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I. Executive Summary

Microfinance has become an increasingly attractive market in the past decade. As one of the first large financial institutions with a significant presence in the microfinance market, Deutsche Bank is currently in a strong position to expand its efforts. We forecast that as a growing market, microfinance can provide sustained profitability. Given Deutsche Bank's current relationships with a large number of micro-finance institutions (MFIs), it is in a position to corner a significant portion of the financial distribution channels in developing countries.

Microfinance refers to the offering of financial products for customers with limited access to financial services, usually due to poverty. Its primary purpose is to reduce poverty in both developed and developing economies by stimulating business growth with capital. Although microfinance can exist in every part of the world, we will focus our study of it to developing regions such as Africa, Asia, Latin America, and parts of Eastern Europe.

Microfinance can take on many forms. Its most common form is microcredit—offering small loans to stimulate local businesses. However, microfinance can also assist clients with securitization, equity stakes, risk management, and currency swaps. End-user services are also offered, such as low-cost international money transfer. Direct financial distribution takes on two forms; international banks can either provide funds to local banks for microfinance (wholesale), or they can directly offer financial products to end users (retail). Non-profit organizations have traditionally served the microfinance industry, but the market is currently in a state of transition towards the involvement of for-profit firms.

The dual purpose of microfinance organizations to satisfy both corporate citizenship and commercial functions gives rise to a spectrum of different approaches that a firm can take to microfinance investment. In a broad sense, firms can be purely devoted to corporate citizenship, solely focused on commercial gain, or a mixture of the two. These three types of involvement can be characterized as development funds, commercial microfinance funds, or quasi-commercial funds, respectively. There are two primary factors that distinguish these types from one another, the interest rate charged to the borrowers or MFIs and the types of investors. As the commercial nature of the involvement increases so does the interest rate, because investors expect a greater return. In accordance with this trend, both private donors and developmental organizations contribute funds at the most charitable levels. These organizations, along with socially responsible investors, also give funds to quasi-commercial funds. The latter also invest in commercial microfinance funds, along with purely commercial investors.¹

II. Deutsche Bank's Current Involvement in Microfinance

Deutsche Bank has so far positioned itself largely in the first two (least commercial) types of investment vehicles. In particular, Deutsche Bank's Global Commercial Microfinance Consortium can be classed as a quasi-commercial fund (USAID is a contributor), while their Microcredit Development Fund, supported almost entirely by private donation and foundation endowment, is obviously a vehicle intended merely to further corporate citizenship responsibilities.² Only Deutsche Bank's startup fund, which attempts to provide funding to support new commercial MFIs, can be considered at all to be a commercial fund. However, the amount of money and effort that Deutsche Bank has put into this venture to date is very small—

¹ Deutsche Bank Research, *Microfinance: An Emerging Investment Opportunity*

² USAID, *The Deutsche Bank Global Commercial Microfinance Consortium and USAID's DCA Guarantee*

less than one million dollars has been provided, and loans have only been issued to six microfinance institutions in five countries.³ The extensive relationships that Deutsche Bank has built with MFIs through its less commercially oriented programs should be exploited in the development of more for-profit ventures. At the same time, Deutsche Bank needs to maintain its corporate citizenship functions both to keep money flowing from private donors and to investigate new markets by establishing low-risk, charitable investments to test the waters for commercial profitability.

III. Deutsche Bank's Strategy

Currently, the largest markets for microfinance are India, Bangladesh, Indonesia, Nigeria, Pakistan, and Brazil. Generally speaking, Deutsche Bank must drastically expand investment in these countries. However, each market must be considered separately, as DB's positioning will of course be dependent on the local climate. One important thing for DB to consider is whether or not to enter as a retail or wholesale presence.

One of the fundamental issues with entering commercial microcredit is how exactly to do business with borrowers—whether to adopt a wholesale operation through MFIs or form retail businesses and deal directly with individuals. The latter presents myriad operational issues, as proper retail management requires a thorough knowledge of the local population and government. In order to obtain a high rate of return and thus be commercially viable, a retail microfinance firm must be able to identify the lowest risk borrowers. This is because, generally speaking, clients in developing countries have vastly different causes for defaulting on loans than bankable borrowers in developed countries. Health issues, cultural obligation, or other unforeseen aspects of local life can pose a large risk. This of course would present problems for

³ Deutsche Bank, *Microfinance*, <http://www.db.com/csr/en/content/microfinance.htm>

Deutsche Bank managers, who would have little firsthand experience dealing with such environments and could have trouble operating a business with customers so different from their usual clientele.

