donor support and a general lack of excellence of an MFI. Let me give you an illustration that explains why. Donor money can be likened to medicine. Like medicine, it is a poison that only does good if it is administered in small, very, very carefully dosed quantities. Unfortunately development agencies are usually not good at dosing the medicine carefully. They have to spend a budget after all. MFIs are even worse at this careful dosing process. They get hooked on the poison. As a result, the system is stacked against success. At MicroRate we soon discovered that a look at the vehicles parked in front of a MFI can be a predictor of what we will find once we will pass through the door. If there are plenty of expensive four-wheel drive vehicles – a sure sign of too much donor money – then chances are that we will find heavy, complicated procedures, a bloated staff and poor portfolio quality. The MFI simply hasn't had to go through the painful process of constantly honing its efficiency, of incessantly worrying how to better serve its clients.

In those cases, I am sorry to have to say it so bluntly, the subsidy that was intended to help the poor ended up creating jobs for middle class MFI employees and hurting those it was intended to help. Let me emphasize that these are not isolated cases, this is the rule: donor money in a MFI will nearly always end up impairing the performance of that MFI. The damage tends to be proportional to the degree of subsidy dependence; if a MFI is heavily subsidized the damage is immediately visible, if the subsidy is small the damage is more subtle, but it is still there.

There *is* a case for donor support for MFIs. Donor support can do more good than harm when the MFI is blazing new paths, where nobody has dared to walk before. These paths can either be geographic – an area where nobody thought MFIs could operate successfully – or they can refer to new products or new methodologies. Here, the subsidy will help the MFI to defray the cost associated with experimenting and it will have a demonstration effect that others hopefully will imitate.

In the early days of microfinance, in the 80s and early 90s, much of what went on in microfinance deserved to be subsidized on these grounds. But in the last 10-15 years most donor support for MFIs we analyze would not pass the test of the Hippocratic oath: "*above all else, do no harm*". Indeed we often ask ourselves, why donors insist on subsidizing certain MFIs, when there are others that do the same thing without donor support - and do it better.

(ii) MFIs are used as a mechanism to transfer wealth to the poor.

Donor agencies in particular tend to make this mistake. They reason something like this: people are desperately poor. We are here to help them, but we can't reach them ourselves. So let's give money to MFIs who can reach them. Some of that money might actually come back to the MFI so it can be relent. But even if it doesn't, at least we know that it reached someone who desperately needed it.

This line of reasoning sounds good, but it is deadly for MFIs. Microfinance institutions are, by definition, financial intermediaries. They don't transfer resources to their clients, to the contrary, borrowers have to pay back much more than they borrowed. If the resource transfer mentality creeps into microfinance, MFIs are doomed, since borrowers will sense, that being repaid is not high on the lenders' list of priorities. It is this resource transfer mentality, which tends to be the undoing of so many government owned MFIs.

Donor agencies are often confronted with the argument that "commercial" microfinance tends to abandon the poor. Commercial MFIs, this line of reasoning goes, will always go up-market, where the pickings are richest. This is not what we see happening. MFIs, whether commercial or not, will shy away from untested markets or products, if they think the risks are too high. But they will enthusiastically serve the poor, even the very poor, if it has been shown that this can be done profitably. Yes, we have seen MFIs letting themselves be lured into going upmarket, because they know that when loan sizes get larger, their operating expenses will drop. They the reason that lower operating expenses translate into wider margins. But these MFIs invariably discover, that while operating expenses indeed drop as loans get larger, lending rates drop even more rapidly. The MFIs then invariably perform what has come to be called the "Microfinance U-turn". As they start to make small business loans – rather than microloans – they take a beating and they quickly hurry back down-market. In fact as competition between MFIs has increased, we have seen more and more MFIs *decrease* their average loan size.

The Enterprise Results and Accountability Act of 2004 (PL 108-484) was influenced by this kind of reasoning. Six years later it is safe to say that the law was not an unmitigated success.

