

Microcredit: Looks can be deceiving.



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Executive summary

- Microfinance comprises financial services designed for individuals and small enterprises that do not have access to traditional banking and associated services. It encompasses microcredit, which provides small loans to disadvantaged clients.
- The positive impacts of microcredit are often taken at face value by investors and financial institutions with limited assessment of customer protections or monitoring of social impacts.
- Responsible microcredit serves an important role in financial inclusion and without it many of the global poor, particularly women, would be financially excluded and have poorer social outcomes.¹
- The evidence suggests that microcredit can lead to positive outcomes, but when there is an absence of appropriate consumer protection and supervision, abuses can occur.²
- As responsible investors, we are actively engaging with our investee companies from the banking sector to gather additional information to help better determine whether they are providing responsible microcredit that supports positive outcomes in society.

“The concept of microcredit was abused by some and turned into profit-making enterprises for owners of microcredit institutions. Many went in the inevitable direction of loan-sharking. I felt terrible that microcredit took this wrong turn.”

Muhammad Yunus, the Nobel Peace Prize-winning economist³



¹ Financial Inclusion Overview (worldbank.org)

² Friend or Foe to the World's Poor? Settling the Microfinance Debate | Blog | CGAP

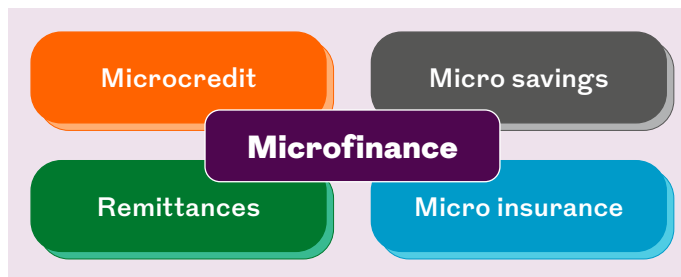
³ How Microfinance Pushes Poor Borrowers Deeper in Debt in Developing Economies (bloomberg.com)

What is microcredit?

Microcredit was popularised in the 1970s in Bangladesh to give small loans at affordable rates of interest to poor people, especially women, to help them achieve success in the marketplace to reduce poverty. The global market is now estimated to exceed US\$180 billion and serves about 200 million customers.⁴

Microcredit is a subset of microfinance, and the terms are often used interchangeably. Microfinance covers the provision of a broader range of financial services and includes deposits, payment services, money transfers, and insurance. There is no common definition of microcredit. It often varies depending on the institution and market. This creates difficulties in creating consistent global standards and regulations. This lack of governance has resulted in products with unaffordable interest rates, high collateral demands, and poor customer protections entering the market.

Fig 1. Microcredit, a subset of microfinance



What is the impact of microcredit?

There is a lack of clarity on the aggregate impact of microcredit. Responsible microcredit serves an important role in financial inclusion and without it many of the global poor, particularly women, would be financially excluded and have poorer social outcomes.⁵ This particularly benefits gender equality as roughly 80% of microfinance customers worldwide are women.⁶ However, positive outcomes of microcredit are far from conclusive. Studies based on Randomised Controlled Trials (RCT) show that the same microcredit provision can have a very different impact depending on the context.⁷ For instance, evidence from Malawi indicates that the use of bank accounts can enhance savings for farmers, leading to increased agricultural output and higher household expenditures. However, when other researchers replicated this field experiment in Uganda, Malawi, and Chile, they did not find similar evidence.⁸ Unfortunately, the RCT methodology means that it is not possible to pinpoint the conditions

which enable microcredit to have a positive rather than negative impact on customers. It is only possible to conclude, with the current evidence available, that microcredit services can sometimes have a positive effect on customers' lives.

Did you know?

- Muhammad Yunus and Grameen Bank were awarded the Nobel Peace Prize in 2006 for their work to “create economic and social development from below”. Grameen Bank’s objective since its establishment in 1983 has been to grant poor people small loans on easy terms - so-called micro-credit - and Yunus was the bank’s founder.⁹
- Five of the largest taxpayer-funded development banks committed almost US\$15 billion to microfinance and small-business lenders in more than 80 countries from 2011 to 2020.¹⁰

What are the risks of microcredit?

