Cows, Kiva, and Prosper.Com: How Disintermediation and the Internet are Changing Microfinance

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The international microfinance community has received a considerable amount of attention in the past few years and has captured the imagination of millions. The understanding of microfinance that has permeated popular culture is simple: poor people run businesses, and providing very small loans to these businesses can increase profits and help them lift themselves out of poverty. In fact, microfinance is much more than small loans. Microfinance includes a range of financial products, including savings and insurance and money transfers, and can be delivered by a variety of institutions, such as nonprofits, cooperatives, nonbank financial institutions, and banks. The line between formal finance and microfinance is blurring. What continues to distinguish microfinance from formal finance is the commitment to work with small enterprises and low-income households and a reliance on "social collateral," such as peer pressure, rather than traditional collateral when lending.

The main challenges for international microfinance remain the lack of sound intermediaries to deliver financial services as well as limited funding, although significant advances have been made in both of these areas in the past decade. The microfinance community is moving quickly to tap into local and international capital markets, particularly so-called social investors.

Recent advances in finance and technology are providing new opportunities for individual investors to support and invest in microenterprises, and in some cases bypassing intermediaries altogether. Although these efforts at disintermediation are still new, they present a new way for poor communities to attract capital that has the potential to unleash the entrepreneurial capacity of the poor. They might also hold the key for innovation in other related fields, such as community development finance.

Putting a Face (or Snout) on Poverty and Opportunity

While most people accept that short-term charity is a necessity in times of acute crisis, a solution to the chronic problem of poverty is harder to "sell." The enormity and ceaselessness of poverty engenders hopelessness and donor fatigue. Relief organizations have had notable success in putting a face on natural disasters by asking donors to sponsor a child or build a house. One of the challenges of supporting economic development is how to put a face on poverty that conveys opportunity and closure. Heifer International is a well-known success story in the development field in part because it has been able to personalize poverty in a way that highlights hard work, self-help, and sustainability. Heifer Projects offers donors the opportunity to provide a cow or other farm animals with the potential for reproduction to needy families to "help people feed themselves." This disintermediation, creating a sense of a direct relationship between a donor and beneficiary, and the promise of a sustainable solution have been key ingredients in the Heifer Projects' success worldwide, even if the faces put forward were not always human.

Microfinance uses messages similar to Heifer Projects, highlighting self-help and sustainability. However, microfinance is not well suited to build direct relationships between donors (or lenders). The essence of microfinance is intermediation–to build microfinance institutions (MFIs) capable of managing the risk and relationships between funders and entrepreneurs. The primary reason for all financial intermediation is to overcome the information gap between lenders and borrowers. This need is particularly acute in microfinance when clients have no recorded credit history or land title. A lender in New York, however well informed, is unable to measure the borrowing capacity of an entrepreneur in Nairobi. Still, microfinance has long recognized the power of creating the appearance of a direct link between funders and recipients of microloans. Fund-raising efforts for microfinance have followed the disintermediation model by allowing donors to support specific borrowers, village banking groups, or communities and have built relationships with donors by providing repayment information and stories of successes. Unfortunately, the financial costs and time burden of providing this information are fairly high and are at odds with the need to run MFIs efficiently as a business rather than as a charity.

Several recent attempts using the Internet to overcome the information gap and strike a balance between financial intermediation with relationship disintermediation are noteworthy for their successes and challenges. The lessons learned may offer some long-term solutions to attracting capital to creditworthy entrepreneurs.

