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## Will microfinance continue to evolve into a mainstream asset class? Indications in favor and against

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**Will microfinance (continue to) evolve into a mainstream asset class? – *Indications in favor and against***

*by Katja Kirchstein\* and Kathleen Welvers\*\*<sup>1</sup>*

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**Abstract**

The microfinance sector has been going through profound changes in the last decades: It evolved from a donor-based community, driven by philanthropic objectives, to a high growth market that is today attracting commercial investors who seek social impact and a competitive risk-adjusted return. However, recent discussions in the sector about the assumed financial strength and resistance of microfinance institutions further triggered by the impact of the global economic and financial crisis on the microfinance sector as well as the increasing criticism about irresponsible business practices and limited impact on poverty reduction led to the question if the sector continues to evolve into a mainstream asset class. On the one hand the integration of microfinance institutions (MFI) into capital markets makes investments in the sector more attractive for mainstream investors, as the management of the investments turns more professional. On the other hand the correlation of the performance of MFIs with local and global market movements increases and makes diversification of an investor’s portfolio less likely.

**Keywords: Microfinance; Investments; Risk; Peru**

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## 1 Introduction

Since the 1990s microfinance evolved from a former donor and NGO driven sector into a self-sustainable or even profitable industry. Enthusiasm spread wide that the commercialisation of microfinance would attract mainstream investors enabling high numbers of microfinance institutions (MFIs) to further grow and reach larger parts of the world's poor – independent of restricted donor money. This financial inclusion would help the poor to lift themselves out of poverty and furthermore enhance wider developmental effects, being it economic effects e.g. through labour markets or social effects e.g. through the empowerment of female clients.

The observable growing demand for private social responsible investment seeking a double-bottom-line (financial returns and a positive social impact) turned microfinance into a particularly interesting investment opportunity. At the same time, microfinance was seen as resistant to economic shocks and uncoupled from movements in international financial markets. Furthermore, historical low default rates and good portfolio quality somehow cultivated the belief that microfinance was a low-risk business which offered portfolio diversification effects and hence was even attractive for purely commercially oriented investors.. However, for being attractive for mainstream investors as an “asset class”, microfinance investments have to fulfill certain criteria and the market has to offer the prospect of being able to absorb high investment volumes.

To answer the question if microfinance will (continue to) evolve into a mainstream asset class we will therefore address a set of different aspects. First of all we will turn to the definition of an asset class and analyse whether microfinance can be defined as such or not. Furthermore we seek to know: Will the readiness of (mainstream) investors to invest in microfinance increase in the future? And will the absorption capacity of microfinance institutions keep up with the increasing investor's appetite?

To answer these major questions the paper is structured as follows:

In a first part we provide an introduction into the composition, volumes and directions of international microfinance investments also identifying the most important players and finance mechanisms.

Then, in order to find out what matters in modern portfolio theory and if microfinance fits into this concepts part two discusses the concept of an asset class. As microfinance investors are interested in dual returns (financial and social) we furthermore discuss the level of financial returns reached by microfinance investments. Afterwards, we turn to the assessment of risks related to microfinance. In the category of financial risks we distinguish between systematic and specific risk while we refer to reputational risks when it comes to the social performance of MFIs. Assuming that it is required for an evolving asset class that considerable volumes can be invested we then assess the ability of current vehicles to channel mainstream investments. Finally, we assess the market size and business environments in microfinance in order to identify current and future investment opportunities.

Our analysis of the second part is based on the results of a survey among 60 Microfinance Investment Vehicles (MIVs) conducted by the authors of this study in February 2009. MIVs channel the bulk of microfinance investments to MFIs. The 24 MIVs who responded account roughly for USD 2,7 billion assets under management, which is 57% of all MIVs' assets under management in 2007. Commercial investment

vehicles as Blue Orchard as well as more socially oriented vehicles as Oikocredit were among the participants. The survey was designed to, firstly, collect opinions of microfinance experts on obstacles and opportunities for private microfinance investments in the past and in the future. Secondly, it aimed at assessing the role of microfinance as an asset class and as a socially responsible investment. The survey was directed to MIVs, listed as private investors in the online database MIX Market (Microfinance Information Exchange; The MIX). Excluded were those vehicles exclusively funded by donations, for example the Hivos Triodos Fund or Omydiar Network. We align this with the results of a series of other surveys conducted within the industry such as a survey among European pension funds conducted by the World Microfinance Forum Geneva (2009), the “Banana Skins” reports realized by Centre for the Study of Financial Innovation (2008; CSFI 2009; CSFI 2010) as well as a survey conducted by the International Association of Microfinance Investors (Abrams 2009) about defaults of MFIs. Furthermore we interpret quantitative data from The MIX<sup>2</sup> whenever we aim to further analyze certain observations, especially regarding the microfinance market and related statements of survey participants. Practitioners’ reports as well as academic studies will be consulted to deepen the argumentation.

To illustrate the developed arguments with a concrete example we refer to the case of Peru in part three. Peru is considered to have one of the most developed microfinance markets and thus, is an important target for international investments. The basis of the analysis is a series of 45 qualitative interviews of different stakeholders conducted between February and March 2010, among them representatives of the regulatory bodies for the banking sector and the stock exchange, five rating agencies (two specialized and three mainstream) foreign investors with offices in Lima, one commercial bank (Banco de Credito), two governmental banks (COFIDE, Banco de la Nación) and a total of 19 MFIs with different legal forms (1 bank, 2 finance companies, 4 CMACs, 2 CRACs, 3 EDPYMEs, 2 cooperatives and 5 NGOs)<sup>3</sup>. Results of these interviews together with some quantitative data, audited financial statements from single MFIs as well as sector reports shall bring further insights into the topics elaborated in the previous sections.

## **2 Growth of International Investments in Microfinance**

To facilitate the placement of the argumentation in favour and against microfinance’s development into a mainstream asset class, this section provides an overview on the evolution of international microfinance investments since 2004.

Assets under management (AUM) of Microfinance Investment Vehicles increased from around USD 1 billion in 2004 to USD 6,6 Billion in 2008.<sup>4</sup> MIVs are intermediary sources which channel the bulk of international microfinance investments to microfinance institutions. Total international microfinance investments, which comprises indirect investment through MIVs and direct investments of primary

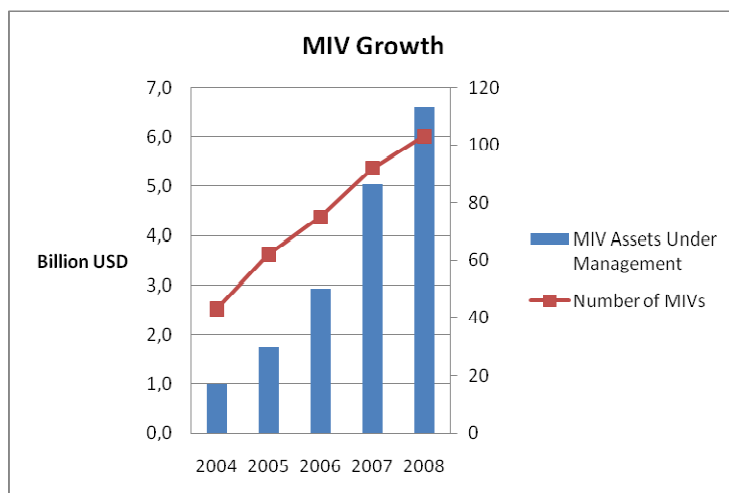
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<sup>2</sup> An often cited critique for using data from The MIX is the fact, that data from MFIs is self-reported and that little controls are in place in order to verify the data. Thus, these numbers have to be interpreted with caution. Still, it shall be considered adequate to use the data in order to give a broad, general overview. Furthermore as more and more MFIs report to The MIX from single sectors/countries knowing each other the possibility to cheat diminishes. For instance, in Peru almost all MFIs also upload their financial statements and rating reports so that wrong information can be easily tracked. Another critique is that The Mix does not reflect the whole worldwide microfinance sector as a lot of MFIs might simply not want to share their data. Still, for the purpose of this study, considering the MFIs reporting to the MIX seems reasonable as MFIs reporting voluntarily to this information exchange platform are probably those seeking international funding, and thus attach importance to international visibility, which nowadays only The MIX provides.

<sup>3</sup> Please note that the interviews were realized during the research for one of the author’s doctoral thesis about ratings in the context of microfinance. The results presented in this study are based on the first insights right after having realized the interviews and are not based on profound analysis of the latter.

<sup>4</sup> Since 2007 CGAP regularly conducts an MIV Survey which comprises 80 MIVs. The facts presented in this part are based on the CGAP MIV Surveys 2006 – 2008.

investors into MFIs, reached USD 10 billion in December 2008 (CGAP 2009d). As MIVs present the main instrument for international microfinance investments they will be in the focus of this analysis. MIVs can be self-managed or work with external fund managers and fund advisors. Most MIVs are set up as a SICAV (Société d'Investissement à Capital Variable) which is an open-end investment vehicle registered in Luxembourg. They are investment entities that have a clear focus on microfinance and receive funds from



Source: Own diagram, data taken from Reille, Forster (2008), CGAP (2008a), CGAP (August 2009)

primary investors through the issuance of shares, units, bonds, or other financial instruments (CGAP 2008b).

The number of MIVs grew from 38 in 2004 to 103 in 2008. Average MIV asset sizes also increased significantly from USD 20 million in 2004 to USD 161, 2 million in 2008.<sup>5</sup> In 2008, the growth slowed down: While assets under management increased on average by 71% from 2005 to 2007, MIVs grew only by 31% in 2008. Compared to

other asset markets, such as the market for socially responsible investments (SRI), the asset growth of

MIVs since 2004 is impressive<sup>6</sup>. To identify the main drivers of the boom we first analyze the level of primary investors and secondly the level of investment vehicles. We find that institutional investors and commercial investment vehicles, as registered mutual funds and structured finance vehicles, contributed most significantly to investment growth. The following graph gives an overview on investments flows and main actors which are explained in more detail in the following paragraphs.

### ***Institutional investors are main drivers of investment growth***

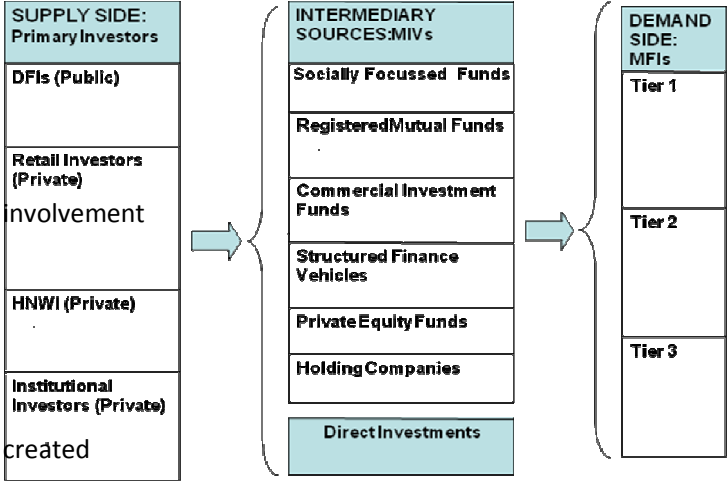
Private institutional investors' share of MIV's AUM has increased from 14% in 2005 to 43% in 2008, whereas the share of individual investors, including retail investors and High Net Worth Individuals (HNWI), and public investors, so called Development Finance Institutions (DFIs), has decreased.

<sup>5</sup> Average MIV size refers to the participants of the CGAP survey (54 participants).

<sup>6</sup> The SRI markets grew from 2,7 trillion in 2003 to over USD 4 trillion assets under management in 2007, see **Reille, X. and S. Forster (2008)**. Foreign Capital. Investment in Microfinance. Balancing Social and Financial Returns, Washington D.C., CGAP.

Examples of private institutional investors are international commercial banks, global investment banks, insurance companies and pension funds, as well as emerging markets private equity investors. A large number of international banks, from ABN Amro MV, Citigroup, Deutsche Bank over ING Group MV to Société Generale are involved in microfinance (Bouúaert 2008, p.4). International banks' activities are very broad: They include investments

**Microfinance Investment Flows**



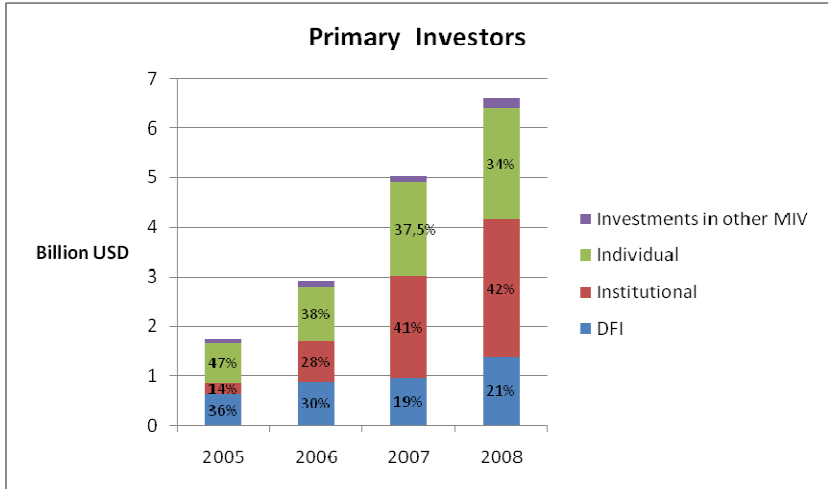
into MIVs, retail and wholesale loans, guarantees, technical assistance, equity stakes in MFIs, and the management and structuring of new MIVs (Crijs, Lansbergen *et al.* 2006, p. 60). The of pension funds is a novelty in the microfinance world. For instance in 2006 TIAA-CREF, a mainstream asset manager, made a USD 40 million investment in Developing World Markets Microfinance Equity Fund I and a USD 100 million Global Microfinance

Source: Own elaboration, adapted from (CGAP 2009b)

Investment Program (GMIP) within its SRI allocation. The pension fund is also holding a USD 43 million private equity

stake in ProCredit Holding AG (N.N. 2009). Private equity investors focused on emerging markets (such as Sequoia Capital, the Blackstone Group, Carlyle Group and the Dubai based firm Legatum) have invested in MFIs' equity (Reille and Forster 2008). In November 2008, the Indian MFI SKS Microfinance has raised direct investments of USD 75 million from the investors Sandstone Capital and Kismet Capital, both mainstream equity funds with an international investor base (SKS 2008). Also insurance companies, such as Morley (United Kingdom) and AXA (France) are starting to get interested in microfinance (CGAP 2008a).