Allow me to comment briefly on where we see microfinance succeeding and where we see warning lights blinking. Overall, as I said at the very beginning, microfinance is a stunning success. For example, during the last decade the MFIs we track in Latin America have increased their lending nearly 30-fold. Today, in many markets, the poor not only have access to financial services, but they can choose between fiercely competing MFIs. The picture repeats itself in other parts of the world.

Another aspect of this success is that today, more than a billion dollars flow annually from mostly private investors in rich countries via MFIs to the poor in the slums of Latin America, Africa or Asia. A whole industry of specialized intermediaries (so-called "Microfinance Investment Vehicles – MIVs") has emerged that mobilizes and channels these funding flows. In 2008 for example – yes, in the crisis year 2008 – the assets of MIVs grew by $1.2 billion to $5 billion. This is hugely encouraging.

But as we rate MFIs, we increasingly see that these funding flows test the limits of the absorptive capacity of MFIs. To put it crudely, too much money is chasing too few MFIs. This is dangerous. It leads to MFIs getting loans they shouldn't get and it pushes some MIVs into expanding the definition of microcredit recklessly. The situation is made worse by multilateral and bilateral development banks – IFIs for short – who are eager to prove their development credentials through ever-greater lending to MFIs.

Let me give you two examples picked at random: The MicroCapital Monitor, the leading trade publication of the microfinance industry reports in its January edition that the Inter-American Development Bank has just approved two microfinance loans of $10 million each. One is to Banco de Credito y Inversiones, a Chilean commercial- and investment bank with assets of $ 21 billion (2008). The other is Mibanco, Peru's largest MFI with assets of about $ 1 billion. Neither of them needs IFI funding by any stretch of the imagination. Much less do they need grants of $ 600,000 and $ 3 million respectively, which the IDB's Multilateral Investment Fund threw into the deals. Both could easily borrow from a wide array of MIVs, but then MIVs could not match the terms offered by the IDB, nor could they offer the grants which the MIF threw in to sweeten the deals.

Examples of this kind of "trophy lending" by IFIs unfortunately abound. A characteristic of trophy loans is that the lender needs the loan more than the borrower – as the accompanying grants suggest. It is not rare to hear MFIs tell how IFIs pressure them to take loans and how grants are used to beat out competing offers from MIVs. Among Washington-based IFIs, the IDB is by no means the only one to engage in trophy lending for microfinance. The International Finance Corporation has a large and growing collection of such loans. If development institutions crowd out private funders in this way, then there clearly is something very wrong. The World Bank, by the way, has wisely kept a low profile in microfinance. They know that they are not well equipped to deal with private financial intermediaries.

Not all is bad news as far as official development banks are concerned. OPIC, a relative newcomer to microfinance, has been remarkably innovative and catalytic. On the whole OPIC does, what development banks should do, but few achieve: they open up new areas for lending where private funders fear to tread and they then mobilize private funding.

Another problem facing the Microfinance sector is the tendency to expand the definition of microcredit. Not all lending to poor people is microcredit. Moneylenders have made small loans to poor people for thousands of years. But today we see consumer credit, a modern and more respectable version of traditional money lending, increasingly posing as microcredit.

From a distance, it is nearly impossible to distinguish consumer credit from microcredit. The loan amounts are often similar, as are the borrowers. So, what's there to criticize, you might ask?

The acid test of microcredit is whether it enables the borrower to create wealth. This wealth-creating characteristic is at the heart of microfinance. Good MFIs can spot among the thousands of people asking for money those who will create enough wealth to be able to pay the loan back with interest and to have enough left over to better their lives. Consumer credit agencies, by contrast, base their lending decisions not on the borrowers' ability to create wealth, but on his capacity to secure a loan. Consumer credit is collateral based – some loans might end up being used for productive purposes, but that would be coincidence. The Consumer lender would neither know, nor care.

Why is this tendency to include consumer credit in microfinance dangerous? Because investors who entrust their money to MIVs will not be amused if they discover that their funds did nothing to lessen the poverty of the borrower. An investor backlash against microfinance could follow such a discovery. Nor should donor governments take it lightly if supposed microcredit funding by IFIs fails to alleviate poverty.

Thank you very much.