Financial Disintermediation, or "Cutting out the Middleman," Goes Small

One of the most profound changes in finance in the past fifteen years has been the spread of financial disintermediation on a global scale. Traditionally, the financial markets centered on banks that acted as a conduit between suppliers of funds (usually deposits) and users of funds (usually borrowers). Banks made their money on the spread between the interest rates paid and charged as their reward for managing the risk of intermediation. Banks now seek to take advantage of their risk-management capabilities to arrange direct deals between lenders and borrowers in the form of private placements, fixed-income securities, and more sophisticated derivative products. The growth in loan syndications (selling participations in loans) and asset securitization in particular (bundling and selling thousands of smaller financial assets to investors) is the most dramatic example of disintermediation. Both have severed the traditional link between underwriting and credit risk: institutions arranging loans or underwriting securities no longer hold them. These securities are assigned credit ratings by rating agencies, sold in the market to the highest bidder, and traded so often that the debtor, issuer, and investor may not know who holds them. A Japanese investor may now own the credit card debt of a Canadian household issued by an American finance company and not even know it.

Prosper.com has sought to bring this financial technology to bear in small loans. Prosper.com is an online auction place for personal loans. It is not microfinance per se, but combines elements of consumer finance, social investing, and microfinance with an online market place. Prosper.com allows individual borrowers to post online their request for a loan with a proposed interest rate. Lenders in turn can shop on Prosper.com and bid to fund loans. As with a loan syndication, lenders may spread their risk by buying small parts of multiple small loans, such that a dozen or more lenders may fund a single loan. Lenders can bid down the offer rates on loans and receive updates to see if they have been outbid. Prosper.com facilitates the transaction for a 1–2 percent fee by providing basic credit information on the potential borrower (for example, credit score, home-ownership status, debt-to-income ratio). It also provides faces to the lenders by giving them space to share a photo and tell their story. Prosper.com has excelled in creating a true "people-to-people lending marketplace" in which the best borrowers get the best rates. The highest-rated borrowers pay slightly less than 10 percent on average, and it is not uncommon to see rates as low as 7 percent.

Prosper.com has been less successful in moving lenders to less qualified, riskier borrowers. The website was not intended to focus primarily on microenterprise or community development. A brief look at the inventory of available loans shows that the majority of lending is done to refinance consumer debt and most borrowers are salaried, although business and home-improvement loans are frequent. Since inception, lenders have been steadfastly risk averse. Only 17 percent of the $91 million in brokered loans have gone to borrowers with a credit score of less than 600 or no credit score. This percentage dropped to 8 percent in the wake of the subprime lending crisis. To its credit, Prosper.com has tried to incorporate some traditional microfinance methods to help lower-rated clients. Borrowers can voluntarily associate themselves with certain groups (professional, ethnic, service, etc.) that act as a character reference and a screening mechanism. Theoretically, borrowers can upgrade their creditworthiness by being associated with a group's collective credit grade. However, group-payment rewards led to group organizers trying indiscriminately to attract as many members as possible, leading Prosper.com to discontinue these rewards and de-emphasize group affiliation on their website.

Kiva is a nonprofit organization that seeks to disintermediate the lending relationship between socially motivated lenders and developing world microentrepreneurs using the Internet. Kiva works with MFIs in developing countries to build Internet profiles of borrowers with a brief biography, loan requested, loan term, and purpose. Rather than wait for individual loans to be funded, Kiva's MFI partners first approve and disburse the loan, which is then refinanced by several Internet lenders. Like Prosper.com, Kiva encourages lenders to diversify risk (and currently limits lenders to $25 participation on any single loan). Kiva's website also includes a detailed summary and rating of the MFI field partner. It is the collection rate and rating of the MFI partner that Internet lenders rely on to make decisions rather than a borrower's credit score. Unlike Prosper.com, Kiva's lending is not market-based; at present, lenders receive 0 percent interest, although Kiva plans to allow lenders to earn a return in the coming year.

Kiva's efforts at true financial disintermediation are complicated by cross-border transactions. Legally, Internet investors are lending to Kiva, not to the microenterprises. Kiva then lends to MFIs or has an agency agreement through which the MFIs manage Kiva's funds. Despite this, Internet lenders agree to assume the full risk of Kiva's loans, including foreign currency risk, mimicking a direct lending relationship with the borrower. Kiva relies on its MFI partners to identify and screen borrowers and approve, disburse, monitor, and collect loans. MFIs are also required to post borrower profiles with occasional updates, which can be time-consuming and outside their daily business routine. In return, MFIs are allowed to keep all the interest earned on the microenterprise loans, usually in excess of 25 percent. Most important, Kiva was created to move lenders to poor households. It deliberately selects some "young and unproven" MFIs that have the potential to reach poorer entrepreneurs overlooked by more established MFIs. Its lending has been constrained by the limited number of qualified and appropriate MFI partners as well as the time and cost required to screen, monitor, and enroll them.