**Investments of individuals and public investors grow more slowly**



The share of retail investors in total MIV investments actually decreased from 47% in 2005 to 34% in 2008. However, investments by individuals increased in absolute numbers from around USD 800.000 million in 2004 to more than USD 2 billion in 2008. Hence, their growth still contributed considerably to the investment boom. Individual investors include retail investors and HNWI. HNWIs are according to

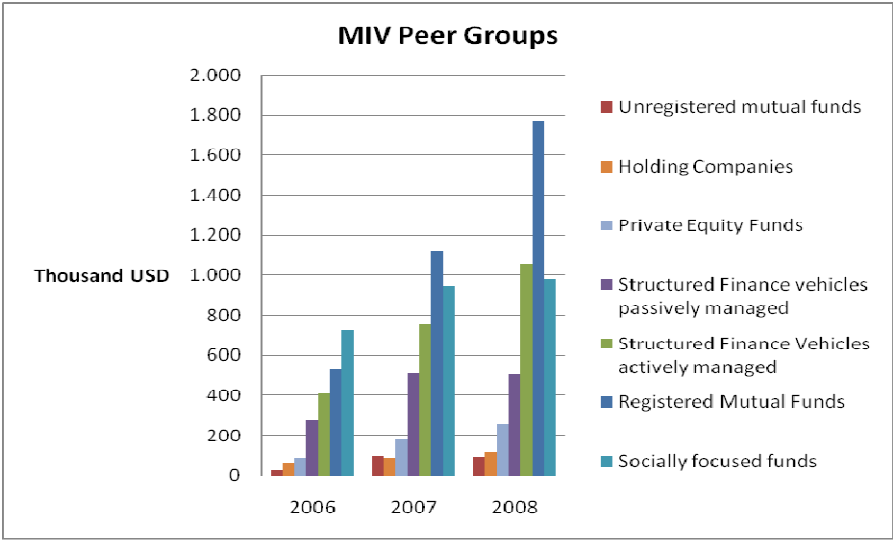
Source: Own diagram, data taken from Reille, Forster (2008), CGAP (2008a), CGAP (August 2009)

Eurosif individuals with more than USD 1 million in financial assets (Eurosif 2008). Retail investors manage financial assets less than USD 1 million. The first vehicle targeting retail investors is the cooperative society Oikocredit, which issues shares of EUR 200. Two vehicles focused on socially oriented retail investors were founded as cooperative societies in the 1990s in the Netherlands (Incofin in 1992, Alterfin in 1994). The Calvert Social Investment Foundation entered the microfinance market in 1995 by issuing Community Investment Notes to the general public in the United States. A major turning point was the foundation of the Dexia Microcredit Fund in 1998. This vehicle was the first registered mutual fund and the first which aimed at financial returns, while promoting actively its “double bottom line” character. Two important mutual funds targeting retail investors were opened to retail investors in 2000 and 2002: The ASN Novib Fund, founded by the bank ASN, and Oxfam Novib Triodos Fair Share Fund, initiated by the Triodos Bank in the Netherlands. These vehicles were followed by ResponsAbility Global Microfinance Fund, set up by three Suisse banks (amongst them Credit Suisse) in 2003, which accepts minimum investments of USD 1.000. Since then the options for retail investors increased, because more mutual funds have been entering the market (e.g. Wallberg Fund or Dual Return Microfinance Fund). HNWIs constituting the second group of individual investors also engage increasingly in the microfinance scene. However, aggregated data about their investment volumes is not available. Examples are Pierre Omidyar, the founder of ebay, who invested USD 100 million to establish the Omidyar Tufts Fund in cooperation with Tufts university, and Bob Patillo who founded the Gray Ghost Fund. These kinds of funds are often funds that invest in other vehicles, e.g. Omidyar Tufts Fund invested in ProCredit Holding AG (ProCredit Holding AG 2009) and the Gray Ghost Fund invests in Calvert Foundation, Bellwether Fund, Acción Investments in Microfinance etc. HNWI also engage in structured finance transactions in microfinance: They constituted 10% of the first close of Blue Orchards Microfinance Securities I in 2004 (Swanson 2007). Public investors are private sector arms of government-owned bilateral and multilateral development agencies as defined by CGAP. All Development Finance Institutions (DFIs) accounted for an outstanding microfinance portfolio, containing MIV and direct investment, of USD 4.1 billion as of December 2007. Main players are the German Kreditanstalt für Wiederaufbau (KfW), the International Finance Corporation (IFC) and the European Bank for Reconstruction and Development (EBRD). The KfW has been the initiator and promoter of the European Fund for Southeast Europe (EFSE). The fund attracted besides DFIs, individual and institutional investors as Deutsche Bank, SAL Oppenheim, Omidyar Tufts Microfinance Fund and the SRI Fund “Good Growth Fund” (European Fund for Southeast Europe 2009). KfW is a main shareholder of the ProCredit Holding AG (ProCredit Holding AG 2009) and supported the group since its beginning in 1998. As a reaction to the financial crisis in February 2009 KfW created additionally a refinancing facility for microfinance institutions (KfW 2009) in cooperation with IFC. It aims at building a total portfolio of USD 500 million by attracting private investors. Furthermore DFIs have provided seed capital for microfinance funds, e.g. for PROFUND and Lok Capital and helped to attract institutional investors to microfinance by purchasing equity and junior tranches of structured finance vehicles.

### ***Funds by commercially oriented asset managers overtake socially focused funds***

Looking at investment vehicles, it is notable that vehicles managed by commercially oriented asset managers (registered mutual funds and actively managed structured finance vehicles) outperform long established socially focused funds, in terms of absolute portfolio size. From 2006 to 2008 registered mutual funds grew by 113,5%. One of the main players, ResponsAbility Global Microfinance Fund, increased its portfolio by 98% in 2008. The responsAbility Microfinance Leaders Fund, focusing on institutional investors, grew by 378% to reach a microfinance portfolio of USD 128 million. The Dexia Microcredit Fund increased by 138% to reach USD 255 million. Structured finance vehicles passively

managed increased by 86%, which can be explained by the entrance of vehicles managed by Blue



Orchards S.A. The growth of actively managed structured finance vehicles (83%) was driven by the growth of EFSE whose microfinance portfolio grew by 71% reaching USD 308 million in 2007. Whereas average total assets of socially focused funds as Oikocredit increased by around 30% (CGAP 2008b). The high growth rates can partly be explained by the age of

Source: (CGAP 2009b)

the vehicles: Registered mutual funds and structured finance vehicles are relatively young compared to socially focused funds. They are still in a high growth phase, being on average only 3 years (registered mutual funds) and 1,5 years (structured finance vehicles ) in existence. Socially focused funds count in contrast on average 12,1 years since inception. The vehicles mentioned above refer to six “peer groups” identified by CGAP and Symbiotics according to business model, commercial orientation, financial instruments and asset classes (equity, fixed income)(CGAP 2008b).

**Characteristics of MIV Peer Groups**

Peer group	Registered Mutual Funds (publicly distributed, strict disclosure regulations)	Socially Focused Funds	Unregistered Mutual Funds	Structured Finance Vehicles	Holding companies	Private equity funds
<b>Examples</b>	ResponsAbility Global Microfinance Fund, Dexia Microcredit Fund, Dual Return Fund Vision Microfinance	Oikocredit, Triodos Doen Foundation	Minlam Microfinance Fund, Impulse Microfinance Investment fund	Blue Orchards Loans for Development 2006 -1 (BOMS 1) (passively managed) EFSE (passively managed)	ProCredit Holding AG, Access Holding	Bellwether Fund, Shorecap Intl. Africap, Acción Investments
<b>Type of investment</b>	Focus on fixed income	Focus on fixed income	Senior debt and sub-ordinated debt	Focus on fixed income	Equity	Equity
<b>Business Model</b>	Close to money market returns	Below market returns, strong social mission	Close to money market return, Large investment sizes	Close to money market return, (Collateralized Debt Obligations, tranches of different risk-return profiles)	Not disclosed	Differs widely regarding the vehicle



<b>Primary Investors</b>	Mainly retail and institutional investors	Mainly retail investors	Public and private institutional investors, HNWI	Institutional investors, also DFIs, other MIVs, foundations and NGOs ((junior and equity ranches)	Closed group of (mostly private institutional and public) investors	Public and private investors, NGOs
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Source: Own elaboration, information taken from (CGAP 2009b)

### ***MIVs maintain strong focus on debt***

Debt has always been the preferred investment type (over 75% end of 2008). The average maturity of loans to MFIs is 32 months (CGAP 2009b, p.8) average debt investment size comes to USD 1,8 Million. Equity investments are growing faster than debt investment, especially fuelled by India. Equity investment plays an increasingly important role, as more MFIs become regulated institutions and need to comply with regulatory equity requirements (Reille and Forster 2008, p.13). For instance, the pension fund TIAA CREF holds non-voting preferential shares in ProCredit Holding AG (ProCredit Holding AG 2009). Nevertheless equity investors in microfinance still face insufficient valuation of equity participations and a lack of exit options (Goodman 2006) . Furthermore the number of MFIs, which are able to undertake these investments, is limited (Reille and Forster 2008).

### ***Highly concentrated MIV market dominated by a few main players***

The MIV market is dominated by a few players: Top 10 MIVs account for 55% of MIV investments in 2009. 52% of total MIV assets are managed by five asset managers. The concentration is also very high regarding the investees: MIV investments remain concentrated in a few tier 1 MFIs, with average top five investment exposure accounting for 41% of MIV investments. The largest 150 microfinance institutions (out of more than 3000 worldwide)<sup>7</sup> account for 86 % of MIV total assets (Reille and Forster 2008). Investments are also geographically very concentrated, especially on Eastern Europe and Central Asia (45% of investments) and Latin America (32% of investments) (CGAP 2008b). However, investment in South Asia and Africa is rising, it increased by 164% and 119% from 2006 to 2007. This corresponds to a high concentration within the regions: 58% of investments is concentrated on the TOP 5 countries (CGAP 2009b). For example, half of the investment of ResponsAbility Global Microfinance Fund and Dexia Microcredit Fund is concentrated on seven countries(Blue Orchard 2010a; Credit Suisse 2010). The concentration of structured finance vehicles is even higher: Blue Orchard Loans for Development 1 invests half of the portfolio in four countries<sup>8</sup> and Blue Orchard Microfinance Securities 1 invests half of its portfolio in three countries<sup>9</sup> (Blue Orchard 2010b). The European Fund for Southeast Europe invested 46% in two countries (EFSE 2009). We will refer to this concentration in chapter 3.6.

<sup>7</sup> Please note that it is a difficult to assess the exact number of existing MFIs worldwide. While it is relatively easy to count regulated MFIs, unregulated MFIs such as credit unions often operate without the knowledge of public authorities. For example, in Mexico the estimation of existing MFIs until 2006 varied between 388 and 863; please see **Kirchstein, K. (2008).** *Institution-Building im mexikanischen Mikrofinanzsektor. Das Beispiel der Cajas Solidarias.* Saarbrücken, VDM Verlag Dr. Müller. For another examples of how information can vary please refer to part three of the present study.

<sup>8</sup> Colombia, Peru ,Bolivia, Nicaragua

<sup>9</sup> Peru, Nicaragua, Ecuador

### Top 10 MIVs at the end of 2009

Rank	MIV	Year Established	Valuation Currency	Total Assets (2009 million USD)	Microfinance Portfolio (2009 million USD)
1	European Fund for Southeast Europe	2005	EUR	836.0	428.7
2	Oikocredit	1975	EUR	770.0	447.4
3	Dexia Microcredit Fund	1998	USD	541.7	384.5
4	responsAbility Global Microfinance Fund	2003	USD	489.4	338.7
5	SNS Institutional Microfinance Fund I	2007	EUR	261.2	210.8
6	ASN-Novib Fund	1999	EUR	175.8	123.7
7	responsAbility SICAV (Lux) Microfinance Leaders Fund	2006	USD	166.6	138.4
8	responsAbility SICAV (Lux) Mikrofinanz-Fonds	2007	EUR	145.9	102.3
9	Microfinance Enhancement Facility	2009	USD	122.7	87.5
10	Dual Return Fund - Vision Microfinance Sub-Fund	2005	EUR	118.8	94.9
	<b>Total</b>			<b>3628.1</b>	<b>2357.0</b>

Source: CGAP (2010)

### 3 Microfinance – A future mainstream asset class?

After having assessed the growth and composition of international microfinance investments, we now turn to the definition of microfinance as an asset class. In order to evaluate the risk-return profile of microfinance investments we furthermore analyze the returns reached by microfinance investment vehicles. Regarding the risks we distinguish between financial risks on the one hand and reputational risks on the other hand.

#### 3.1 Track Record and Benchmark

“A perceived attractive risk-return profile is not sufficient, microfinance investments need to be benchmarked and established as an asset class, to become integrated in portfolios of commercial investors”, as pointed out by De Sousa-Shields and Frankiewicz (2004, p.10). Has that changed in the last years? Opinions of experts are wide apart: New funds as Wallberg Fund, Good Growth Fund and Dual Return Fund are stressing that microfinance is close to or has already evolved into an asset class (Dual Return Vision Microfinance Fund 2009). Swanson (Developing World Markets, microfinance asset

manager), however, believes that microfinance is far from meeting the requirements to be evaluated as an asset class (Swanson 2007, p.13). In 2006, Norbert Kloppenburg (KfW) stated that “[Microfinance] has not yet matured into an asset class that can attract hordes of mainstream investors” (Kloppenburg 2006, p.5). But change seems to be underway: the 2006 MicroRate MIV Survey is titled “Microfinance – an emerging asset class” (MicroRate 2006). Also Merrill Lynch finds that “MFIs are creating an emerging asset class of microfinance investment vehicles” (Merrill Lynch 2009).

***Formally, microfinance does not yet meet the characteristics of a mainstream asset class***

In general an asset class is a group of assets that can be clearly differentiated from other assets, regarding important financial characteristics (Hockmann and Thießen 2007, p.555). In the process of asset allocation of investors, the portfolio is divided into different asset classes to achieve a most efficient diversification (Hockmann and Thießen 2007, p. 556). As a first step the differentiating characteristics (risk – return profile) of an asset class are derived from past performance and result in a track record of the performance which can be put in relation to benchmark indices. Common indicators for mainstream investors to evaluate the performance are the Jensen's alpha, the Sharpe ratio and the Treynor ratio. (Hockmann and Thießen 2007, p. 652). To derive these indicators the returns earned in excess of the risk free rate (as treasury bills), the standard deviations of returns over an adequate time period (measuring the total risk), and the beta coefficient<sup>10</sup> (measuring the systematic risk) are needed (see chapter 3.3 for further details). Looking at the level of MIVs, the performance history is still short. With the exception of Oikocredit, established in 1975, and Dexia Microfinance Fund established in 1997, all MIVs were set up after 2003. Moreover, the underlying assets of MIVs cannot be evaluated on a marked-to-market basis. As mentioned above MIVs invest more than 70% in loans. As will be shown in chapter 3.6 Initial Public Offerings (IPOs) and securitization of MFIs' portfolios are still few exceptions. Most of the investees are private companies, not listed on a regulated stock or market exchange. Therefore these investments are non-tradable (with few exceptions) and there does not exist a secondary market (Swanson 2007, p.3). In addition, the liquidity of the market is very limited. For instance, shares of ResponsAbility Global Microfinance Fund can only be liquidated on a quarterly basis. Hence, it is difficult to derive potential portfolio diversification effect of microfinance and to compare the performance of the investment to a peer group.

However, there are attempts to assess the track record of microfinance investments. Krauss and Walter looked at the level of MFIs and used accounting earnings of MFIs taken from annual reports. The study by Galema, Lensink & Spierdijk (2008) uses key performance indicators of MFIs to assess a potential positive portfolio diversification effect. Krauss and Walter stress many constraints of this data source (Krauss and Walter 2008, p.8) Therefore (Janda and Svarovska 2009) and Marco Deiana (2009) use the Net Asset Values (NAVs) of MIVs to evaluate the performance. But the analyzed period is very short (2006 – 2008). After having measured the track record, the next challenge is to identify suitable benchmark indices to derive the beta factor which is needed to include systematic risk in the assessment of the performance. Benchmarking an asset is generally a precondition for conventional investors to adequately assess the risk-return profile of an investment and to include it in a portfolio. Mainstream asset classes are normally benchmarked to market indices. The cited studies use the S&P 500, MSCI World and MSCI Emerging

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<sup>10</sup> The beta coefficient is result of a simple regression and gives information on the sensitivity of the returns regarding market movements. A fund which performs according to the market shows a beta of 1.0, whereas a fund with a beta lower or higher than one, it moves less or more than the market, see **Deiana, M. (2009)** "Ethical Investments in Microfinance Mutual Funds: An Empirical Analysis." DOI: <http://ssrn.com/abstract=1564610>.

