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WHAT BALANCE BETWEEN FINANCIAL SUSTAINABILITY AND SOCIAL ISSUES IN THE MICROFINANCE SECTOR?

What are the best practices for financial management and governance? What priorities must MFIs set in order to maintain their social mission?
This issue compares experts' views on the topic.

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Editorial

By Luc Rigouzzo, ***Chief Executive Officer of Proparco***

Building on the success of the second issue of Private Sector and Development, *which covered the topic of access to water, Proparco has chosen to devote this issue to the challenges facing the microfinance sector today.*

The overarching virtue of microfinance is that in recent years it has managed to demonstrate that it is not only possible and necessary to implement services tailored to the poorest – it can also be profitable. Indeed, to quote the "Bottom of the Pyramid" concept coined by the economists S.L. Hart and C.K. Prahalad, moving into the market of low-income populations – and serving them – may constitute "the biggest business opportunity in the history of commerce" and at the same time helps combat poverty. Microfinance would seem to embody this concept. Although it may lead to higher costs in order to reach the poorest borrowers, this can be offset by the profitability of the investments financed.

The microfinance sector has also often proven more "resilient" than the banking sector, particularly in crisis countries – this is, for instance, the case in the Democratic Republic of Congo. However, the current crisis has brought several systemic weaknesses in the sector to the fore and underscored the need to consolidate fundamentals, strengthen sector regulation and better control microfinance institutions' (MFIs) quest for growth and profitability. Without these improvements, there is a real risk of client overindebtedness and the sector will develop at the expense of its poverty reduction targets.

I would like to extend my warmest thanks to each of our authors for their contributions which not only have the merit of challenging certain conventional beliefs – they also question the roles and strategies of all sector players. As they demonstrate, the financial capacity of investors with "social motivations" no longer suffices to meet the considerable financing needs of MFIs which are estimated at 200 billion dollars in the long term.

New sources of financing are therefore essential and private investors will certainly be playing a key role in the sector by providing the funds MFIs need to pursue their growth. However, private players must remain aware of their responsibilities and they must be regulated in order to ensure that the social vocation of this poverty reduction tool is maintained. It has now become essential to consolidate supervision and develop impact measurement. This will provide a framework for all activities in the sector and allow it to make the required adaptations, while preserving the capacity to innovate that is a cornerstone of the sector since its beginnings.

I hope you enjoy reading this issue.

WHAT BALANCE BETWEEN FINANCIAL SUSTAINABILITY AND SOCIAL ISSUES IN THE MICROFINANCE SECTOR?

The Agence française de développement (AFD) has been supporting a large number of microfinance institutions since 1990. FINCA Perú is a non-profit association that successfully combines additional non-financial services with its microfinance loan activity. In this article, Philippe Serres (AFD) and Iris Lanao Flores (FINCA Perú) analyze the impact this diversification of services has had on profitability, after comparing the different management methods of microfinance institutions.

Microfinance and non-financial services: an impossible marriage?

Microfinance institutions (MFIs) can - in addition to their classic products - develop non-financial services: vocational training, technical assistance, agricultural or health education. The comparative assessment of five Latin American MFIs (including FINCA Peru) shows that performance varies depending on how non-financial services are integrated into usual activities, but that this diversification is possible and even seems to make a great improvement to the quality of the portfolio. However, the choice of the integration model ("linked", "parallel" or "unified") and its implementation must be carefully tailored to the context.

By Iris Lanao Flores, ***CEO of FINCA Peru,***
and Philippe Serres, ***Project Officer at Agence française de développement***

Like many other development instruments, microfinance has generated various debates about its capacity to fight poverty. Many practitioners argue that microfinance *per se* needs to be combined with other actions to effectively improve the living conditions of its beneficiaries. Based on this principle, a number of microfinance institutions (MFIs) with a strong pro-poor positioning promoted the idea of comprehensive microfinance services (Hickson, 1999). Under this approach, MFIs provide beneficiaries with financial services (credit, savings, insurance) along with non-financial services (primarily education, but also health services, practical training, and technical assistance). These aim at improving the borrowers' capacities to develop sustainable income-generating activities.