- **Debt traps and predatory lending practices:** In the past few decades as microcredit has expanded in developing markets, anecdotal evidence has emerged that poor customer protections and predatory lending practices have led to the most vulnerable being trapped in debt spirals and forced to take drastic action. For example, in 2020, consumer advocacy groups claimed roughly 200 people committed suicide in Sri Lanka over the preceding three years because they were unable to pay back microcredit loans and creditors had resorted to extreme tactics.¹¹
- **Reputational risks to investors:** In 2022, Bloomberg reported on ‘**The Dark Side of Microfinance**’ linking personal stories to not only microcredit providers but also other financial institutions providing funding to the microfinance institutions. This creates a reputational risk for investors who may be lending to providers that do not lend responsibly.
- **Regulatory risks:** Following allegations of predatory lending practices, some microcredit institutions have started coming under regulatory scrutiny. The International Finance Corporation, a member of the World Bank Group, is currently investigating claims against the practices of 10 microfinance institutions in Cambodia.¹²

⁴ Friend or Foe to the World’s Poor? Settling the Microfinance Debate | Blog | CGAP

⁵ Financial Inclusion Overview (worldbank.org)

⁶ Microfinance-Barometer-2019_web-1.pdf (convergences.org) p.2

⁷ Friend or Foe to the World’s Poor? Settling the Microfinance Debate | Blog | CGAP

⁸ Looking Beyond the Average Impact of Financial Inclusion | Blog | CGAP

⁹ Muhammad Yunus – Facts - NobelPrize.org

¹⁰ How Microfinance Pushes Poor Borrowers Deeper in Debt in Developing Economies (bloomberg.com)

¹¹ Micro-finance firms drove 200 poor borrowers to suicide during last three years: MONLAR, Sri Lanka (viacampesina.org)

¹² Cambodia: Financial Intermediaries-04 | Office of the Compliance Advisor/Ombudsman (cao-ombudsman.org)

The actions we have taken

- We researched the issues and assessed our portfolios based on the materiality of microcredit to both the investee companies' overall business and the underlying customers, as well as our evaluation of the associated reputational risk.
- We found that annual reporting or sustainability disclosures tend to focus on positive impact measurement and lack detail around the nature of products, client protections and responsible debt collection practices.
- We wrote letters to 12 financial institutions to engage for information to help us better assess if our exposure to microcredit is managed responsibly.

Key questions for microcredit institutions:	Key questions for microcredit financiers:
<ul style="list-style-type: none"> • How do you ensure affordability and suitability of microcredit products? • How do you ensure debt collections are responsible? 	<ul style="list-style-type: none"> • How do you conduct due diligence on and oversee a microcredit provider's social performance?

As long-term investors, it is important for us to identify providers that engage in harmful and irresponsible lending practices. Therefore, having a clear understanding of best practices is essential.

Our best practice findings and approach

Our analysis has shown that through our engagement, which included participation in one investor event, receipt of three written responses, and three meetings, we have identified best practices, as outlined below, to be applied alongside a recognised industry standard: the Cerise + Social Performance Task Force (SPTF) Client Protection Pathway.¹³

- **Governance and Policy:** Establish a set of principles requiring microfinance institutions to adopt fair practices and thorough client due diligence.
- **Continual monitoring:** Perform independent, annual due diligence assessments, including branch visits and reviews of the microfinance institution's operations.
- **Stakeholder engagement:** Engage with end microfinance customers to gain insights on their experiences.

- **Transparency:** Disclose social performance metrics of microfinance, such as job creation numbers, hours of support and training provided, and the proportion of female and rural clients served.
- **Community Engagement:** Offer financial education and community services to microfinance customers.
- **Collaboration:** Participate in industry-wide efforts to promote responsible and inclusive financing, such as the World Bank's Consultative Group to Assist the Poor (CGAP).¹⁴

Engaging for a transparent and inclusive financial future

There are challenges associated with microcredit. While it has the potential to empower the economically disadvantaged, particularly women, and contribute to financial inclusion, there are significant risks involved. Predatory lending practices (such as very high interest rates or high collateral demands), lack of clear regulations, and inadequate consumer protections can lead to detrimental outcomes such as debt traps and reputational risks for investors.