On the other hand, the wholesale approach makes garnering large-scale profits from microcredit extremely difficult because the higher interest rates required for commercial operation make the loans from these firms less desirable. The largest firms have a significant level of bargaining power because leading microfinance institutions exhibit an extremely high return on equity both in absolute terms and relative to less successful MFIs. In a study of 704 MFIs, the leading 176 MFIs, judged to be the most reliable, exhibited a stable return rate of 17.2% even through economic cycles, much higher than that of conventional banks. Given the average 4% return on equity of MFIs, this points to the extreme desirability of taking stakes in the most lucrative and stable microfinance institutions.¹ Since the most reliable MFIs are the most sought after by both for-profit companies and non-profit organizations, they have the option of choosing which loans to take. In this way, an MFI can always take loans from a less costly source and thus prevent larger interest rates from being extracted.

Several of Deutsche Bank's competitors have managed to either make retail workable or avoid the troubles of direct operations altogether while still charging commercial level interest rates by making various deals with MFIs. Deutsche Bank's competitors have taken the risk of loss either partially or completely away from MFIs and shifted it to themselves in exchange for a greater interest on loans. One successful example of the retail type is the ING Vysya Bank in India. This firm got its start locally, but was acquired by ING and has become very profitable in conducting both retail and wholesale microfinance operations.⁴ Given this precedent, it is possible for Deutsche Bank to effectively convert local MFIs with which it has formed strong

⁴ ING, *ING Vysya Bank's Net Jumps to Rs.89 Crores*

working relationships into profitable microfinance operations, avoiding the costs of reorganization. This approach based on vertical integration allows Deutsche Bank to efficiently harvest revenue without sharing profit with local companies. For example, Deutsche Bank's well-established presence in Eastern Europe makes that region a candidate for this approach. Deutsche Bank should also consider establishing a retail presence in cases where the market is large, potentially profitable, and currently underserved. The first mover advantage here can be significant, especially if DB is able to initiate binding long term ties with those few (if any) MFIs proven to be able to identify trustworthy clients. This situation is common in areas that have a low relative supply of microcredit, in Latin America and Africa.⁵ A prominent example of a country like this is Nigeria. Despite a large unserved market for microcredit of over 80 million people, due principally to weak capital and managerial bases for existing MFIs, less than one percent of total credit is accounted for by microcredit.⁶ This is a clear example of a location where Deutsche Bank is able to provide valuable resources for existing MFIs, as well as establish a retail presence in a potentially highly profitable underserved market (provided that local expertise can be effectively contracted).

Moreover, by taking equity stakes in local microfinance institutions, or simply purchasing their portfolios, Deutsche Bank can monopolize the distribution of capital in developing regions. Indeed, some of DB's competitors have formed short-term relationships with MFIs by buying their loan portfolios wholesale while leaving the company autonomous. For example, Germany's second largest bank, Commerzbank AG, is one of the only companies that pursues microfinance with a purely commercial strategy. Commerzbank owns a large amount of

⁵ Wikipedia, *Microfinance*, www.wikipedia.org/wiki/Microfinance

⁶ SEEP Network, *Developing a Long-Term Sustainable Microfinance Sector in Nigeria*

the equity of a chain of MFIs throughout Central and Eastern Europe.⁷ This partnership has been consistently profitable, and shows that wholesale relationships can be maintained at high interest rates and without acquisition by sharing risk. This provides a more temporary arrangement, which would be useful to Deutsche Bank in expanding its functions to commercial operations. Indeed, Deutsche Bank recently securitized ProCredit Bank Bulgaria's euro-dominated loan portfolio with €100 million.⁸ Deutsche Bank should strive to maintain these relationships, as well as develop more throughout suitable markets. Another successful example of portfolio purchasing was executed by Citigroup in 2007, when Citigroup purchased 44 million dollars in loans from SKS Microfinance, contributing to an annual growth rate of nearly 300 percent. A strategy like this provides a first mover advantage, since the control of reliable MFIs is highly competitive. By entering the market early, Deutsche Bank can secure a stake in the market while decreasing competitive incentive.