This approach has been challenged by other practitioners. Arguments include MFIs' lack of skills or lack of a mandate to provide non-financial services. Such services may divert the attention away from the financial services and send contradicting messages to clients (especially if they are free of charge). Non-financial services may also impede MFIs' ability to reach financial self-sufficiency, as they generate high costs that add to the already expensive microfinance operations.

However, some successful models, including CRECER in Bolivia, the Pro Mujer network in Latin America, FINCA Peru, BRAC Bangladesh and ASA India, show that institutions can be sustainable while combining financial and non-financial services in highly competitive environments. What is the real impact of non-financial services on MFIs' performance, especially their financial and operational results? This article will briefly address these issues through a review of the existing delivery models, a performance benchmarking exercise based on Latin American MFIs, an attempt to identify the performance factors and a focus on one particular provider that puts the double bottom line high on the agenda: FINCA Peru.

Various models, various results

There are three main models of integration of non-financial services with microfinance, leading to different results in terms of performance and management: the linked, the parallel and the unified models. In the linked model, services are provided by two independent organizations. The MFI does not directly provide non-financial services but establishes a partnership with another entity to do so. This may be very appropriate for schemes including specialized non-financial skills that cannot be found within the MFI, like health services or technical assistance for agriculture. This model also allows to know the exact cost of non-financial services and to decide how to better handle it. However, one of its weaknesses is that the MFI has little control on the quality of its partner's services.

The parallel model is often applied by multiservice organizations, as opposed to fully-fledged MFIs. Here, financial and non-financial services are offered by the same organization under different programs and are managed by separate, specialized personnel who share the same brand. For example, FUNDAP in Guatemala, or Interactuar in Colombia, have strong training and microcredit programs, provided by different departments to clients who are not necessarily beneficiaries of both services. This model allows to employ spe-

[1] *www.freedomfromhunger.org*
[2] *The MIX is the leading provider of business information and data services for the microfinance industry (www.themix.org).*

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cialized staff and to have direct control on each program. However, managing each program separately generates a significant financial and administrative burden on the organization. Also, the comprehensive approach is not really implemented since financial and non-financial services are offered to different beneficiaries.

The unified model seeks complementarity between financial and non-financial services by embedding them in a hybrid product to be provided by the same staff. In this scheme, unlike the two other models, non-financial services are generally compulsory for the beneficiary of financial services. Services usually involve education activities, which occur during regular group meetings. A well-known example is the *Credit with Education* model developed by Freedom From Hunger[1]. It is based upon a village banking methodology, whereby groups of 15 to 25 women meet every week to receive financial services from a loan officer, who then gives a 10 to 20 minutes education session on issues such as health, nutrition, business and financial literacy. If well integrated, this model can be cheaper for MFIs than the two others: apart from management costs (for training materials, training of trainers, etc.) it only requires extra time at the end of each meeting. However, measuring this extra cost is challenging, since all services are provided by the same staff.

Looking at the numbers

The table below compares the performance of five major Latin American MFIs with a strong non-financial services component to peer groups in Latin America and throughout the world reported by The Microfinance Information Exchange (The MIX)[2].

The five non-financial service MFIs analyzed report diverse operating expense ratios, ranging from 21% to 58%, but always higher than their peers in Latin America (19.5%). The larger non-financial service MFIs (CRECER, Pro Mujer Bolivia, Pro Mujer Peru) have an operating expense ratio quite similar to that of MFIs using the village banking methodology (25.4%). However, the smaller FINCA Peru and Pro Mujer Nicaragua have a much higher operating expense ratio than MFIs using the village banking methodology (48.3% and 38.0% respectively). Given that the MFIs using the village banking methodology have a small outstanding portfolio (3.8 M USD), quite comparable to the outstanding portfolio of FINCA Peru (2.7 M USD) and Pro Mujer Nicaragua (5.1 M USD), one can state that overall, MFIs providing non-financial services face a heavier cost structure. Some studies have intended to look closer at the cost of non-financial products. Freedom From Hunger has made an interesting valuation of the extra cost of the Credit with Education model (Dickey *et alii*, 1999). The study shows that this extra cost is less than 10% of the total costs of the MFI, with lower cost rates as the program matures.