In October 2007, eBay launched Microplace to help link individual investors to purchase a part of institutional investors' microfinance securities. Rather than disintermediation, Microplace is pursuing democratization of investing as an online registered broker-dealer that sells participations in wholesale loans and securities issued by social investors to MFIs. Investment choices are fairly limited at present and will be constrained by the number of credible social investors in microfinance. Returns are fairly low, ranging from 0 percent to 3 percent, reflecting the rates charged by the selected social investors. The potential in Microplace is to offer another option for individual investors to participate in microfinance with the confidence that selected social investors are able to analyze, monitor, and collect from MFIs.

The Bigger Gap: Information

The Internet is also helping to bridge the information gap between investors and borrowers without resorting to disintermediation. Founded in 1997, the MicroBanking Bulletin (MBB) has become the benchmarking source for the microfinance industry. The industry commentary, analysis, and benchmarks have created more standardization and a better understanding of developments in the microfinance sector. More than 200 MFIs are now included in the MBB. All financial data is provided voluntarily by MFIs (with substantial supporting statements) and then reviewed and adjusted by the MBB staff to provide comparable results for profitability, efficiency, and loan portfolio quality. This led to the founding of the MIX Market, a global, web-based, microfinance information-exchange platform. It provides information on and to a broad variety of microfinance players, such as MFIs, investment funds, MFI networks, raters/external evaluators, and others. With more than 1,000 MFIs self-reporting, the MIX Market seeks to develop a transparent information market to link MFIs worldwide with investors and donors and promote greater investment and information flows. The self-reported data on the MIX Market is not analyzed or adjusted, but participants are ranked according to their level and quality of information disclosure. Neither the MBB nor the MIX intermediate or directly manage lender and borrower relationships. Arguably, the MBB and MIX Market services have done more to foster funding flows to MFIs, and ultimately to their microenterprise clients, than any other mechanism to date by providing a platform for exchanging information and promoting transparency. [For a look on how the MIX Market example may help promote a secondary market for domestic community development loans, see Laura Choi's article in this issue of the *Review* and her working paper: "Creating a Marketplace: Information Exchange and the Secondary Market for Community Development Loans" (July 2007) at: http://frbsf.org/publications/community/wpapers/2007/wp07-01.pdf].

Early Lessons Learned

The early experience of Prosper.com, Kiva, Microplace, and the MIX Market is instructive, if not definitive. First, Internet lending is attracting a new class of Internet investors comfortable with person-to-person lending, even across borders. This requires building some semblance of a relationship between the borrower and lender, providing accurate credit information, a mechanism for diversifying and sharing risk, and facilitating contracts and the physical (or electronic) exchange of cash. And yes, it has to be fun and either personally or financially rewarding. The ease with which lenders can browse Prosper.com's website is irresistible, allowing lenders to sort by credit rating or keyword, screen borrowers, and even place standing orders to automatically buy loan participations that meet certain criteria. With Kiva, lenders can sort by country, gender, business, and other categories. While Kiva and Microplace have targeted social investors, Prosper.com's online auction is also appealing to an investor who enjoys the investing process and financial returns.