Markets (and indeed find relatively low volatility and a positive portfolio diversification effect of microfinance as explained in chapter 3.3). It is debatable if the track record so far and the degree of volatility of MIVs' NAVs, give mainstream investors enough information about the underlying risk, since they are smoothed, as 90 percent of MIVs are charging fixed interest rates and are not subject to daily value changes, in contrast to stock and bond markets (CGAP 2009d). Hence, to predict future performance it is important to look more deeply into the determinants of returns and risk of microfinance.

**Most MIVs and half of interviewed pension funds view microfinance close to a mainstream asset class**

Our MIV survey gives insights into the discussion of microfinance evolving into an asset class. 38% state that microfinance can be classified as an asset class and 46 % find that it will be evolving into an asset class within the next years. Only 8% object, and 4 % are not sure. The pension funds survey shows that 50% of the participating pension funds understand microfinance investments as socially responsible investments (SRI). In this category microfinance investments do not compete directly with other mainstream assets. However, the other half categorizes microfinance as a mainstream asset classes for fixed income (in emerging market or higher risk subsets) or private equity. Both surveys indicate that microfinance is on its way to be understood as a mainstream asset class, even by mainstream investors such as pension funds. The track record of microfinance does not seem to be an issue for many MIVs anymore (as stated by 46% of participants). Pension funds have a different perception. As they rely on MIVs as their main source of information, they look at the track record of the *vehicles*, not of microfinance institutions and express a short track record as a major barrier. They see the financial and economic crisis as a crucial test. "Should this relatively young investment pass this test, then it will be viewed as a viable investment option for a much larger group of pension funds." (World Microfinance Forum Geneva 2009, p.5).

**3.2 Returns of microfinance investments**

**MIVs reach moderate returns**

Investors of the fastest growing MIVs (mutual funds and structured finance vehicles) seek a double-bottom line (financial and social return) of their investment. In 2004, non-competitive returns of

**Symbiotics Microfinance Index (SMX)**



Source: CGAP (2010)

microfinance investments were still seen as a major obstacle for the entrance of commercial investors, as pointed out by a SRI director of an investment services: The argument that "commercial investors' financial returns cannot be sacrificed for social returns" (Meehan 2004, p.17), heads the list of ten reasons why commercial investors hesitate to invest in microfinance. Yet, in 2009, the second largest microfinance asset manager Blue Orchards S.A. lists on its website the competitive return as the first important component of its profile: "Microfinance debt offers a better return than monetary instruments (an estimated additional 150 to 200 basis points) with only a slightly higher level of risk: it is an excellent alternative to fiduciary deposits or certificates of deposits" (Blue Orchard 2009b).

ResponsAbility, as the third largest microfinance asset manager, states that the ResponsAbility Global Microfinance Fund aims “for long term growth in value that is in excess of the fund currency money market value” (responsAbility 2009). Also Merrill Lynch promotes microfinance investments: Investors would not have to pay the “conscience penalty - lower returns for socially directed investments”(Merrill Lynch 2009). The pension fund ABP, that has invested USD 150 million in microfinance, also emphasizes that the fund is SRI committed, but “not at the cost of sacrificing investment returns” (Spijker 2008). As mutual funds and structured finance vehicles are fixed-income investments, they are often compared to money market returns.

Aggregated data on MIV’s performance, available for 2006 to 2007, confirm that returns of registered mutual funds, accounting for a large part of overall MIV growth, have been improving and are close to money market returns. The Symbiotics Microfinance Index (Symbiotics 2009) which reflects the development five registered mutual funds since May 2004<sup>11</sup>, shows a positive trend.

Total expense ratio improved slightly from 2,7% to 2,3% at the same time. The group of socially focused funds, exhibits the lowest average return of all MIV peer groups (1.5% in 2006, 3,4% in 2007, Euro terms), which is below money market returns. It also shows the highest total expense ratios (6,1% in 2006 and 5,6% in 2007). Structured finance vehicles could offer competitive returns right from the start: For AA rated senior tranches CGAP identifies an average annual return of USD 5,3% (CGAP 2008b, p.6). The first structured finance vehicle, Blue Orchard Microfinance Securities I (BOMS I) offered in 2004 subordinated shares, divided into three risk levels (A lowest risk, C highest risk) with the following returns: 8% (C), 6% (B), 5% (A). Equity shares were sold at 12% (Blue Orchard 2009a). The structured finance vehicle “Blue Orchard Loan for Development 2” offered in 2007 two senior tranches, which were directed at commercial investors. They were rated AA and BBB (Standard and Poor’s), and were offered at a premium of up to 40 basis points and 95 basis points above three months Euribor. Equity and Junior tranches were purchased by public investors and MIVs, offering an average yield of 8% in US Dollars (Reille and Forster 2008, p.10). Compared to annual average Euribor and Libor rates for 2004 to 2007, all stated returns of mutual funds and structured finance vehicles are above or close to three months Euribor (or Libor rates respectively) (Bundesbank 2005, p.88; Bundesbank 2007, p. 112; Bundesbank 2009, p. 136). After the positive trend until 2007, the returns of MIVs have developed into a different direction since 2008.

### ***Total expense ratios decrease, but liquidity and hedging costs increase during crisis***

Determinants of MIV returns may indicate, if the level of today’s moderate, competitive returns can be maintained in the future. Returns of MIVs are influenced by several factors: Since there is no secondary market, the Net Asset Value (NAV) is not determined by the value of the principal (Pouliot 2006, p. 270). Hence, the change of the NAV) depends on the net interest cash flow. Furthermore, the NAV is influenced by total expense ratios.

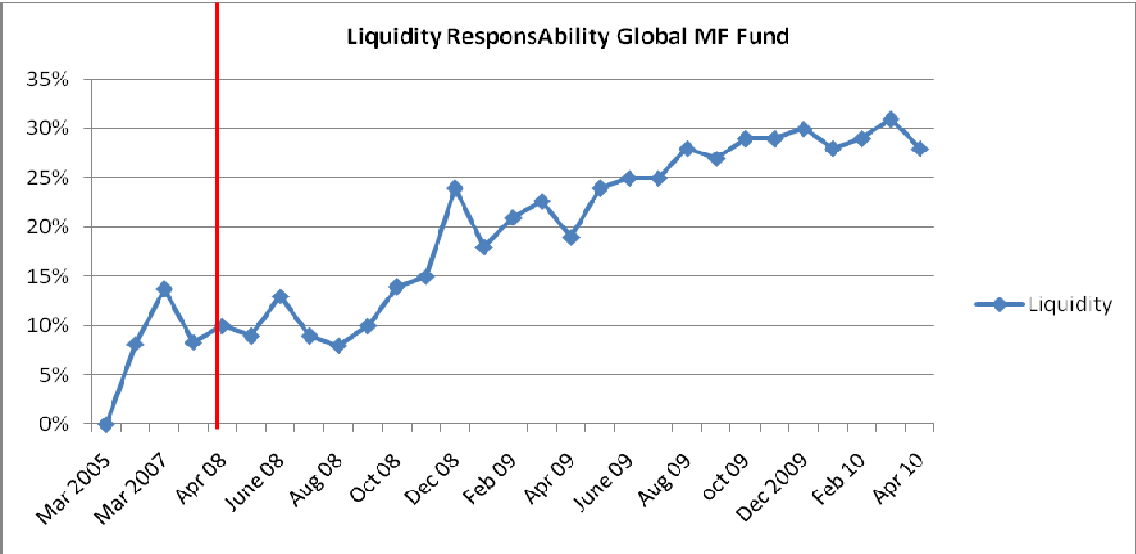
As indicated earlier, total expense ratios have decreased. This can be explained by the increasing number of MIVs reaching a critical size and realizing economies of scale. The average asset size increased from USD 20 million in 2004 to USD 80 million in 2007. Goodman finds that the minimum sustainable size of commercial investment funds is between USD 20 million and USD 30 million. An increasing number of MIVs reached this break-even point (Goodman 2006, p. 34). Higher deal sizes were realized because MFIs have increasingly been able to absorb long-term funding. Registered mutual funds’ average fixed income

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<sup>11</sup> According to Symbiotics Website each fund or sub-fund is equally weighted in the index and the index rate of return is calculated using the average monthly return of each fund or sub-fund share price. The index assumes full capitalization of earnings.

investment sizes increased within one year from USD 0,9 million to USD 2 million in 2007. For all MIVs included in the CGAP surveys this deal size increased from USD 1,3 million to USD 2 million (CGAP 2008b, p. 3). If the market allows, deal sizes and the average MIV size may further increase, which would drive down the expense ratios.

In 2008 / 2009, the international financial and economic crisis started to affect the microfinance sector. The impact on MIV returns are mixed: At a Virtual Conference organized by CGAP in November 2008, participants concluded that refinancing costs for MFIs are increasing, but availability of funding is decreasing. Especially non-deposit taking MFIs refinanced by hard currency are affected. In general, credit risk of MFIs has increased (variations depend on the region) and hence, growth rates have slowed down considerably (CGAP 2009e, p. 10). Due to the increased risk and low growth, MIVs are lending less to MFIs and suffer from increased liquidity and increased loan loss provisions which impacts returns. The example of responsAbility Global MF Fund shows how liquidity increased since 2008. Along with increased hedging costs these development had negative impact on MIV returns.



Source: (responsAbility 2005-2010)

Another countervailing development is that the high concentration on the top tier 150 MFIs tends to drive costs of funding of MFIs down and shifts the bargaining power towards the MFI side that could now become more powerful in negotiations with lenders, as analyzed by Reille and Forster in February 2008. In well developed microfinance markets competition among MFIs is increasing as well. Not operating anymore in markets with little competition, MFIs need to offer lower interest rates to their clients (Reille and Forster 2008, p.11). However, this development is currently balanced out in most regions by the financial crisis with the increased costs of funding as described above. But when credit risk decreases again and the consequences of the crisis on costs of funding are weakened, it is likely that competition remains with decreasing interest rates impacting MIV returns.

### ***Competitive returns are an important prerequisite for institutional investors, but social impact equally matters***

Our MIV survey reveals a mixed opinion on the influence of returns on investment volumes: 42% see this feature as a strong driver of private investments until today, but 21% state that returns have had little influence on private investments until now, 8% think that it has not had any influence at all. Regarding investors' motivations, it sticks out that especially retail investors are not as interested in returns as the other groups. The importance is measured on a scale of five, with five being "very important". Respondents state that retail investors would on average classify risk-adjusted returns as "somewhat important" (level three) in their investment decision, but the social impact as "very important". Whereas institutional investors and HNWI classify returns and social impact as equally "important" (level four). These findings indicate that the rise of registered mutual funds, which attract mainly retail investors, is to a high extend fuelled by the social interest of investors. In contrast the rise of structured finance vehicles, dominated by institutional investors, is a result of the double bottom line character of microfinance.

However, according to the pension fund survey the most important reason for pension funds investing in microfinance is "social responsibility". Risk-adjusted financial returns and diversification are still placed high, but do not rank first. Pension funds believe that financial returns are on an adequate level. Hence it can be concluded that, financial performance is a prerequisite for institutional investors entering the market, but that social performance remains of high importance (World Microfinance Forum Geneva 2009, p.6).

### **3.3 Financial risk of microfinance**

After having analyzed the return side of microfinance investments we now turn the risk profiles starting with a categorization of different risks linked to microfinance.

#### ***Risk profile of microfinance – Looking at systematic and unsystematic risk of microfinance***

The attractiveness of microfinance as a future asset class lies in its risk profile compared to other asset classes. Especially the low correlation of microfinance with global and local market movements, as identified by Swanson (2007), gains attention among mainstream investors. Still, discussions among microfinance practitioners on microfinance risks tend to be little structured. However, in the last two years – accentuated by the global financial and economic crises – risks of different levels became apparent.

Modern portfolio theory distinguishes between two major risk categories: 1) systematic and 2) unsystematic, idiosyncratic or specific risks. Systematic risk refers to the risk that cannot be avoided through perfect diversification (Hockmann and Thießen 2007, p. 648). Systematic risks refer to overall market risks (e.g. recessions). Also part of systematic risk – is the systemic risk - though a clear definition is lacking. One possible, rather broad definition of systemic risk is offered by Kaufman and Scott and "refers to the risk or probability of breakdowns in an entire system, as opposed to breakdowns in individual parts or components, and is evidenced by co movements (correlation) among most or all the parts." (Kaufman and Scott 2003, p. 371) In contrast, specific risks are inherent in each investment one makes. Specific risk can be eradicated through appropriate diversification.

The following table shall help to structure the following analysis of risk profiles in microfinance. In the category of specific risks, a further distinction has to be made between external factors and internal factors while the exposure of MFIs to systematic risks is given as external:

Risk Category		Risks in Microfinance (Examples)
Systematic	External (per se)	Country Environment (including systemic risk) Natural Disasters
	Internal	Inefficient Governance Weak Management or mismanagement (Over-)expansion
Specific	External	MF Regulation and Legal Issues Competition among MFIs

Source: Own elaboration

**Awareness for risks in microfinance increases. Specific risks are dominant**

Beginning with the specific risks inherent to microfinance, the industry had gained the reputation of being a low risk business as it stands out for good portfolio quality and microfinance clients for high repayment rates. Important microfinance institutions are characterized by low write-off ratios. In 2006, the largest 340 MFIs had a write-off ratio of 1,2% on average. The standard indicator used to measure portfolio quality of MFIs, portfolio at risk over 30 days, is 2,6% on average for the same group of MFIs in 2006 (MIX 2009).

Hence, the loss given default (LGD) tends to be relatively low and present value of expected recoveries (ER) of microfinance investments relatively high. The U.S. asset managers Blue Orchard S.A. advertises microfinance for having default rates apparently lower than of many traditional commercial banks (Blue Orchard 2008a). As one possible explanation Blue Orchard S.A stresses the high diversification of MFI’s portfolios as MFIs are serving a large amount of customers with low average loan sizes. Another possible explanation generally brought up is linked to the methodology used by MFIs to deliver credits. One of the business principles in microfinance has traditionally been the exclusive relationship of an MFI with its clients in order to enforce payments based on “alternative” collaterals (collaterals with a foremost “emotional” value to the client rather than a resale value for the MFI) or collateral substitutes (e.g. peer pressure in group lending mechanisms). Furthermore, the exclusivity of MFI-client relationships contributed to a strong repayment incentive for clients in order to get a new loan. The “closeness” of credit officers to their clients including a sound cash flow analysis and the assessment of repayment capacity and willingness plus the possibility to react at short notice once repayment problems occur mainly made the difference between a high risk “subprime loan” to a low risk microloan.

However, the assumption that microfinance is a low risk business has been increasingly challenged in the last two years. This is partly due to an increasing exposure to systematic risks as MFIs become more integrated into the international and local commercial financial markets. But also the financial crisis brought to light and speeded up specific risks dozing in many microfinance markets for a couple of years now.