In order to cover the costs of delivering non-financial services, MFIs tend to charge higher interest rates. Indeed, the five non-financial service MFIs boast a higher yield on portfolio (good estimate of their actual interest rate) than their peer groups. Consequently, they report solid profitability ratios, with a ROA ranging from 6% to 16%, while the ROAs of their peers do not exceed 2%. Such strong profitability may mean that these MFIs want to self-finance themselves, since it is particularly difficult for them, at least initially, to negotiate loans from local commercial banks. They initiate operations as NGOs and their evolution from a grants-based structure to a commercial funds-based structure is often problematic. In any case, such high profitability raises the question of the right balance between the delivery of non-financial services and interest rates. Are clients really ready to pay more for non-financial services? If not, are they given the chance not to pay for non-financial services?

In terms of operational performance, non-financial services MFIs clearly have a much better portfolio quality than their peers. With the remarkable exception of Pro Mujer Nicaragua, which has suffered from the 2008 crisis of the microfinance sector in Nicaragua, all non-financial service MFIs show an excellent portfolio quality, with portfolios at risk at 30 days (PAR 30) lower than 1%. As a reference, the peer groups have all a PAR 30 higher than 2.0%.

What lies behind good financial and operational performance?

As a whole, the analysis of different MFIs' performances shows that sustainability and delivery of non-financial services are not incompatible: they may generate higher operating costs, but these are compensated by higher portfolio yields. The cost of non-financial services will be highly dependent on how streamlined they are with the regular fi-

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Philippe Serres is a Microfinance Investment Officer at AFD and has ten years of experience in development and microfinance. After a short experience in the British NGO ActionAid, he worked for two years at the European Commission Delegation in Peru as a project officer. Back to Europe, he worked for six years in the microfinance rating agency Planet Rating as Network Director. Philippe has conducted more than 50 ratings of MFIs throughout the world. He joined AFD in 2008. Philippe graduated from the Institute of Political Studies of Paris (Sciences-Po) and holds a Masters Degree in Development Studies from the London School of Economics

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nancial services of the institution. In that sense the unified model seems more cost-effective. For MFIs that are starting a program of this nature, the initial costs of training staff, of bringing technical assistance to implement the model and of integrating the courses within the meetings, will be much higher than for institutions where the non-financial services are already a fully-fledged component of the operational structure. The case of CRECER, one of the oldest Credit with Education programs, with diminishing operating costs and education representing only 7% of its total costs, is emblematic.

Regarding portfolio quality, a number of factors explain why MFIs proposing non-financial services show relatively good results:
• Portfolio monitoring is very tight, involving regular weekly or bi-weekly meetings with the loan officers, during which both financial and non-financial services are delivered.
• Eligibility for credit services of each borrower is based on community selection. Peer pressure is exercised all along the credit cycle to ensure repayments, and in some cases it can lead to the exclusion of defaulting borrowers.
• Health, business and financial education services improve the living conditions of clients, hence their capacity to repay loans and access other financial services.
• Non-financial services can lead to increased loyalty of clients.

Overall, the review suggests that implementing non-financial services along with typical microfinance services is possible and can even lead to sustainability, good portfolio quality, while achieving the primary goal of fighting against poverty. Choosing the right delivery model, integrating it in the most cost-effective way with financial products, adjusting pricing and training staff are prerequisites for a successful comprehensive scheme. All MFIs may not be interested in developing non-financial products. But those which support this approach have a legitimate reason to do it as long as they respect some basic implementation rules. ●

The case of FINCA Peru

Today, FINCA Peru serves 12,276 clients with a loan portfolio of 2.7 M USD and is particularly active in the least developed regions of Peru. It is a small but very reputable MFI in the country, with a strong commitment to serving poor populations by providing microfinance and social services.

