

Dangers: Credit crunch holds many key lessons for the future

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The most high-profile attempt to boost financial inclusion in recent years has been in the news for all of the wrong reasons. The sub-prime crisis in the US has its roots in attempts by Bill Clinton to increase access to credit for low-income families.

So does the sub-prime debacle hold lessons for institutions looking to extend access to financial services to the unbanked and underbanked in other parts of the world?

"There is a huge difference between access to finance and predatory lending," says Greg Larkin, banking analyst at RiskMetrics. "A huge proportion of the world's population earns income, holds assets and is financially responsible but does not get the access to credit that they deserve – and that is an enormous profit opportunity."

It is generally estimated that microfinance has given about 100m people access to financial services, but that leaves 3bn-4bn people still unbanked, says Jon Williams, a partner in the Sustainability and Climate Change practice at PwC.

Murray Gardiner, microfinance and community banking strategy manager at Temenos, a provider of banking software, says: "At the moment microfinance is sufficiently profitable to attract mainstream funding that has some altruistic intent, but not [generally] sufficiently profitable to attract a more unscrupulous, predatory element. Sadly, this is likely to change, especially as microfinance becomes more complex, and especially in middle-income (such as Indonesia) to high-income (such as Mexico) developing countries." Prashant Thakker, head of microfinance at [Standard Chartered](#), says: "There is already a feeling that in some parts of the world, the growth of microfinance institutions (MFIs) is putting stress on their governance and the systems that support them."

Good governance within lending institutions is an essential part of risk management, says John Wilcox, chairman of Sodali, a governance consultancy.

Rather than turn their backs on the underbanked, banks should learn lessons from the sub-prime episode, Mr Larkin says. The most important factor is transparency on both sides. "Products that enable a poor person to conceal his income are a bad idea, as are those where the principle of the mortgage is hard to understand."

Louise Holly, deputy director of Results UK, an anti-poverty NGO, says: "Lots of work is needed to educate people who have no experience of dealing with money or financial services."

Other lessons include the need for a thorough understanding of the business and the quality of the products being offered, as well as the quality of the borrower, says Mr Wilcox. "These sound like basic issues, but they were clearly forgotten over the past few years."

While repayment rates for microfinance loans are very good at the moment, there must be systems in place to avoid over-indebtedness, says Mr Thakker. These systems should be able to cope if people are unable to repay – and to consider the various combinations of circumstance that might bring this about. "Our advice is to temper your growth rates and choose your customers carefully," he adds.

The sub-prime problems developed partly because the uncharacteristic stability of the economy, combined with low interest rates, meant that proper analysis of the fundamentals of economic health went by the wayside, Mr Larkin says.

Some people point out that microfinance is a product very different from sub-prime loans. Balaji Iyer, vice-president, Microfinance, [HSBC](#) India, says that while mortgages are long-term loans that last for years, microfinance loans are very short-term, with most loans being extended for less than a year.

Also, mortgages are a consumer product while micro-loans are used for productive purchases that boost economic output and activity, says Dr Gabriel Montes-Rojas of London's City University.

Many microfinance loans are made on a group basis to a community of lenders who vet the quality of the loan and the borrower, while sub-prime mortgages were offered to individual consumers who took the full risk of what was essentially a speculative bet on the property market, Dr Montes-Rojas adds.

And yet as the sector grows it is branching out to offer a wider range of products, including micro-insurance, consumer loans and even mortgages. Most MFIs are currently financed by large banks such as Standard Chartered or HSBC, by specialist investment funds such as Geneva-based BlueOrchard or from their own

deposits. However, microfinance is beginning to be introduced to capital markets, "which needed to happen," says Mr Larkin. "But it was when the sub-prime sector met the capital markets that we got the banking crisis. If you accelerate loan growth at an unsustainable rate, that is destabilising."

Beyond microfinance there are dangers, too, says Mr Larkin. In many markets, consumer credit is expanding much faster than wage growth, with Russia especially vulnerable. Consumer credit is more than 100 per cent of income in a number of countries, including many thought to be in relatively good shape such as Malaysia, South Korea and Chile. That could lay the foundation for future banking crises.

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