In 2008 the Centre for the Study of Financial Innovation (CSFI) launched its first “Microfinance Banana Skins” report (CSFI 2008). Through a survey of 305 microfinance stakeholders from 74 countries (analysts, observers, regulators, investors and practitioners) the authors identified 29 mayor risks microfinance



institutions face. The first ten risks mentioned were (following the order): management quality, corporate governance, inappropriate regulation, cost control, staffing, interest rates, competition, managing technology, political interference and credit risk. All of these risks are inherent to the microfinance industry and some of them even linked to each other. For instance, the limited management quality (“MFIs tend to be dominated by visionaries who are strong on charisma but less so on management skills”<sup>12</sup>) can lead to inefficiencies and high operational costs (“cost control”) while the risk of excessively high interest rates (“interest rates”) is attributed mainly to the effort of covering cost inefficiencies. At the same time, credit risk and competition are interrelated: increased competition induce MFIs to lower credit standards and to take on more risk when lending to clients This can cause a spread of over indebtedness and thus – besides painful experiences for their clients – a deterioration of loan portfolio. To avoid increasing credit risk, proper managing technology are necessary and then, again, appropriate staffing and strong management skills. In this sense the risks of inadequate cost controls and non-competitive interest rates and partly also the absence of adequate management technology as well as credit risk are rather outcomes of limited management quality than risks per se. At the same time, the governance problems many microfinance institutions face – especially those based on courageous initiatives of individuals mostly in the NGO scene – are perceived as a high risk especially among investors and are majorly linked to problems of “low calibre personnel” (“management quality” and “staffing”) but also poor transparency. The risk of political interference as a specific risk in contrast to political instability in a broader sense is seen on the rise as microfinance gains more attention from politicians since its assertion as an important development tool. The danger of increasing political interference was named by one survey participant as “the dark side of Nobel prizes.” (CSFI 2008, p.20).

In 2009, the second Banana Skins report was published and not surprisingly – due to the international financial crisis – external if not systematic risks increased in the opinion of then 430 participants (CSFI 2009). These were majorly linked to aspects of funding (“Liquidity”, “Refinancing”, “Too little funding”) but also macroeconomic trends gained importance as MFIs experienced that portfolio deterioration was partly due to client’s affection of the real economic crisis following the financial crisis. The former hit also developing or emerging countries which did not suffer major distress within their banking system. Still, the main risks identified in the years before which are only partly related to the crisis remained under the first ten, namely credit risk (nr. 1), management quality (nr. 4), corporate governance (nr.7) and competition (nr.9).

In February 2010 CSFI (2010) published an update on its second survey based on a series of meetings in which the results of the latter were discussed. It was further highlighted that in the first survey mainly “institutional” thus specific, internal challenges were perceived as major risks reflecting the belief that microfinance would be insulated from shocks at a global level. In the second survey only in Africa risks of this category continued to domain, while in other parts of the world risks systemic factors began to prevail. While the effects of the world economy totally defy MFI’s control the problem of funding had “sharpened the question of whether MFIs should go into deposit taking” (CSFI 2010, p.4). Still, special emphasis was put on the increasing competition (external specific risk) MFIs had to face and will increasingly have to face in the future; the related risk-taking business practices; and the limited management capacities of many MFIs to deal with these risks. An “urgent need for a fundamentally more professional approach” (CSFI 2010, p.5) was claimed as many managements a) had shown to be unprepared for shocks, b) had little understanding of “new” risks such as liquidity and c) knew little about risk management. Interestingly enough the management problems were one of the key issues already

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<sup>12</sup> See **CSFI (2008)**. Microfinance Banana Skins 2008. Risk in a Booming Industry, New York, CSFI.p.15.

mentioned by Claus-Peter Zeitinger – the founder of IPC, later converting into the ProCredit Holding – in the mid nineties (Schmidt and Zeitinger 1996).

***Microfinance institutions face increasing competition, leading to multiple borrowing and client's over indebtedness***

Even though the first delinquency crisis in microfinance took place as early as 1999 in Bolivia (Rhyne 2001) not before today the problem of multiple borrowing caused by fierce competition has become a major issue within the international discussion among microfinance stakeholders. Yet, multiple borrowing does not have to be a bad thing per se (especially from a client's perspective) if the MFI knows about its clients' relationships with its competitors and can thus properly incorporate this knowledge in the cash flow analysis of micro entrepreneurs and their families to adequately assess the repayment capacity. In contrast, if MFIs due to increasing competition loosen their credit policies and explicitly start to target their competition's clientele in concentrated geographic regions credit risk becomes a key issue. Apart from culpable negligence of credit officers and managers the organisational adaption of a rapid expansion (e.g. the introduction of adequate managing technology) as well as infrastructural features – especially the existence of credit bureaus providing timely information – strongly influence the capacity to assess and manage risks related to increasing competition.

This has been shown not only by the above mentioned Banana Skins Reports but also by the recent experiences of repayment crises in four countries, namely Nicaragua, Morocco, Bosnia and Herzegovina and Pakistan (Chen, Rasmusen *et al.* 2010). In all four countries the portfolio at risk over 30 days rose sharply from 2008 onwards (Chen, Rasmusen *et al.* 2010, p.5) reaching as high levels as 13% in Pakistan.<sup>13</sup> All four countries had at least two phenomena in common: a) a rapid growth in credit portfolio and b) that savings were neither a major service nor a large source of funds compared to the world's average. Instead foreign debt capital as well as commercial borrowings from local markets was the major source of funding. Furthermore, in Nicaragua, Bosnia and Herzegovina as well as Morocco all large MFIs were affected by increasing delinquency (with a portfolio at risk > 30 of 22%, 12% and 12% respectively). While in Nicaragua delinquency was further pushed by political support of the "no pago" (no payment) movement in the northern part of the country which, receiving political support, than spread over the country, in Morocco a contagion effect by the failure of a leading MFI – Zakoura with 20% of total assets – led to a sharpening of the repayment crisis.

***Microfinance Institutions not complying with their obligations are still rare but have serious consequences***

That increasing competition and thus credit risk through over indebtedness can be one of the main courses of MFI defaults in the future was also highlighted by an investor's survey realized by International Association of Microfinance Investors. Between 1994 and 2008 the author of the study identified at least 60 payment defaults to MIVs totalling nearly USD 8.1 million (Abrams 2009, p.3). Reasons mentioned for MFI defaults were in line with the risks identified in the Banana Skins report. Even though illiquidity was mentioned as the number one cause (risk) of MFI defaults it was often an outcome of an inherent, specific risk rather than a risk in itself ("There were numerous underlying causes of illiquidity, such as fraud,

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<sup>13</sup> Chen et al. define a PAR>30 level over 10% as a clear indicator of a repayment crisis.

mismanagement, and poor portfolio quality”<sup>14</sup>). Only one systematic risk – exchange rate fluctuations creating liquidity shortfalls – was mentioned as a reason for illiquidity.

The very low level of debt default rate of (~2%) was attributed to the specific relationship between MFIs and investors (such as restructuring of loans and repayment accelerations). An interesting, external factor is the importance of “institutional support or rescue of promising MFIs” (Abrams 2009, p.10). Especially MFI Networks do not want MFIs to fail and intervened with fresh capital in times MFI went through times of distress. This is also pointing to the increasing need of equity rather than debt financing. However, the author states that the microfinance investment industry has a rather short track record and that further research should include studies on MFI failures prior to the recent investment activities.

In cases when financial distress actually leads to the liquidation of an MFI, also the percentage of investments affected by the default has to be considered evaluating the riskiness of microfinance investments. Rozas (2009) studied 5 individual cases of MFI failures<sup>15</sup> pointing out that in two cases investors walked away empty handed while in other cases a recovery rate of 20%-40% had to be considered as good. Comparing these figures with the 4% unsecured creditor losses during the liquidation of Washington Mutual in September 2008 – one of the largest banks in the USA – Rozas highlights the difficulties particular to the microfinance industry of transferring assets (here the MFI’s portfolio) to another institution for recovery. He argues that – besides the restrictions in the legal environment which allows to enforce property rights properly – the lending methodology of MFIs, especially the “closeness” of credit officers to its clients as well as the incentive for clients to repay a loan in order to get a new one, links the portfolio of an MFI to the individual organisation in a manner that “requires evaluating the portfolio not for performance, but for collectability” (Rozas 2009, p.8). Furthermore, he stresses that microloans had the propensity to default en masse. The latter was also true for the above mentioned delinquency crises. Rozas points out, that this might also be of importance regarding the creation of new investment products such as collateralized debt obligation at MFI level, as the portfolio of an MFIs is just worth as much as the MFI as an organisation itself (with its given governance structures and management).

Even though resulting out of specific risks in microfinance, the complex of problems related to mass defaults due to the effects of over-indebtedness and multiple borrowing can also be seen as a (microfinance) systemic risk at local or even national level according to Kaufman’s second definition: “systemic risk is the probability that cumulative losses will accrue from an event that sets in motion a series of successive losses along a chain of institutions of markets comprising a system ... That is, systemic risk is the risk of a chain reaction of falling interconnected dominos” (Kaufman 1995, p. 47).

Nevertheless, the low systematic risk of microfinance in general and the potential weak correlation of microfinance investments with global and local market movements recently attracted much attention.

### ***Public attention is high, but few studies try to prove low systematic risk***

Dieckmann (2007) underlines that MFIs follow a substantially “different business model” than conventional banks, characterized by a smaller integration of their clients into the formal economy and the focus on domestic products and services which are less affected by currency fluctuations (Dieckmann 2008, p.3). CGAP argues that it is “conventional wisdom” that microfinance is countercyclical and less

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<sup>14</sup> See Abrams, J. (2009). Zero is Not the Number: The Microfinance Debt Default Rate. A Baseline Analysis, New York, IAMFI., p. 9.

<sup>15</sup> SOMED in Uganda, WEEC in Kenya, Bank Dagang Bali in Indonesia, FOCCAS in Uganda and ICICI Bank in India

vulnerable to economic downturns (CGAP 2009c). Since 2007 articles in business newspapers and the general press have been increasingly reporting on this topic. The Financial Times reports on the low correlation of microfinance with world economic movements in May 2007 (Tully 2007). Financial Times Deutschland followed with several articles, among them one about microfinance funds' performance in times of crisis in 2008 (Diekmann 2008). The articles, with headlines as "Microfinance Funds – Returns with a good conscience" („Mikrofinanz-Fonds - Gewinne mit gutem Gewissen“) (Euler 2008) stress, besides the improving returns, the good performance and constant portfolio growth of microfinance mutual funds during crisis. ResponsAbility claims that microfinance institutions even tend to increase their client base during crises (Blue Orchard 2008a). Blue Orchard S.A. finds that the value of microfinance investments is not influenced by hard to predict interest rates and credit spread movements and therefore shows a lower volatility than other emerging market securities. In addition, the investment research firm Morningstar recommends that microfinance funds can be suitable for the integration in a portfolio because of the low correlation with other asset classes contributing to portfolio diversification (Morningstar 2007).

Despite the considerable public attention on that topic, few academic studies have been published, proving these statements. First exemplary evidence regarding the resilience of microfinance during crises was presented regarding the 1997- 1998 financial crisis in Asia. McGuire and Conroy (2009) examined Malaysia, the Philippines, Thailand and South Asia finding that MFIs focusing primarily on the poor appear to have been more resistant to the crisis than institutions focusing on higher income target groups (McGuire 2009, p.18). Benoit Calderón (2006, p. 65) presented in 2006 data on the development of portfolio growth and portfolio quality of MFIs in three Latin American countries during economic and political crises. He found for the case of Bolivia that in the period from 1995 to 2003 MFIs' portfolio grew steadily whereas aggregate portfolio of commercial banks declined. The portfolio quality (PAR > 30 days) of commercial banks has deteriorated since 1998, at the same time the portfolio quality of MFIs improved (Calderón 2006, p. 67). For Peru and the Dominican Republic similar anecdotal evidence is presented. Gonzales, a researcher affiliated to The MIX, conducted the first econometric study in this field and examined the correlation of MFIs' portfolio quality, measured in Portfolio at Risk > 30 days, with local macroeconomic movements, measured in GNI per capita (Gonzalez 2007, p.7). The dataset comprised 639 MFIs in 88 countries, in the period from 1999 to 2005. He did not find a statistically significant positive relationship between these variables and concluded that MFIs are immune to local economic shocks, controlling for MFI and country characteristics. The most elaborated study was conducted by Krauss and Walter (2008). The last version of their empirical analysis, examining the systemic risk of microfinance, was published in 2008 and indicated that there is no exposure of MFIs to global capital markets, but significant exposure to domestic market movements (Krauss and Walter 2008, p. 2). These results imply a positive portfolio diversification effect for international investors, but not for local investors. Walter and Krauss regressed six indicators of MFIs' performance (Net operating income, ROE, portfolio growth, total asset growth, PAR >30 days and profit margin) against proxies for global market risk (S&P 500, Morgan Stanley Capital International (MSCI) World and MSCI Emerging Markets) and against domestic GDP, as a proxy for domestic market risk (Krauss and Walter 2008, p. 8). The dataset included 325 MFIs in 66 emerging countries. The same regressions were conducted for commercial banks of the respective countries and resulted in the second outcome of the study: MFIs are less exposed to systematic risk than commercial banks because one or more performance indicators of MFIs were less correlated to the market indices than the indicators of commercial banks. The authors stress that these are tentative results because the data quality regarding the MFI side was low and reporting standards are still not applied on a broad basis.

### ***Financial and economic crisis as a test***

The studies cited above did not include the period of the recent crisis. As stated in part 3.1 pension funds see this crisis as a major test for the systematic risk of microfinance. The drop of returns may indicate that microfinance, being more integrated into international capital markets today than in the periods of the cited studies, are not completely resilient to local and global market movements.

Recent news of a microfinance asset managers strengthens this assumption: ResponsAbility Global Microfinance Fund temporarily suspended the issuance of fund shares in May 2010 and justifies this with a decreased demand for credit due to the impact of the crisis (responsAbility 2010a).

A CGAP survey further analyzes how microfinance clients and MFIs are impacted: The economic contraction, massive job losses, and a drop of remittances is hitting microfinance clients and MFIs are suffering from a dramatic slowdown of portfolio growth, a decrease of portfolio quality, liquidity constraints and higher costs of funding (Reille, Kneiding *et al.* 2009).

The fact that the portfolios of MIVs are highly concentrated on few countries increases the relevance of systematic risk for MIV returns. Countries such as Bosnia and Nicaragua, affected by the global crisis and hence by over indebtedness are among the top ten countries of six large MIVs (Blue Orchard 2010a; Credit Suisse 2010; EFSE 2009; Oikocredit 2010). The example of the Dexia Microcredit Fund shows that if one country is negatively affected there is an immediate impact on MIV returns: The asset manager attributes a negative return in September 2009 to the impact of the crisis on Nicaragua (Fuchs 2010).

### ***MIVs assume a high portfolio diversification effect – Pension funds require longer track record***

59% of the participants of our MIV survey think that the risk profile will be a strong driver for microfinance investments in the future. 38% of the survey participants believe that there is a weak correlation of microfinance with global market movements. Another 38% state that they identify weak correlation with global and local market movements at the same time. On this topic several additional comments were made indicating a high interest of MIVs. Two participants point out that this low correlation will decrease as MFIs rely increasingly on commercial funding, with “mainstream finance moving into the markets”. Although MIV respondents assume a potential portfolio diversification effect, 59% agree or tend to agree that there is a demand among their investors for an intensified research on the correlation of microfinance with global or local market movements. The survey results further suggest that the topic of portfolio diversification is especially relevant to institutional investors (“important” for institutional and HNWI and “somewhat important” for retail investors).