Second, lenders rely heavily on the personal and financial information provided by the Internet underwriters to make decisions. Similar to rating agencies, the borrower information they gather and share directly supports disclosure and transparency, provides peer comparisons, enhances access to new funds, and, in the case of Prosper.com, enhances the terms of borrowing. The information is also directly linked to a person and their story providing some means to assess the borrowers character and the purpose of the loan. While the basis of Prosper.com's borrower ratings are independent credit scores, borrowers are able to improve their ratings by paying on time. Prosper.com also offers a growing statistical database on loan performance that segments lenders by different categories (credit score, home ownership, etc.) that serious investors rely on to analyze risk. Kiva lacks independent ratings of many of their MFI partners and most do not report to the MBB. As a result, Kiva has resorted to rating partners itself based on a set of standard criteria as well as past performance with Kiva's loans. Although these in-house ratings are certainly efficient, it is too early to tell if this will compromise or enhance the soundness of Kiva's underwriting; ratings and credit scores are supposed to be independent and objective because there is an inherent conflict of interest with rating your own securities.

Third, each of these models shows the importance of the role of the Internet underwriter in managing risk on behalf of the lender. The marketplace of Prosper.com works in part because lenders trust that Prosper.com has the ability to monitor and pursue delinquent loans on their behalf. Kiva and Microplace work because lenders are committed to a cause and trust that they have diligently vetted their partners and monitor them closely.

Finally, reaching lower-income borrowers requires a strategy, structures, and incentives to do so. Prosper.com's marketplace offers a financial incentive to take riskier loans–the rates are often three to four times higher than low-risk loans. Still, investors have not lent much to lower or unrated borrowers. If Prosper.com's business model were to be used to reach low-income communities, it might address this by partnering with organizations such as qualified underwriters, and community and social organizations to identify, screen, and analyze prospective borrowers.

For now, all three have more funds than qualified investments. All three face a similar dilemma–how to increase the quantity and quality of borrowers. This is a reminder that capital is only part of the solution to economic development. With capital must come technology, know-how, and access to markets. To use a popular metaphor, development is no longer about handing out fish, teaching to fish, or even lending fishermen money to build a boat. Rather, development is now focused on providing fishermen with GPS, leasing them refrigeration units and packing warehouses, teaching them ISO standards, sending them market prices on their mobile phones, and linking them to export markets. Still, the advent of Internet person-to-person lending holds great promise for the future of microfinance.

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Additional Information Resources

For information on the organizations discussed:

www.heifer.org	www.mixmarket.org
www.kiva.org	www.mixmbb.org
www.microplace.org	www.prosper.com

For More Information on Microfinance:

ACCION International	www.accion.org
Consultative Group to Assist the Poorest (CGAP)	www.cgap.org
Grameen Foundation	www.gfusa.org
Imp-Act	www.imp-act.org
Microfinance Gateway	www.microfinancegateway.org
MicroSave	www.microsave.org
PlanetFinance	www.planetfinance.org
SEEP Network	www.seepnetwork.org
USAID microfinance	www.microlinks.org
World Council of Credit Unions	www.woccu.org

For a good overview of microfinance, see "The Hidden Wealth of the Poor: A Survey of Microfinance", *Economist*, November 2005. http://www.economist.com/surveys/displaystory.cfm?story_id=5079324.

For a deeper understanding of the financial need of poor households, see Rutherford, Stuart. *The Poor and Their Money*. Oxford University Press, 2000.

A detailed textbook on microfinance, Ledgerwood, Joanna. *The Microfinance Handbook: An Institutional and Financial Perspective.* The World Bank, 1999.

A history of the advances in microfinance can be found in Helms, Brigit, Access for All: Building Inclusive Financial Systems. Consultative Group to Assist the Poorest (CGAP), 2006. http://www.cgap.org.

Two articles on Prosper.com and Kiva highlight the business model and intentions of the two organizations. Hof, Robert. "Prosper: The eBay of loans?" *BusinessWeek.* February 13, 2006. http://www.businessweek.com/technology/content/feb2006/tc20060213_147523.htm.

"A Tale of Two Lenders." *BusinessWeek.* Winter 2006. http://www.businessweek.com/magazine/content/06_52/b4015451.htm?chan=search.

A brief survey of the level of international funding into microfinance can be found in Latortue, Alexia et. al. Managing the Floodgates. *Making the Most of International Flows of Microfinance Funding.* CGAP. 2007.