While several methods of establishing commercial microfinance firms and partnering with MFIs have already been pioneered by Deutsche Bank's competitors, only a small minority of MFIs are owned or otherwise bound to commercial industry. There is a large pool of MFIs that Deutsche Bank has done business with that could serve as good candidates for commercial wholesale partners. Remaining potential wholesale MFIs are very prevalent in large, relatively developed Asian markets. One such area is Bangladesh, which is home to perhaps the best known non-profit in the microfinance industry, Grameen Bank. Despite this large established presence, there are several other large MFIs that would be good targets for wholesale work with Deutsche Bank. The Bangladesh Rural Advancement Committee (BRAC) is Bangladesh's largest NGO-MFI and is currently expanding their operations using bonds, establishing a need for

⁷ Commerzbank, *Commerzbank's Investment in ProCredit Bank*

⁸ ProCredit Holding, *First "True Sale" Securitization of a Microfinance Loan Portfolio*

Deutsche Bank funds and a way to form binding contracts.⁹ Bangladesh is still largely open to the commercial market, while nations in which a competing commercial bank has already established a significant contracted wholesale presence, such as in India with ING Vysya Bank, should not be focused on. The best Deutsche Bank can hope for in these situations is a me-too approach in which they attempt to contract from the second-choice MFIs that remain.

IV. Micro-Remittance

An interesting nontraditional form of microfinance that DB could involve itself with is remittance (traditionally migrant workers sending earnings to their native countries). Currently the international money transfer market is largely dominated by corporations such as Western Union, MoneyGram, and Vigo, which charge often prohibitively high standard transaction fees. Roughly 200 million transnational labor migrants sent money home in 2005, comprising a total volume of over 230 billion dollars.¹⁰ Given the rapid increase in the international remittance market, conditions are favorable to enter, and indeed, several of Deutsche Bank's primary competitors have recently initiated remittance programs. For example, Citigroup offers remittance programs in Ecuador in partnership with Banco Solidario¹¹ and with their subsidiary Banamex in Mexico.¹² Similarly, HSBC has partnered with Opportunity International to create a remittance program in the Philippines.¹³ These services are able to dramatically undercut the prices of those offered by Western Union and other established companies in the market while maintaining profitability. The minimal operating cost and large profitability of the money transfer market make entry for Deutsche Bank very attractive. Though other firms have entered

⁹ The Microfinance Gateway, *BRAC Bangladesh to Launch US\$90Mln bond for Agriculture Finance*

¹⁰ Anne Hastings, *Entry of MFIs into the Remittance Market: Opportunities and Challenges*

¹¹ ING, *A Billion to Gain: A Study on Global Financial Institutions and Microfinance*

¹² Citigroup, *Citibank & Casa Puebla...Make Sending Money Back Home Easy & Inexpensive*

¹³ HSBC, <https://www.hsbcmt.com/app/oic/pages/public/Home.jsp>

the market in particular areas, competition is still relatively minimal in some regions in Africa, Eastern Europe, and Asia. In particular, Deutsche Bank's existing connections with local banks in Eastern Europe can give it a decisive first mover advantage in entering international money transfer markets, thereby controlling locally available avenues of service. Especially given the recent geographic expansion of the EU and increased worker migration from many Eastern European countries west, this is a clear opportunity for Deutsche Bank.

Even in regions where Deutsche Bank is less familiar, provided that remittance capital flow is large and conditions seem favorable to foreign investment--such as Vietnam or Laos--Deutsche Bank should attempt to undercut the more established money transferring agencies in the area. In countries where DB is best suited to provide wholesale services (Asia), such large potential connections are ideal for establishing the necessarily significant local footprint that effective remittance services require. However, Deutsche Bank should avoid otherwise tempting markets which are already saturated with competitors, including Mexico, Ecuador, and the Philippines (entered by Citigroup, HSBC, etc).

V. Concluding Remarks

The microfinance market, as it stands now, is highly underserved; it is predicted that microfinance institutions currently only have the capital to serve about 100 million borrowers today, with a current sector demand of approximately 1 billion borrowers; this translates into a 250 billion dollar gap in funding. With worldwide growth and social investment on the rise, we expect individual and institutional investments in microfinance to increase to 20 billion dollars by 2015, compared to an estimated 4.4 billion dollars today.¹ Tempting potential profits should not, however, encourage DB to act rashly in markets that are too risky. A method of minimizing

risk in unproven markets is simply for Deutsche Bank to place more emphasis on its programs motivated by corporate citizenship there. This allows Deutsche Bank to establish relationships with MFIs in these area with token amounts of money, most of which is actually solicited from development organizations and private donors.