Pension funds most frequently mention “uncertainty about longer-term development of risk levels” as a barrier for microfinance investments. For them, the short track record does not allow to adequately assess the risk level (World Microfinance Forum Geneva 2009). In contrast, the track record of microfinance does not seem to be an issue for many MIVs anymore (as stated by 46% of the participants).

### **3.4 Microfinance and Social Investment - Reputational Risk**

A major difference of microfinance compared to other (future) asset classes is also its roots in social and development policies. Investors seek a social return of their investment which is not considered in modern portfolio theory as a factor which influences investors' decision making.

According to our MIV survey, the rise of Social Responsible Investments (SRI) is seen by a majority as a major driver of investments in microfinance. 21% constitute a strong influence until today, and 38% believe that SRI will also in the future be a strong driver. In addition, the publicity for microfinance through the Nobel Peace Prize to Muhammad Yunus and the Grameen Bank has supported investment growth considerably, as stated by 58%.

Thus, it can be assumed that reputation – here for the social/ethical/environmental performance – as an intangible asset has a big potential for value creation as suggested by Roberts and Dowling (2002). Still, “reputation is constructed in the mind of others and as such inherently a subjective construct” and as it is also “a composite measure: in terms of gathering together perceptions from various stakeholders whose perceptions are, in turn, formed from multiple data sources and from their own previous knowledge of the entity in question” (Bebbington, Larrinaga *et al.* 2004, p.8). Therefore reputation is hard to conceptualize.

A survey of 269 senior executives responsible for managing risks conducted by EIU in 2005 furthermore identified reputation as “the risk of risks” (EIU 2005). Among the major findings were: a) reputation is a prized, highly valuable, corporate asset b) companies struggle to categorize – let alone quantify – reputational risk c) compliance failures are the biggest source of reputational risk d) good communication is vital to protect against reputational damage.

In microfinance different levels of reputational risks have to be distinguished. Beyond the reputation of a single MFI, the industry as such has a reputation. Reputation damages of single MFIs can affect the reputation of other MFIs. Furthermore microfinance overall has a certain reputation regarding its way of doing business (such as acting socially responsible) as well as its social impact (poverty alleviation, women empowerment etc.). Consequently, several reputational risks can be identified.

### ***Irresponsible Business practices and ongoing discussions about mission drift might jeopardize microfinance reputation as social investment***

At the latest since Robinson (2001) called out “The Microfinance Revolution” enthusiasm among microfinance practitioners and academics grew believing that microfinance services could be offered both in a social, thus poverty alleviating, and financially sustainable or even profitable way. The euphoria of having found the ultimate weapon against poverty was considerably disturbed by the “Compartamos debate”. For the time being, the criticism about high interest rates in microfinance and little transparency towards its clients peaked in the often cited (and long expected?) phrase of Muhammad Yunus: “We created microcredit to fight the loan sharks; we didn't create microcredit to encourage new loan sharks.”, which was published in April 2010 in the New York Times (MacFarquhar 2010).

Furthermore, there is an ongoing discussion about the “mission drift” of MFIs, thus, the tendency to extend larger average loan sizes (and/or disregard other social goals) leaving behind the “poorest of the poor” as scaling-up. Or, more general, we can find the discussion on microfinance tradeoffs, the tension between meeting social goals and maximizing financial performance. Both are accompanied by the work of academics leading to mixed results. While scholars tend to negate the hypothesis of an existing mission drift among MFIs (Copestake 2007; Mersland and Strøm 2010) they do indeed find a trade-off between financial and social returns (Cull, Demirguc-Kunt *et al.* 2009). This debate will probably continue to be fierce, especially as consent on how to adequately measure social performance has still to be found. Still, there are various social performance initiatives bringing together practitioners, donors, investors (multilateral, bilateral, and private), national and regional networks, technical assistance providers, rating

agencies, academics and researchers; such as the Social Performance Task Force an open network with more than 350 members, with the objective to enhance knowledge exchange and to create a common social performance framework (Social Performance Task Force 2010). To respond to the demands of socially motivated investors and to the increasing criticism on high interest rates, little transparency as well as client's (over)indebtedness it might be crucial in the future to find common social standards and clearly communicate what is meant by social performance measurement and management. Accordingly, the participants of our MIV survey state that the lack of social impact measurement has not been overcome and is still seen as a minor (38%) or major barrier (29%). This lack of measurement coincides with an increasing demand: 87% indicate that they have identified an increasing interest in social impact measurement by their investors within the last four years. The majority (50%) says that social ratings will have high importance in the future. This finding may be connected to the participants' statements about increasing critique towards microfinance: 63% agree or tend to agree that current public critique on microfinance is a considerable threat for the image of microfinance as a SRI.

At the same time, pension funds see "reputational risks associated with microfinance being accused of unethical practices in the media" as a major barrier for further investments. Another indicator, that the documentation of positive social returns towards investors is becoming more and more important could also be the first social performance reports issued by major MIVs. For instance, Incofin (a Belgian microfinance investment manager) launched its first social performance report in 2009. responsAbility Social Investments AG (one of the biggest MIVs based in Switzerland) already publishes social performance reports since 2005. Still, a comprehensive analytical instrument (rADER – responsAbility Development Effectiveness Rating) is still in development (Dewez and Neisa 2009; responsAbility 2010b).

### ***The impact of microfinance on poverty reduction and other social goals is questioned***

Finally, with more sound methodologies (such as randomized control trials) and an increasing interest of leading researchers in the subject (e.g. the Financial Access Initiative of NYU, Harvard and Yale) the assessment of the impact of microfinance and its heterogeneous results increasingly catches the attention of the media and socially motivated investors. Recent studies question specific assumptions of causal impact chains such as the increase in income for female microfinance clients and their progress in decision making as a precondition for their economic, social and political empowerment (Banarjee, Duflo *et al.* 2009; Karlan and Zinman 2009). The media attention on this topic has even motivated some of the most important networks for microfinance (Acción, FINCA, Grameen Foundation, Opportunity International, Unitus and Womens' World Banking) to heavily demonstrate against these studies: "As microfinance practitioners, we have witnessed the positive impact of microfinance first-hand... The media's interpretations of several recent studies on the impact of microfinance, however, have questioned whether microfinance has made a quantitative improvement in the lives of the borrowers, or has had any effect on poverty alleviation on a systemic basis...Such studies face two fundamental challenges: their ability to capture and analyze all the benefits of microfinance, and the duration of the study itself" (Accion *et al.* 2010). Also in this area, it is clear that the last word has not been spoken yet.

### **3.5 Ability of Vehicles to Attract Mainstream Investment**

Before we turn in the next section to the investees and thus the market size and investment opportunities, we now assess the stage of development of MIVs and its capacity to channel mainstream investments.

### ***High number of vehicles – but few main players***

In 2003, a publication on private microfinance investments found that “there is not a single retail social investment fund with significant investment in microfinance in emerging markets” (Jansson 2003, p. 16). This situation has changed significantly as shown in part 3.1. Goodman (2006) underlines the essential role of appropriate vehicles: “The latest developments demonstrate that whenever a microfinance investment fund is structured appropriately for its targeted investors, there is no lack of financial resources ”(Goodman 2006, p.11). Hence, a precondition for mainstream investors entering the market on a larger scale, besides an attractive risk-return profile and a proven social impact, are appropriate vehicles channelling the investments.

Without a doubt there are today professionally managed vehicles available which have built reputation over several years. The establishment of mutual funds and structured finance vehicles have significantly contributed to investment growth as shown before. While the introduction of investment banking techniques, through structured finance vehicles, made large investments by institutional investors possible, the development and professionalization of mutual funds attracted retail investors. They can invest small investment sizes, as vehicles offer shares of USD 1.000 (ResponsAbility Global Microfinance Fund). However, mutual funds still face considerable challenges from regulation. Non-listed and non-rated securities (such as microfinance investments) can only in some countries be included in the portfolio of registered mutual funds. The optimistic growth projections of DB Research are based on the assumption that regulatory barriers for microfinance mutual funds will be overcome (Dieckmann 2008, p. 11).

Swanson (2007) argues that the most fundamental change for MFIs’ funding occurred in 2004, when the first Collateralized Debt Obligation (CDO) was introduced to the market and attracted for the first time high investment volumes by institutional investors (Swanson 2007). One major concern of institutional investors, the small deal size (Meehan 2004, p.24), could be overcome by the characteristics of a CDO. Generally, MFIs have small balance sheets in comparison to commercial banks. CDOs pool together portfolios of several MFIs: Through global securitization, which means the securitization and pooling of portfolios of several MFIs, a size necessary to be cost-effective can be reached (Jansson 2003, p. 12). Secondly, transformation of risk is an essential part of the characteristics of this vehicle. Part of a CDO is the tranching of the issued asset backed securities, which is done by the SPV (Byström 2008)- In this way different risk-return profiles can be offered to investors. This is especially relevant for mainstream investors, because they can choose a less risky asset, when accepting a moderate return (Meehan 2004, p.12). Moreover, the involvement of public investors and foundations as guarantors or purchasers of equity tranches increases the reputation of the vehicle and reduces risk. For example, in the case of BOLD 1, the Dutch development bank FMO underwrote the entire subordinated note class and the Grameen Foundation and Skoll foundation purchased equity tranches. Hence a wide range of investors was attracted, including foundations, SRI Managers, SRI Funds, private and institutional investors (including large European commercial banks and a U.S. pension fund) (Blue Orchard 2008b).

But although there are more than 100 vehicles in the market today, the most investment is attracted by not more than 5 MIVs. As shown in part 3.1 over half of microfinance investments is managed by five asset managers. Blue Orchard S.A. now manages six vehicles (Dexia Microcredit Fund, St. Honoré Microfinance Fund, Dual Return Fund SICAV and three structured finance vehicles) (Blue Orchard 2008b). Credit Suisse Microfinance Fund Management Company manages the four microfinance funds advised by ResponsAbility Social Investment AG (ResponsAbility Global Microfinance Fund, ResponsAbility SICAV Microfinance Leaders Fund and responsibility Mikrofinanz-Fonds). A rating of these vehicles does not



exist, and a labelling of microfinance mutual funds was only introduced recently. So far seven mutual funds qualified for the label “LuxFLAG” (Luxflag 2008)<sup>16</sup>.

### **The largest MIVs are today highly renowned – but their number is limited and hedging remains the major constraint**

The professional management of microfinance investment products is evaluated by 33% of participating MIVs as a strong driver until today; additionally 21% believe that it remains a strong driver in the future. According to a majority of participants, the establishment of appropriate investment vehicles was an important driver of the boom: 46% of the participants find that the lack of appropriate investment vehicles has been overcome. 17% still see it as a minor obstacle today. No respondent evaluates it as an important barrier in the future. Nevertheless, it may be obvious that MIVs themselves see their professional management as an important factor for the sector.

Participants of our MIV survey state that a lack of knowledge about the specific risks related to microfinance investments and a lack of experience in emerging markets investments are no longer important barriers for private investments (67% and 84%). Learning curve effects have been realized. This is underlined by the fact that pension funds have not researched the market in depth but rely on MIVs as their main source of information (World Microfinance Forum Geneva 2009, p.8). But pension funds identify a lack of professional management and suitable products as constraints: The “availability of a larger choice of microfinance fund managers and products”, “better and more professional risk management” would very much increase future investment (World Microfinance Forum Geneva 2009, p.7).

The establishment of professionally managed vehicles also depends on the regulation of MIVs in their countries of origin. Opinions are mixed: 50% evaluate it as a minor or important obstacle, whereas 25% say this barrier has been overcome. The most relevant barrier from the perspective of MIVs is local currency hedging. This notion is reflected in the opinion of participants stating that the development of hedging tools has had little influence until today on investment growth (4%) but will be a strong driver in the future (46%). Despite these barriers, MIV respondents feel that the competition among MIVs will increase: 21% believe this will be a major issue for MIVs, though 33% of respondents categorize competition as a minor obstacle today and only 8% as a current major issue.

### **3.6 Market Size and Investment Opportunities**

Despite the opportunities offered through improved risk adjusted returns, first indications for a positive contribution to portfolio diversification and the fast development of professionally managed vehicles, the growth potential of the market depends on the investees. According to Swanson the top tier MFIs are overbanked. E.g. only about 100 MFIs worldwide are eligible for financing their portfolio by participating in a CDO (Swanson 2007, p.14, 22).

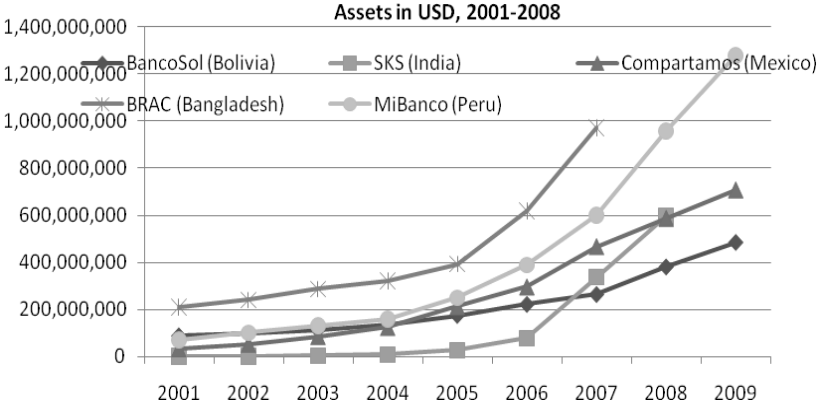
The number of MIVs grew from 38 in 2004 to 103 in 2008. Average MIV asset sizes also increased significantly from USD 20 million in 2004 to USD 161,2 million in 2008.<sup>17</sup> However, in 2008 the growth slowed down: While assets under management increased MIVs grew only by 31% in 2008.

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<sup>16</sup> The Luxembourg Fund Labelling Agency (LuxFLAG) is an independent, non profit making, association created in Luxembourg in July 2006. The primary objective of the LuxFLAG Microfinance Label is to reassure investors that the MIV actually invests, directly or indirectly, in the Microfinance sector.

<sup>17</sup> Average MIV size refers to the participants of the CGAP survey (54 participants).

On the one hand, as shown in part 2, the MIV portfolio grew on average by 71% from 2005 to 2007 (CGAP 2009a). On the other hand, MFIs gross loan portfolio grew by a compound annual growth rate of only 38.6% and the number of borrowers by 23.5% (Gonzalez 2009)<sup>18</sup>. In 2008 the MIVs still grew by 31% (CGAP 2009d) while MFIs gross loan portfolio grew by 20.1%. Foreign investors are clearly not the only



funding source for MFIs (even though an important one for some of them). In 2008 foreign capital investments in microfinance exceeded 10 billion USD<sup>19</sup> while the gross loan portfolio of MFIs was over 44 billion USD. It is still noteworthy that the growth rates of foreign capital flowing into the microfinance sector exceeded

Source Data: The MIX

the growth of MFIs lending activities in all years since

2004. In practitioners' discussions it is often mentioned, that MFIs growth was pushed by capital injections. Even though further econometric research is necessary to find out more about assumed causalities, the graph above, which displays the asset development of some of the world's leading MFIs, shall exemplify the argument<sup>20</sup>.

The development of the market size and the transparency of the market are in general crucial for mainstream investors assessing the future development of the asset. But will the microfinance industry be able to keep pace with the increasing capital injections? To answer this crucial question at least two additional issues need to be analyzed: First, if the number of MFIs ready to receive investments actually has increased considerably in the past and is likely to continue to increase in the future. And then, if yes, how capable is a single MFI and microfinance markets in general of absorbing the increasing capital flows.