Since its inception in 1993, FINCA Peru has promoted a range of social services along with credit, to suit each type of clients. FINCA Peru was the pioneer in Peru of the village banking methodology, educating women, strengthening links among them and promoting savings mobilization. Non-financial services embedded in microfinance include personal development, leadership skills, financial and social literacy and health.

Education is the key element of FINCA Peru's non-financial services, and aims at turning people into actors of their own development. Training sessions range from the explanation of the loan product characteristics to the means of improving small businesses.

Non-financial services also increase clients' loyalty. Healthy and educated clients are more willing to repay their loans, even when interest rates are higher. As of December 2008, FINCA Peru's retention rate is 72.6% and its PAR 30 has always been under 1%.

Owing to the social, geographical and business diversity of FINCA Peru's clients, the institution has entered partnerships to develop tailored solutions for specific financial and social requirements. This approach avoids the time and monetary costs of developing specific in-house expertise. Indeed, establishing alliances has allowed FINCA Peru to leverage the knowledge and experience of other organizations. For instance, FINCA Peru co-operates with public and private organizations on health training programs, which are conducted by health care professionals, while loan officers provide adequate information on preventive health measures to their clients. Similarly, through alliances with specialized partners in agriculture, FINCA Peru was able to offer both financial and non-financial services to small farmers that required both working capital and technical assistance.

Partnerships with market studies and/or research organizations have also enabled impact studies on non-financial products that are both difficult and expensive to perform for FINCA Peru.

MFIs offering non-financial services can also lever their geographic positioning and the possibility to run community group meetings in order to build stronger communities and thereby enhance the self-esteem of vulnerable borrowers. As such FINCA Peru can be considered as a developer of stronger local communities, which are then able to establish links with other communities without external assistance.

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Benchmarking on Latin American MFIs providing non-financial services

Institutions	*CRECER Bolivia 2008**	*Pro Mujer Bolivia 2008**	*Pro Mujer Nicaragua 2008**	*Pro Mujer Peru 2008**	*FINCA Peru 2008**	*Latin America 2007***	*Village Banking 2007****	*All MFIs 2007****
Financial products	Village Banking	Village Banking	Village Banking	Village Banking	Village Banking, group lending	NA	NA	NA
Non-financial products	Training on business, health and personal development	Health assistance, training on business development and sanitation	Health assistance, training on business development and sanitation	Health assistance, training on business development and sanitation	Training on business development	NA	NA	NA
Outstanding portfolio (USD)	37,143,879	27,812,930	5,109,398	12,964,008	2,745,594	6,638,122	3,861,404	6,897,451
Number of borrowers	100,387	87,626	26,365	49,308	12,276	11,682	17,694	11,041
Average loan outstanding per borrower (USD)	370	317	194	263	224	743	186	520
Yield on portfolio	38.6%	37.2%	47.5%	51.0%	66.5%	31.7%	32.9%	29.9%
Operating expense ratio (Operating expenses/ outstanding portfolio)	21.5%	22.5%	38.0%	25.8%	48.3%	19.5%	25.4%	19.2%
Loan officers productivity (active borrowers/loan officer)	480	440	463	394	261	230	277	209
Portfolio at risk > 30 days	0.6%	0.8%	5.8%	0.0%	0.6%	3.2%	2.2%	2.7%
ROA	9.0%	7.4%	6.2%	16.4%	9.3%	1.7%	0.8%	0.6%

** www.mixmarket.org, ** MIX (2008), *** 2007 Annual MFI Benchmarks; www.themix.org*

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The Moroccan association Al Amana was set up in 1997. It employs 2 000 people, has a portfolio of 500 000 clients, and has now become the biggest microfinance institution in North Africa. In this article, its CEO, Fouad Abdelmoumni, makes a review of the different sources of financing that need to be mobilized – and the challenges that this implies – in order to ensure growth in the microfinance sector.

What resources to finance the development of the microfinance sector?