As long-term investors, we stress the importance of responsible lending practices, thorough due diligence, and the need for a standardised approach to microcredit to ensure it truly benefits those it aims to serve, such as adhering to the Cerise + SPTF Client Protection Pathway. It is imperative for investors to engage actively with microcredit providers to promote transparency, accountability, and positive social impacts. This is only achieved through active monitoring and reporting on microfinance social performance indicators. By doing so, investors can support the growth of a more inclusive financial system that not only provides access to credit but also safeguards the well-being of its customers.

¹³ Cerise+SPTF – Cerise+SPTF (cerise-sptf.org)

¹⁴ <https://www.cgap.org/>

Risks

Past performance is not a guide to future performance.

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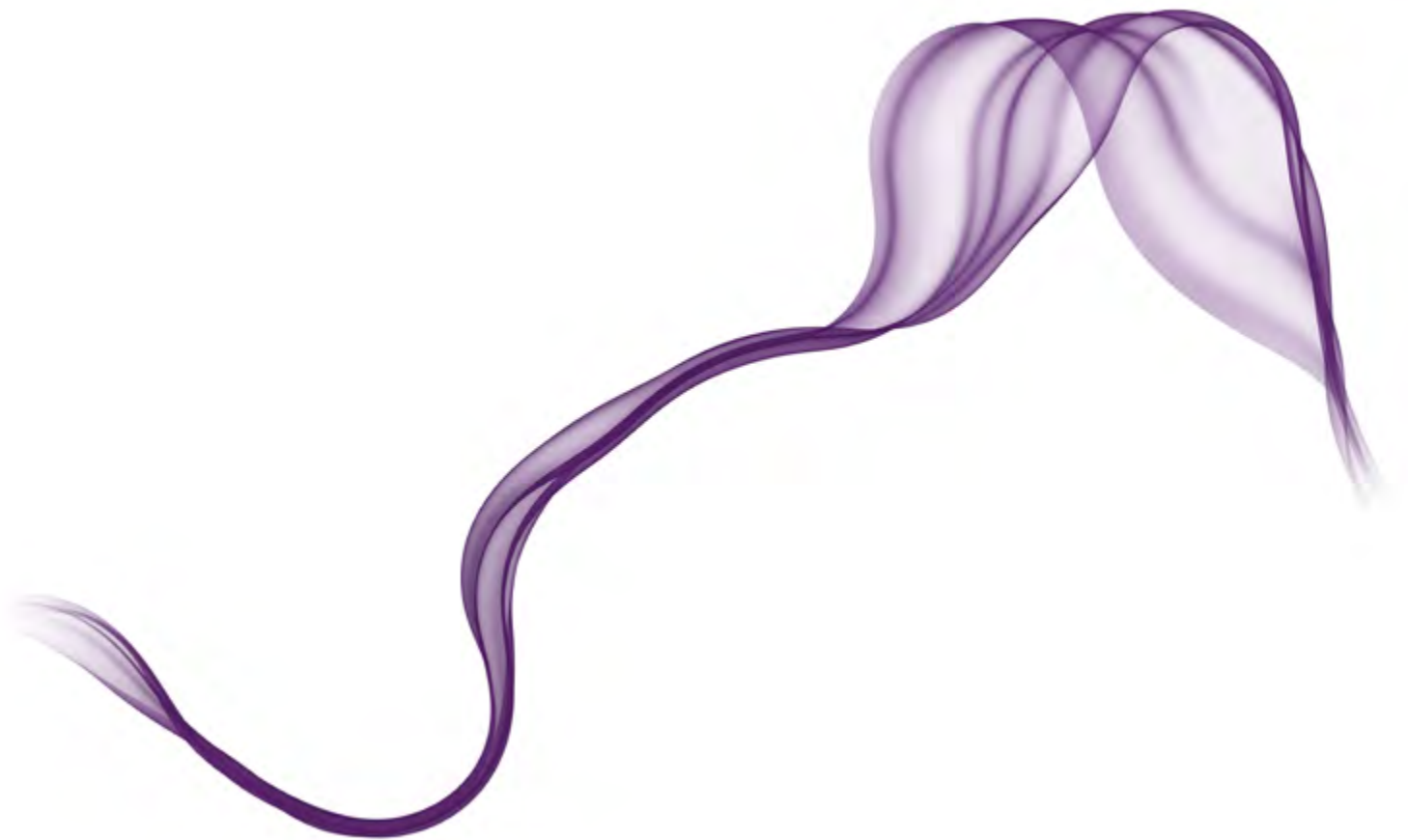
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