***There are an increasing number of sustainable MFIs. Still, concentration of assets in single MFIs or markets is pronounced***

In 2007, 3.316 microfinance<sup>21</sup> institutions were reported worldwide (Daley-Harris 2007). Three years before Meehan (2004, p.7) distinguishes between four different tiers of MFIs. Only 2% - at most - could

<sup>18</sup> These numbers are based on the analysis of 1,395 MFIs reporting to the MIX. In the following, for aggregated for 2008 please refer to the same source.  
<sup>19</sup> Equity and debt capital from DFIs and private investors. See **CGAP (2009d)**. MIV Performance and Prospects: Highlights from the CGAP 2009 MIV Benchmark Survey, Brief, Washington D.C., CGAP.  
<sup>20</sup> The MFIs within this graph have been chosen because: a) BancoSol is the first MFIs which ever transformed into a microfinance bank and is known for its promising development. Bolivia where BancoSol is located is one of the countries with the best microfinance regulation and investment climate. b) SKS is the biggest MFI in India and lately called attention because of its planned international IPO. c) Compartamos already launched the first international IPO in 2007 and attracted a lot of international as well as national investments. d) BRAC in Bangladesh is known for the first securitization in Microfinance and d) MiBanco is the biggest MFI in Peru which lately has been named as the most favourable country for the development of microfinance.  
<sup>21</sup> This number gathered during the Microcredit Summit Campaign does not reflect the total number of worldwide existing MFIs but might be representative for the MFIs with international visibility and connectivity.

be considered 1<sup>st</sup> tier MFIs with strong financial and operational track records (“Top 50 or 100”<sup>22</sup>; regarding portfolio size and profitability). 8% of all MFIs were in the 2<sup>nd</sup> tier compounded mostly by successful NGOs (nearly) reaching profitability. Meehan attests the majority of these MFIs good chances to rise. 20% of MFIs, the 3<sup>rd</sup> tier, were approaching profitability while 70% of all MFIs were unprofitable with only some of them having a chance to rise. Dieckman (2008, p.7-8) adds, that 10% of the MFIs (1<sup>st</sup> and 2<sup>nd</sup> tier MFIs) held the bulk of microfinance clients and loan portfolio. He counts 150 MFIs in this category which are mostly regulated MFIs and the most attractive for institutional and private investors. As further certification mark for interested investors Dieckman mentions a loan gross portfolio over 100 Mio.USD which by then was reached by 30 MFIs.

According to the MIX “Microbanking Bulletin: 2008 Benchmark” database accounting for 1.087 MFIs worldwide, 62% of all MFIs declared to have a non-for-profit status while 38% had a for-profit status. At the same time 51% of all MFIs reached financial sustainability (MIX 2009). Still, financial sustainability does not automatically indicate that the MFI has reached a degree of profitability interesting for (commercial) investors. Considering the data from 1.163 MFIs directly reported to The MIX in 2008<sup>23</sup>, 280 MFIs (24.12%) reached negative returns on assets (ROA<0%), 365 MFIs (31.3%) reached low returns (ROA≥0%<3%), 172 MFIs (14.8%) reached moderate returns (ROA≥3%<5%) and 277 MFIs (23.8%) reached high returns (ROA≥5%) while for 69 MFIs the data provided to calculate the ROA was not sufficient. Only 5.7% of MFIs reached a very high return on assets between 10% and 20% and as little as 1.5% reached a return on assets like the “all-time profit champion” Banco Compartamos (ROA>20%). Thus, the portion of sustainable or even profitable MFIs (with publicly available information) has increased considerably since 2004 and by 2008 already 80 MFIs had a gross loan portfolio of USD 100 million. Anyway, there is a strong regional concentration of highly profitable MFIs. Nearly 70% of MFIs reaching return on assets over 10% are located in Eastern Europe and Central Asia as well as Latin America. Furthermore, the concentration of number of clients in MFIs remains pronounced. In 2008 less than 2% of MFIs reached more than 500.000 active borrowers – a number which Compartamos reached between 2005 and 2006. 8.6% of MFIs concentrated 78,6% of all active borrowers. The concentration of clients within a few MFIs cannot only be observed on a worldwide scale but also within single countries. In India 10% of all MFIs hold 76% of all MFI clients (excluding Self Help Groups), a picture extremely similar to the world’s average (Srinivasan 2009, p.47). In Morocco by end 2008 the three biggest MFIs (Al Amana, FBPMC, Zakoura) concentrated 84% of total assets (based on 10 MFIs which reported to The Mix) while the single biggest MFI alone (Al Amana) already concentrated 45%. The finding that the number of highly profitable MFIs is still limited is underlined by the fact that there are only few examples of Initial Public Offerings (IPOS) so far. Bank Rakyat, BRAC, Equity Bank and Compartamos are high-performing institutions showing a very strong growth. They successfully started refinancing their institutions through the issuance of shares at local stock markets. Although it means a breakthrough in the history of microfinance investments, the requirements for MFIs to go this step are very high and hence prospects for an increasing number of IPOs rather pessimistic at this stage (Lieberman, Anderson *et al.* 2007).

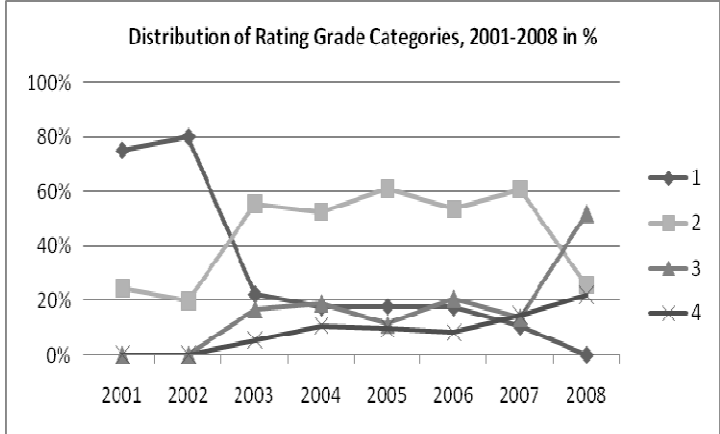
Another way to assess the numbers of MFIs ready to attract funding of investors interested in financial returns is the use of ratings provided by specialized and mainstream rating agencies. The statistics of the

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<sup>22</sup> Please note that, unless Meehan does not clearly disclose her data sources she refers to 100 MFIs max. as 2%, thus counting a total of 2,000 existing MFIs.

<sup>23</sup> Considering the MFIs reporting to the MIX seems reasonable for the following argument as MFIs reporting voluntarily to this information exchange platform are probably those seeking international funding, and thus attach importance to international visibility, which nowadays only The MIX provides.

Rating Fund 1 encompass 526 rating reports of 388 MFIs worldwide<sup>24</sup>. The rating grades of different rating agencies cannot be compared easily. One reason is the diverse symbologies. For example MicroRate uses Greek letters while Planet Rating uses Latin letters. Some older rating reports even show no letter grades at all. But even if you want to compare ratings of different rating agencies applying letter grades, the comparison might be misleading due to the difference in their rating methodologies. Still, one can identify major rating categories. Focusing on 404 ratings where letter grades have been assigned to the major categories – letters lifted or lowered by another letter or +/- – will be attached to a number from 1 to 4 with 1 being the highest and 4 the lowest category.<sup>25</sup> To assess the number of MFIs “ready” for investments multiple ratings of one and the same MFI will be excluded. In case various rating issues exist only the last rating will be taken into account. Thus, the following analysis only assess the percentages of MFIs which in any moment between 2001 and 2008 reached a certain rating category and leaves aside



any rating movements which might have occurred. Doing so, the number of MFIs with a letter grade rating is reduced to 317. Of these MFIs rated between 2001 and 2008 17.4% were in the first category, 52.3% in the second category, 19.7% in the third and 10.7% in the fourth category. Thus, in over half of the ratings MFIs were considered to have a low or moderate risk exposure and/or a good institutional performance

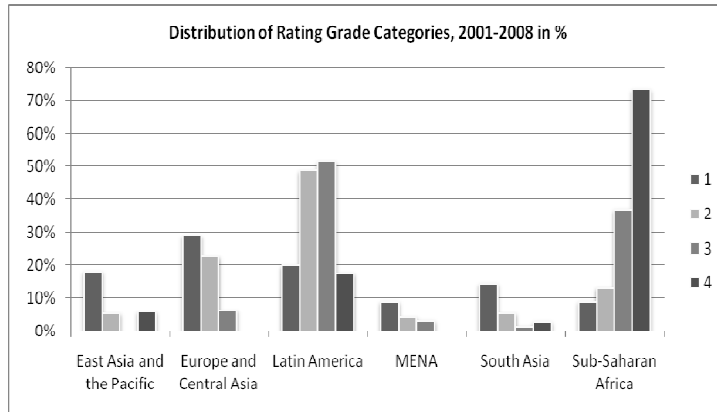
Data source: Rating Fund I (approximately reaching A and B letter grades).

Looking at the different rating grades assigned in different years the distribution of rating grades does not differ too much between 2003 and 2007. Before 2003 the percentage of category 1 ratings appears so high mainly because only a limited numbers of ratings were realized with subsidies from the Rating Fund I (4 ratings in 2001 and 10 ratings in 2002). Also the number of ratings in 2008 – the last year of funding through this mechanism – is much lower than in previous years (27 in 2008 versus 95 in 2007). Thus, the decrease of good performing MFIs does not necessarily reflect the influence of the beginning financial crisis on MFIs but rather the limited data availability. Considering the 22 ratings funded by the Rating Fund II (20 in 2009 and 2 in 2010) which covers only the Latin American region 73% of all rating grades assigned were within the second category while 27% were in the third category.

The statistics from the Rating Fund I and II are not representative in so far as a) they encompass only a limited number of MFIs which furthermore are more likely to be good performing MFIs compared to non-rated MFIs and b) there is much larger number of non co-funded ratings and the proportion of co-funded

<sup>24</sup> In May 2001, the Inter-American Development Bank (IADB) and the Consultative Group to Assist the Poor (CGAP) launched a joint initiative called the Microfinance Rating and Assessment Fund. The European Union subsequently joined the Rating Fund in January 2005. The Rating Fund 1 was suspended in 2008 and in 2009 the Rating Fund 2 was launched by Multilateral Investment Fund (MIF) of the Inter-American Development Bank and the Andean Development Corporation (ADC) in order to fund ratings in the Latin American region. All funded ratings are available online. For further information see: <http://www.ratingfund2.org/dnn494/EN/Home/tabid/67/Default.aspx>.

<sup>25</sup> In the case of mainstream rating agencies a fifth category for cases where insufficient information has been provided should be added. But as there were no such cases it can be ignored in this study. In case of Planet Rating the letters D and E are both in the fourth category. In case of MicroRate and M-Criil and the application of Greek letters β- has been attached to the third category although all other β-grades were within the second category. This is due to the fact that MicroRate only uses three different letters while looking at the explanation a fourth major category can be established.



Data: Rating Fund I

versus non-co-funded ratings declines. In 2004 nearly 1/3 of all ratings realized within the microfinance sector were co-funded while in 2007 the proportion declined to 1/5 (ADA 2008).

Still, comparing these rating grade assignments with the results of the rating activities of one of the mayor rating agencies specialized on microfinance, the percentages do not vary too much with slightly more assigned grades in the lowest category.

In its 2008 activity report, Planet Rating stated that in 2008, 33% of the MFIs rated have received an “Investment” grade (from A++ to B), while 50.5% received a “Speculative” grade (from B- to C-) and 16.5% were classified as “Technical Assistance Required” (D and E).<sup>26</sup> These numbers do not vary too much considering the previous two years (Planet Rating 2009, p.12).

At this point it is noteworthy that 55 out of 317 MFIs rated within the programme of the Rating Fund I were very good performing MFIs and that most of them (49%) are concentrated in two regions: Eastern Europe and Central Asia as well as Latin America while most MFIs with very low ratings are based in Sub-Saharan Africa.

However, more and more MFIs voluntarily choose to receive a rating for the first time, especially in regions with less mature markets like Africa (ADA 2008, p. 32) thereby increasing transparency and investor’s trust. This might be an indication that in future there will be more (though perhaps not highly profitable) MFIs ready to receive funds.

### ***The legal status of MFIs matters – Microfinance regulation and the transformation of NGOs***

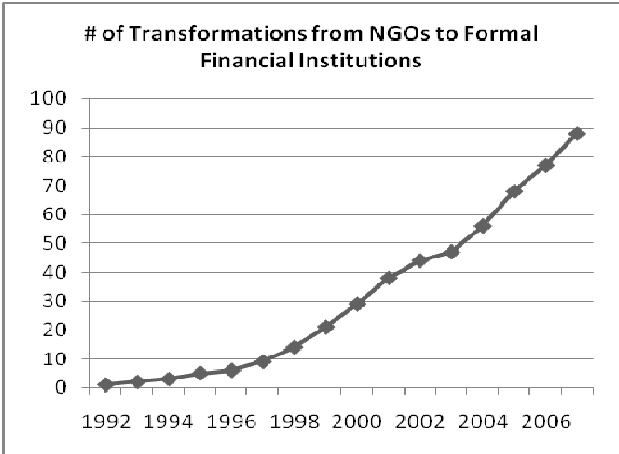
One aspect closely linked to the regulatory framework is the legal status an MFI can choose for its operations. The legal form highly influences the capacity of MFIs to have access to loanable funds as well as to equity (Fernando 2004). In 2008 out of 1075 MFIs 36% were non governmental institutions (NGOs), 31% non bank financial institutions (NBFIs), 17% were credit unions, 7% banks and 7 % rural banks (MIX 2009). This distribution is similar to the years from 2005 to 2007 (based on the data of 487 MFIs) though the percentage for NGOs declined from 45% to 39% and the percentage of NBFIs increased from 29% to 35% respectively. Two explanations are possible for this shifting: a) changes in the distribution as more and more MFIs report to The MIX and b) some NGOs transformed into NBFIs or even banks.

Since the first transformation of an MFI in 1992 (PRODEM into BancoSol in Bolivia) there have been in total 88 MFI transformations into formal financial institutions in 35 countries worldwide (Lauer 2008) until the end of 2007 - with increasing tendency.

Again there is a distinct regional concentration with 31 cases in Latin America, 26 in Eastern Europe and Central Asia, 21 in Asia, 8 in Sub-Saharan Africa and only 2 in Middle East and Northern Africa. Even within the regions there are strong concentrations e.g. for Latin America there were 10 transformations just in

<sup>26</sup> Please note that as Planet Rating is not recognized by any banking supervision authority, the classification of „Investment“ and „Speculative“ grades cannot be compared to the same classification of recognized, mainstream rating agencies.

Peru and six in Bolivia . In Asia transforming MFIs were in India (7) while in Sub-Saharan Africa most transforming MFIs were in Uganda (4). This concentration is also linked to the legal environment in which



Data source: Lauer (2008)

MFIs operate. For example, in Peru all cases took place between 1999 and 2001 just after a law was passed which required NGOs to pay value-added tax on all interest from loans. Thus, EDPYMEs as new regulated credit-only institutions were created. Most Peruvian NGOs transformed into this EDPYMEs (Ebentreich 2005). In Bolivia one of the driving forces was the creation of Private Financial Fund (FFPs) in 1995 which allowed the MFIs to capture deposits (Meagher and al. 2006). In Uganda the need to regulate informal NGO with established deposit taking activities led to the formalisation of Microfinance Deposit-taking Institutions (MDIs) in

2003 (Fiends Consult 2007) while transformations of the above mentioned MFIs took place in the two following years.

In India, some of the major MFIs (among them SKS Microfinance, Share Microfin, Spandana and Bandhan) all transformed into Non Bank Financial Corporations (NBFCs) between 2000 and 2007. These are regulated institutions even though this legal form is not specifically designed for MFIs and there is an ongoing discussion about finding an adequate regulatory environment to facilitate the development of microfinance besides the governmental SHG linking banking model (Srinivasan 2009). Microfinance Institutions are not authorized to capture deposits and taking the legal form of an NBFC helped these for-profit MFIs to gain access to local commercial funding. The fact that local commercial funding for MFIs is available in abundance led to very high levels of MFIs leverage of up to 40% (Srinivasan 2009, p.50) - some stakeholders already start to worry about. The average debt to equity ratio of NBFCs of 9% is three times higher than the MIX average for non bank financial institutions (MIX 2009). Not surprisingly, the call for equity financing rather than debt becomes louder.

**Microfinance business environments – Latin America is the most attractive region of Microfinance Investments**

In 2009 the Economist Intelligence Unit (EIU) together with the Interamerican Development Bank (IDB) the Corporación Andina de Fomento (CAF) and the International Finance Corporation (IFC) launched a pilot study to assess the microfinance business environment of 55 countries worldwide. In the two previous years similar studies for Latin American and the Caribbean have been published

Three major categories (with a total of 13 indicators) have been assessed as crucial for a favourable development of the microfinance sector: 1) the regulatory framework (regulation of microfinance operations, formation and operations of regulated/supervised specialized MFIs, formation and operation of non-regulated MFIs, regulatory and examination capacity), 2) the institutional development of the microfinance industry (range of MFI services, credit bureaus, level of competition) and 3) the investment climate (political stability, capital market stability, judicial system, accounting standards, governance standards, MFI transparency) (EIU 2009). For each indicator a score from 0 to 4 has been assigned with 4 being the best and 0 the worst score. The indicators were then normalized so that each country is scored on a scale between 0 and 100. Even though this study has important shortcomings ( firstly, due to

difficulties to secure sufficient and high quality data on such a broad range and secondly as Latin American countries are over-represented) it still gives a valuable overview about the global distribution of favourable microfinance markets

Regarding regional strength and weaknesses Sub-Saharan Africa has been ranked highest for the legal and regulatory framework as a result of regulators' openness to introducing microfinance specific laws and regulations. Still, considering single countries the best scores (top ten) have been reached by countries from all the continents headed by two South-East-Asian countries<sup>27</sup>. Regarding the investment climate Eastern Europe and Central Asia is the strongest region closely followed by Latin America<sup>28</sup>. As for the institutional development the majority of highly developed institutions are in the South Asian region which has been attributed to its pioneering role in microfinance<sup>29</sup> again closely followed by Latin America and the Caribbean.

Regarding the overall score Latin America and the Caribbean is still the most favourable region which is in line with the analysis of MFIs performance in the previous passages. Even more interesting is the overall score of single countries. The ten countries with the most favourable business environments are: Peru, Bolivia, Philippines, India, Ghana, Ecuador, Nicaragua, Colombia, El Salvador and Uganda. This corresponds to the fact that Peru, Ecuador, Bolivia and Nicaragua are among the top ten countries of the Dexia Microcredit Fund, ResponsAbility Global Microfinance Fund, Oikocredit, BOLD 1, BOMS 1. In addition, India is most important country for the Dexia Microcredit Fund and Oikocredit (Blue Orchard 2010a; Blue Orchard 2010b; Credit Suisse 2010; Oikocredit 2010).

#### **MIVs do not fear a lack of investees; pension funds see it as the major constraint**

Accordingly, the majority of asset managers of MIVs believe that there is not anymore a lack of investees. In addition, due to new investment products the small deal size of microfinance investments is not seen any more as a major obstacle. The issue has been overcome (38%) or is only a minor obstacle (46%). The development of the microfinance sector towards a sustainable industry is clearly identified as a barrier that has been overcome (46% of respondents support this). Yet, a considerable percentage of respondents identify the lack of investment opportunities in sustainable MFIs still as a minor (25%) or as an important (25%) obstacle. Notably no participant thinks this will be an important barrier in the future. Transparency in this relatively new sector is of main importance to identify potential investment opportunities. The issue seems to be mainly overcome, according to the survey results. Participants do not make a difference between transparency at the industry level and transparency at the MFI level, both are viewed as minor obstacles (by 46%) or as barriers that have been overcome (by 25% of participants). This might be the result of increasing transparency set forth by CGAP, the MIX Market as well as specialized microfinance ratings agencies. Nevertheless, one should note that this represents the MIV view. Easy and accessible information might not be available to primary investors. One survey participant added the issue "transparency at the MIV level", which would have been interesting to include in the survey as well.

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<sup>27</sup> The top ten countries for their regulatory framework are: Cambodia, Philippines, Bolivia, Kenya, Kyrgyzstan, Peru, Ghana, Pakistan and Uganda.

<sup>28</sup> The top ten countries for their institutional development are: Bolivia, Peru, Ecuador, India, Nicaragua, Colombia, El Salvador, Guatemala, Honduras and the Philippines. The top ten countries for their investment climate are: Chile, Turkey, Bosnia, Morocco, Panama, Costa Rica, Mexico, Peru, Trinidad and Tobago and Ghana.

However, looking at the conditions for the development of the market size, the survey participants identify further issues: State intervention distorting the competition is seen as an important obstacle by 41% of the participants. Only 4% thinks this has been overcome. The same applies to the barriers regarding local market regulation and the supervisory framework in target countries: While 4% think this is not an issue anymore, 38% (29% respectively) are convinced that it is hindering investments.

Whereas MIV managers still seem to see a high market potential, **pension funds** identify market size as one of the major constraints for further investments. The second most cited concern of pension funds is the “limited size of the microfinance market and its limited capability to absorb large investments” (World Microfinance Forum Geneva 2009, p.6).

#### **4 Investments in Highly Developed Microfinance Markets – Insights from Peru**

In this last section we now turn to the case of Peru in order to further underpin certain arguments developed in the previous sections. As mentioned before, Peru is one of the most attractive countries for microfinance investments.

##### ***Peru is characterized by a very good regulatory and investment environment***

In its “Microscope 2008” issue dedicated solely to the region Latin America and the Caribbean, the EIU characterised Peru as the country with the most microfinance-friendly environment in Latin America (EIU 2008a). The regulatory framework was weighted with 40% of the overall score, the institutional development of the microfinance industry with another 40% and the investment climate with 20% (EIU 2008b). Especially the very high score when evaluating the regulatory environment, which placed Peru in the same position as Bolivia, was highlighted. Already in 2005 Peru was rated high by the World Bank- IMF Financial Sector Assessment Program due to the good reputation of Peru’s principal regulator (Superintendencia de Bancos y Seguros, SBS). Microfinance specific regulations have been developed, such as loan-loss provisioning based on loan status rather than institutional type. Furthermore, stringent requirements for internal MFIs controls and on-site inspection procedures have been increasingly applied (Ebentreich 2005). The adoption by SBS of the Legislative Decree 1028 in June 2008 aims at facilitating the access of regulated MFIs to local capital markets and enables non-bank MFIs to engage in a series of financial operations previously restricted to banks (e.g. trading stocks and bonds) (EIU 2008a, p.48).

The latter also influences the raise of Peru’s investment climate. In this category also broader indicators, not necessarily related to microfinance are assessed. The relative high score which places Peru in the 5<sup>th</sup> position of all Latin American countries is also supported by the raise of Peru’s sovereign rating of two major rating agencies to the investment grade category in 2008 due to the countries decline in fiscal and external vulnerabilities (Lesova 2008b). Especially the first upgrade by Fitch in April 2008 created enthusiasm among financiers as the stock market was expected to boost, private investment to increase while Peru’s financial channels were supposed to improve (Lesova 2008a).

Also taking a look at some of the largest MIVs confirms the important role Peru plays for investors: Since its inception in 2004, the ResponsAbility Global Microfinance Fund has invested the largest portion of its capital in Peru. For Oikocredit Peru is the third most important country in terms of outstanding portfolio. Regarding the portfolio of BOMS 1, BOLD 1 and the Dexia Microcredit Fund, managed by Blue Orchard, Peru is among the top ten countries (Blue Orchard 2010a; Blue Orchard 2010b; Credit Suisse 2010; Oikocredit 2010).



As for the institutional development of the microfinance industry, Peru is placed 3<sup>rd</sup> right after Ecuador and Bolivia. According to COPEME (2009) in June 2009 there were 39 regulated financial institutions dedicated to microfinance: 1 bank (MiBanco), 2 finance companies (Edyficar and CredScotia), 13 Cajas Municipales de Ahorro y Crédito (CMACs), 10 Cajas Rurales (CRACs) and 13 Entidades de Desarrollo de la Pequeña y Microempresa (EDPYMEs). Furthermore there are 161 cooperatives (out of which 8 have an important orientation towards microfinance) and 16 NGOs offering microfinance services. Since two EDPYMEs transformed into finance companies (financieras) in the course of 2009 (Crear and Confianza) at present there are 4 finance companies and 11 EDPYMEs.

***There is a distinct concentration of assets deployed in the microfinance sector***

The difference of the various legal forms concerns primarily the product range the institutions are allowed to offer. Especially the allowance to offer savings products is reserved to banks, finance companies, CMACs and CRACs and cooperatives while EDPYMEs and NGOs are credit-only institutions. But also the sizes of the institutions differ considerably. In 2008, 60 MFIs reported to The MIX, and the microfinance bank MiBanco can be clearly identified as the individual market leader on a national scale with 20% of total assets in the sector. The group of CMACs held 45% of total assets, yet, with significant differences between one CMAC and another. Four CMACs (Piura, Trujillo, Arequipa and Sullana) held 64% of total assets within this group. Therefore it was mentioned by different stakeholders that MiBanco was indeed the national market leader but CMACs often held the first position within their respective region. In 2008 CMACs were allowed to operate on a national scale for the first time and some of them hope to gain market share at a national scale in the near future. Another important player in the microfinance industry is Crediscotia which was created when Scotiabank bought Banco del Trabajo in July 2008 within its downscaling strategy to attend the microfinance segment. Furthermore, in 2009 Banco del Crédito bought EDPYME Edyficar – the leading institution within this sub-group – and converted it into Financiera Edyficar. The following table provides an overview about the market shares by institution type and further details for the most important MFIs:

	% of Total Assets		% of Active Borrowers		% of Deposits	
MiBanco	19.94%	19.94%	14.39%	14.39%	21.74%	21.74%
Crediscotia	9.21%	17.48%	19.21%	34.86%	12.19%	12.41%
Financiera Edyficar	4.65%		6.83%		0.22%	
Rest Financieras	3.62%		8.82%		0.00%	
CMAC Arequipa	7.87%	44.91%	5.71%	29.45%	8.58%	54.29%
CMAC Piura	8.11%		4.67%		10.60%	
CMAC Sullana	4.78%		2.84%		5.86%	
CMAC Trujillo	8.01%		4.65%		9.81%	
Rest CMACs	16.14%		11.58%		19.44%	
CRACs	6.85%	6.85%	6.04%	6.04%	7.52%	7.52%
EDPYMEs	5.31%	5.31%	9.94%	9.94%	0.00%	0.00%
COOPACs	3.56%	3.56%	3.32%	3.32%	4.04%	4.04%
NGOs	1.98%	1.98%	6.64%	6.64%	0.00%	0.00%
Total	100%	100%	100%	100%	100%	100%

Source: The Mix, own elaboration

A specific feature in the Peruvian microfinance market compared to many other countries is that deposits account for an important funding source for major MFIs. While the world's average of the ratio of deposits to outstanding loans is 46% (Chen, Rasmusen *et al.* 2010, p.3) in Peru it is 67%. Especially the CMACs – based on the business model of German savings banks – keep this percentage high. The biggest CMAC (Piura) has a ratio of deposits to outstanding loans of 90%. But also MiBanco as the largest MFI has a ratio of 74%. This has also consequences regarding the willingness to absorb international investments under given conditions.

### ***Funding through local capital markets of major MFIs will increase***

Taking MiBanco for instance, the most important lenders are bilateral public entities (IFC, Instituto de Crédito Oficial de España, FMO) with 79% of outstanding borrowings by the end of 2008 (Ernst&Young 2009). The duration of these loans are up to 10 years (IFC and Instituto Nacional de Crédito de España). This level of maturity was only offered by one of the private international MIVs (Triodos Fair Share Fund). MiBanco furthermore received loans from international commercial banks with durations between one and two years. While the costs of these funds were not disclosed, the interest rates applied for national funds (of development banks as well as commercial banks) varied between 6.15% and 9.65%. In order to diversify the sources of funding, an increasingly used instrument is also the issuance of corporate bonds. MiBanco issued its first bonds in 2005 with a total value of 30 Mio. Nuevos Soles (~ USD 9.5 million <sup>30</sup>) followed by three more issuances until 2009 of the same amount. The interest rate of these bond issuances varied from 5.94% to 7.38%, thus the interest rate is up to 2% lower than for national debt.

Funding through bonds can be much cheaper especially with medium-term maturities (here between 2 and 4 years) as exemplified by Financiera Edyficar. The average interest rates of bonds placed at the local stock market was 7% (for 2 years) while the interest rate for important borrowings from international MIVs varied mostly between 8% and 10% while the highest interest rate (due in 2015) was 12.85% (PriceWaterhouseCoopers 2009).

Crediscotia received its first allowance for bond issuance in 2008 and placed those in 2009. CMAC Arequipa got the allowance to place deposit certificates with a maturity of one year in 2009 and is now waiting for a good moment for the issuance. Other CMACs plan to issue deposit certificates in the long run as well. According to representatives from CONASEV – the regulatory body for stock exchange – the local capital market is welcoming new investment opportunities and they expect more and more MFIs to follow these examples. Refinancing through local capital markets is also envisaged by at least one of the lately transformed financieras. Two major advantages are considered to be linked to refinancing through local capital markets. First of all, international debt often contains an exchange risk which can be mitigated with a stronger reliance on local markets. Secondly, local capital is cheaper than international debt and often cheaper than deposit taking.

### ***MFIs are searching for a suitable refinancing mix. The significance of deposit taking will increase***

Taking the CMAC Arequipa as an example the interest rates for deposits vary between 1.20% and 12.00% (JAU 2009, p.22). While interest rates for demand deposits (ahorros) are usually very low, the interest rates for fixed deposits (depósitos a plazo) are high. The majority of deposits (~85% by end of 2008) are fixed deposits. Long-term fixed deposits of over one year even reach share of 13%, for which the highest interest rates usually has to be paid. Therefore, it was stated that for CMAC Arequipa the right funding

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<sup>30</sup> Exchange rate as of 31 December 2008: 1 Nuevo Sol = 0.31526 USD

mix was crucial for the future development. Still, it was stressed that the deposit ratio should not decrease. Instead, measures will have to be taken to bring down the interest rates for fixed deposits. The reason mentioned by one of the MFIs for relatively high interest rates compared to commercial banks was the relatively higher risk as perceived by depositors to hold their deposits with an MFI. The latter is also reflected through the lower credit risk ratings of the four rating agencies recognized by the Peruvian authorities. For example, in 2006 the highest grade reached within the subgroup of CMACs was B+ (Piura, Trujillo, Arequipa). The worst grade received by a bank was A- (Banco Financiero) while most of the banks reached A (e.g. Citibank, COFIDE, Internbank and MiBanco) or the highest grade A+ (Banco de Crédito, BBVA Banco Continental).<sup>31</sup> This becomes especially important concerning institutional depositors (e.g. local governmental organisations). Furthermore it was stressed that higher interest has to be paid also due to the limited product range the CMAC Arequipa is still offering in order to hold clients with more sophisticated financing needs. Therefore the CMACs would have to broaden their product range and also offer factoring and leasing for example.

However, unlike the CMACs which also (if not mostly) serve relatively better-off depositors the newly transformed financieras target mainly their current clientele – most of them individual small-scale savers. In these cases the refinancing costs are expected to sink considerably. But not only might the costs decrease due to interest payments. In December 2008 EDPYME Crear Arequipa (now Financiera Crear) had investment relationships with 6 national investors (commercial banks and governmental development entities/funds) and 14 different international investors (19 if 2007 is considered as well). The average outstanding debt balance from international investors was 13,866,000 Nuevos Soles (~ USD 4.5 million) with a maximum amount of 15,860,000 Nuevos Soles (~ USD 5 million). The interest rate for international debt mostly varied between 9% and 11%. Searching, setting up, monitoring and reporting about so many different financing relationships also imply high transaction costs for an MFI. In case that the application of funds is earmarked – as it is often the case for MIVs – the obligations of documentation and thus transaction costs further increase.

Besides the lowering of funding costs, the motive to offer savings products to their clients for the two newly transformed financieras was also to offer a wider product range as a precondition to satisfy clients' needs and thus stay competitive. Financiera Confianza even plans to further transform into a bank. However, it was mentioned that strong alliances, mergers and/or the entrance of strong shareholders (as happened with EDPYME Edyficar) were necessary for the next steps. At least one other EDPYME stated that it had plans to transform into financiera in the medium-term and it seems likely that others will follow the examples in the long run.

***Microfinance NGOs depend mostly on international investments. Still, sums in absolute terms are rather small***

NGOs instead seemed mostly resilient to transformation. Only one NGO mentioned that it planned to transform into EDPYME and further into financiera in the long-run. Still, a precondition would be that shareholders with clear social objectives could be found. NGOs fear of mission drift when converting into a for-profit entity seemed high. Some of the NGO-MFIs are part of a bigger development NGO (e.g. ADRA Peru and Manuela Ramos). They stated that even if self-sustainability was very important for them, becoming a leading microfinance institution at a national scale was not part of their vision. The latter was instead envisaged by most of the financieras, CMACs, CRACs and EDPYMEs. Regarding their funding

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<sup>31</sup> A database with the rating grades from 2000 to 2006 obtained by financial institutions was provided by SBS.

sources, NGOs very much depended on international investments. For example, the Cusco-based NGO Asociación Arariwa refinanced itself with a percentage of 91% through international MIVs with an average interest rate of 8.6% (Alfonso Munoz & Asociados 2009, p.17). In comparison, only 6% of the liabilities of CMAC Arequipa were compound of international debt (JAU 2009, p.3,24) with an average interest rate of 6.5%. Still, in absolute terms, the sum of international debt was almost four times higher than for Asociación Arariwa (15.5 Mio Nuevos Soles versus 60 Mio Nuevos Soles; ~ USD 5.4 million versus ~ USD 21 million). Asociación Arariwa was with 9.1% of total assets of all NGOs in the fifth place within this sub-group.

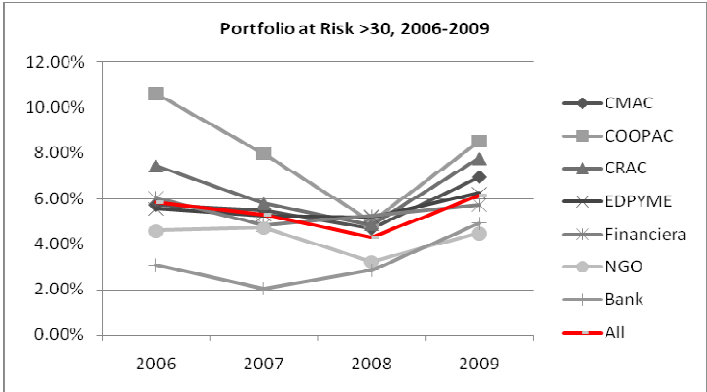
**National banks start to serve as second tier lenders**

Another funding source which will gain importance in the future is debt financing through local banks. In 2006 a revolving fund of 200 Mio. Nuevos Soles was set up by the state-owned bank Banco de la Nación to support micro entrepreneurs through MFIs. Currently Banco de la Nación works with 22 regulated MFIs and discussions on raising the funding resources have already begun.

At the same time, the Banco de Crédito has established credit lines with several MFIs even though a guarantee of 100% is still necessary to qualify. Thus, Banco de Crédito transfers the credit risk to a third party. However, as the microfinance sector gains importance and recognition as a sustainable and profitable business and as traditional business segments of commercial banks turn out to be less and less profitable Banco de Crédito already started internal discussions on loosening these strict guarantee policies.

**Increasing competition makes a consolidation of the microfinance sector necessary**

An increasing interest of commercial banks in microfinance is also indicated by a)

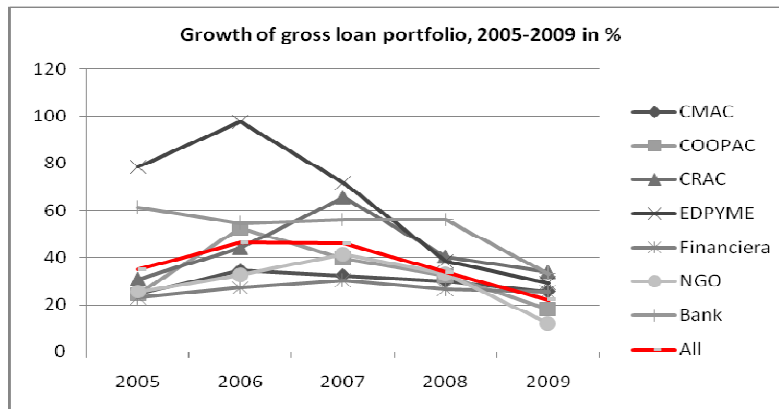


Source: The MIX, based on the data of 38 MFIs

b) the acquisition of specialized MFIs (Crediscotia and EDPYME Edificar and b) their direct entrance into microfinance, mostly the SME segment. The result is an ongoing commercialisation and an increasing competition within the microfinance sector. The allowance for CMACs to operate on a national scale furthermore increased competition especially in highly developed microfinance regions. As a result the problem of cross-indebtedness of clients appeared. While Peru did not

suffer too much with the global economic crisis some MFIs still stated that clients were indeed affected and thus, portfolio quality worsened. Still, it was highlighted that the first reason for portfolio deterioration especially within the course of 2008 was the practice of multiple borrowing and increasing indebtedness among microfinance clients.

As a consequence many MFIs pointed out, that ambitious growth rate regarding microfinance clients and loan portfolio had to be corrected. In May 2010 CGAP claimed that between 2004 and 2008, the average compounded growth rate of MFIs reporting to The Mix was 43% (Latorture 2010). Portfolio growth of Peruvian MFIs reached these levels in 2006 and 2007, while in 2008 growth started to slow down. In 2009 the compounded growth rate of gross loan portfolio was 22% (based on the data of 38 MFIs).



Source: The MIX, based on the data of 38 MFIs

While all MFIs felt the effects of increasing competition, especially the regulated entities stated that a consolidation within the microfinance sector was necessary. This will not only result in lower growth rates but also in the creation of strategic alliances and mergers between MFIs or the further acquisition of smaller entities by bigger players. Furthermore some MFIs try to adjust to the changing

environment by “mainstreaming” their management. For example, two of the interviewed MFIs hired upper management members from the commercial banking sector in 2009 and 2010. However, proper staffing on lower levels was a still problem – especially for CMACs as public entities where 100% of share capital is in the hands of the respective community. It was mentioned, that MFIs often could not pay competitive salaries and that trained staff was enticed away by commercial banks.

***Product diversification and rural outreach are seen as the answers to increasing competition.***

Finally, MFIs also stated that they had to further diversify their product range as well as enter into new market segments. Offering savings products was seen by some MFIs as a client retention mechanism as well as a mean to ensure that clients repay their loans. Clients with credit at various institutions were expected to pay back first to those MFIs they saved with. But also reaching out into untapped markets – mainly in rural areas – was mentioned as important in order to ensure future growth. However, most of the regulated for-profit MFIs avoid actual agriculture finance as it is seen as little profitable and extremely risky. The latter is also due to the absence of proper insurance mechanisms already available in other parts of the world (such as index based crop insurance) as well as due to the regional concentration of many MFIs. For example, in early 2010 one of the NGOs suffered heavy losses because of flooding in the area of Cusco. Furthermore, Peru is periodically hit by El Niño, which makes such losses more probable also in the coastal regions. In the early 2000s many CRACs suffered heavy losses in their rural portfolio and consequently withdrew from these markets in the following years.

Still, MFIs plan to achieve outreach starting with targeting entrepreneurs who (partly) dedicate themselves to the breeding of small animals (e.g. guinea pigs). In order to ensure efficiency while reaching out to more marginalised costumers, one CMAC in 2009 even introduced group lending mechanisms – though traditionally CMACs only offer individual loans. However, only one MFI stated to have clearly defined strategic objectives towards agricultural finance. In 2008 the Spanish foundation BBVA Microfinanzas bought three MFIs (Caja Rural de Ahorro y Crédito Nor Perú, la Caja Rural de Ahorro y Crédito del Sur, y Edpyme Crear Tacna) and created the CRAC Nuestra Gente. By end 2008 CRAC Nuestra Gente hold 3.4% of total assets of the sector while BBVA was with 96.7% the major shareholder. As part of the policies of Corporate Social Responsibility of the bank BBVA the foundation aims at increasing outreach majorly through agricultural finance and instructed the management of CRAC Nuestra Gente to create an integrated approach of financing and production promotion. Since then CRAC Nuestra Gente cooperates with other organizations in the field of agricultural production. However no short-term profits

are expected from this business line even though the self-sustainability of the overall institution should not be in peril.

## **5 Conclusion**

As the microfinance industry matured, the commercial approach became widely accepted, more and more microfinance institutions (MFIs) became self-sustainable and the transparency within the sector increased considerably. Accordingly, investments in microfinance especially of private Microfinance Investment Vehicles driven foremost by private investors grew at a significant scale in the last five years. Returns of MIVs reached moderate, but acceptable levels compared to standard money market indices, showing low volatility so far. Moreover, in past economic crises in Asia and Latin America MFIs appeared to be less vulnerable to market risks than commercial banks or other large industries. Also in the current economic crisis many MFIs continue to grow even though at lower rates. Bankruptcies of MFIs are rare in general and no case is known for being caused explicitly by the economic crisis. Thus, microfinance shows to be an attractive anti-cyclical investment opportunity for portfolio diversification. First efforts to benchmark microfinance investments with other asset classes – as a precondition for being recognized by mainstream investors – have been made. Also, further steps towards increasing professionalism among MIVs can be observed making use of structured finance mechanisms since 2004 and registered mutual funds which might help mainstream investors to better cope with risks linked to microfinance, especially in regard to investments beyond corporate social responsibility strategies. The MIVs offer investors to enter the market with larger volumes. The general increasing demand for socially responsible investments might also help to lift microfinance into a position of broader recognition. Thus, there are many indicators in favor of microfinance converting into a mainstream asset class.

However, microfinance as a social investment not only creates new opportunities: Threats and upcoming debates on irresponsible business practices, mission drift and limited impact reveal the vulnerability of the industry's reputation. And reputation is seen incrementally as a valuable and highly prized asset. This especially applies to social investments. Efforts to find common social standards and to increase transparency in this field are increasingly on the rise but they are not yet sufficiently developed. As microfinance is competing with other socially, ethically or environmentally friendly investment opportunities this could turn out to be a race against time. Furthermore, the options for mainstream microfinance investors are still limited, as investments are highly concentrated on the five largest MIVs. This is also related to the regulation of primary countries where changes are needed to allow the set up and public distribution of mutual funds. There is still much uncertainty about risk profiles for the financial performance of MFIs and it seems that specific risks linked to microfinance have been underestimated in the past. A high concentration of investments at a country level exists, which also increases the exposure to systematic (market) risks, a fact some mainstream investors might be little aware of at present. The concentration on the country level also increases the exposure to the systemic risks specific to microfinance, which has been revealed by the current crisis of over-indebtedness in four countries. The market concentration is also high regarding the investees: Although there are many (sustainable) MFIs in absolute terms, the number of MFIs with attractive portfolio sizes and promising high returns is limited, reducing the possibility for MIVs to invest in a variety of different MFIs. Regarding the development of the number of countries and MFIs ready to absorb investments it can be observed that changes in countries' regulatory framework and business environment as well as internal processes of MFIs to become more professional are costly and longsome. This is unlikely to change in the future which makes it difficult for

MIVs to substantially increase the number of countries in their portfolio and which is hindering high number of MFIs to rapidly grow and thus become potential investees for large investment sizes. .

The limitations for further high growth rate of microfinance investments have been shown with the case of Peru: In Peru, an example of a more developed microfinance market – which are at the same time the most attractive ones for investors – the need for consolidation and the search for ways to enter into new market segments has been identified and growth plans have been corrected downwards. At the same time, local investments are gaining importance especially deposits but also refinancing through local capital markets and increasingly through interbank lending – at least for the case of Peru. This fact, as well as the increasing competition between MIVs, might lead to decreasing returns. MIVs might be forced to invest in less profitable and smaller MFIs and operational costs might increase. The increasing need of equity rather than debt will force investors to assume higher risks especially as trade of MFI shares at stock markets is still underdeveloped.

These findings paint a rather ambiguous picture in favor and against the development of microfinance into a mainstream asset class – at least in the near future. Regarding the investor side, the performance during the current crisis will be a test, crucial for the entrance of increased mainstream investments. In addition, further research is needed concerning the specific risks of microfinance as well as the competitiveness of MIV investments compared to other upcoming funding options for MFIs. The prospects for the evolvement of new profitable or sustainable large MFIs seem rather bad, which limits investment opportunities in a highly concentrated market. Hence, CGAP's rather intuitive argumentation seems plausible that "MIVs may need new investment approaches, such as expanding to new markets (e.g. Africa and Asia), funding in local currency, taking equity positions, or reaching beyond the top tier MFIs." (CGAP 2010).

Regarding the impact of international microfinance investments on MFIs and their clients it will be interesting to see if MFIs can translate increasing resources into a primary access to financial services for unbanked clients – including the ones in remote, rural areas – or if the competition among MFIs for existing clients will further intensify. Increasing outreach of the sector versus increasing (over-) indebtedness of clients would be the simplified extremes – with far-reaching consequences. As it is a high challenge for MFIs to quickly increase the client base in untapped, e.g. rural areas, it will be crucial for microfinance investments that the number of potential investees increases and MIVs reach beyond the "investment darlings". If a considerable number of "next generation" Tier 2 / Tier 3 MFIs graduates to Tier 1 MFIs and achieves to attract mainstream investment, MIVs will have more investment options and better growth prospects, hence attract more mainstream capital, while the supply of financial services to the poor could be substantially increased. On the other hand, if microfinance fails to become a mainstream asset class, many MFIs might stay depended on donor money with limited outreach. Others might further discover client's savings as a viable funding base. The latter – though at a slower pace – would not only offer MFIs to tap a more stable finance source but also provide solutions to urgent financial needs of the poor. The lessons learned from the current and future economic downturns may reveal if this does not turn out to be an even more attractive option for MFIs and their clients.

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