Microfinance is booming and requires considerable additional funds. The equity of microfinance institutions (MFIs) needs to be strengthened; private investors – that invest when certain conditions are met – can play a key role in this development. In terms of borrowed funds, although recourse to global markets may not be a solution, it is essential to mobilize public deposits and bank debt in order to meet current needs. To a lesser extent, donors must also support growth in the sector. In order to mobilize all these sources of financing, MFIs must hybridize themselves and strike the best possible balance between social mission and profitability targets.

By Fouad Abdelmoumni, ***Economist and Chief Executive Officer of Al Amana***

Fouad Abdelmoumni
Al Amana

Fouad Abdelmoumni is an economist, holds a diploma in development economics from the Mohammed V University in Rabat and an MBA-equivalent diploma from the Institut supérieur de commerce et d'administration des entreprises in Casablanca. Fouad Abdelmoumni was formerly Vice President of the Moroccan Human Rights Association and is still very involved in Morocco's civil society. He has been CEO of Al Amana since it was founded in 1997 and also sits on several boards of directors.

Microfinance has earned its wings by underscoring – via its promoters – its mission to combat poverty and support economic and social inclusion. But its worldwide appeal lies first and foremost in the fact that it can claim to actually fulfill this mission. It has been built on an economic model based on the *credo* that those who are excluded from classic financing systems are very often self-employed workers that need long-term financing, and that they can repay their debts and pay the entire cost of the service. The economic dimension of microfinance is consequently the cornerstone for the implementation of its social mission.

The rates actually charged for microfinance loans are generally well above those of banks financing due to their very nature (small amounts, short maturity, fragility of guarantees and other recourse,etc.). Clients are much less sensitive to interest rates than they are to opportunity and transaction costs; they are mainly concerned about the profits that microfinance will allow them to earn via their activity. Opportunity costs relate to the lack of access to financial services and the fact that the amounts allocated, loan maturities, repayment frequencies and waiting periods do not match demand, and products and methodologies are not adapted. Transaction costs concern, among other things, the quality of the service and the constraints of guarantees and travel. Unlike MFIs, banks cannot reduce transaction costs and opportunity costs. Poor populations consequently continue to prefer microfinance, despite high nominal rates and both apparent and real costs. According to Rosenberg (2008), the median value of overall effective interest rates in 2007 stood at 35% and ranged from 60% in Mexico to under 20% in Sri Lanka; these rates are historically on a downward trend. According to Gonzalez *et alii* (2009), the global average stood at 26.4% at the end of 2008. A third of so-called profitable institutions are of a capitalist nature, the other two thirds include NGOs, cooperatives, public banks and non-profit organizations. The fall in rates can be explained by the maturation of the sector, underpinned by competition and economies of scale, the increase in average outstanding debt and a better control over operating expenses. For example, the Moroccan MFI Al Amana has lowered the overall effective rate it charges its clients. It was over 40% in 2000 and fell to below 20% in 2008. Yet it is still well above bank rates which have an official ceiling of below 15%. In Bolivia, the average microfinance interest rates fell from 60% in 1992 to 18% in 2007.

Studies concerning the need for additional funds are in their infancy and do not always tend toward the same conclusions. They do however converge on some hypotheses that make it possible to estimate these needs: client base multiplied by 10 (from 100 millions to a billion people) and average loan amount multiplied by 3 or 7 depending on the period considered. In order to face their need to grow, MFIs can rely on grants and subsi-

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dies, capitalized operating surpluses, bank loans, recourse to financial markets, public deposits and equity investments.

Although national and international development aid – both public and private – is the main provider of start-up funds for MFIs, it is not destined to bear operating and development costs. Those that are better organized have managed to include the cost of their refinancing in the fees charged to their clients. A lot of ink has been spilled over the development strategy of Compartamos[1]; by applying extremely high interest rates (up to 100%), it has built up a very comfortable endogenous growth fund that allows it to attract commercial funds. Many other institutions have, over long periods, managed to achieve margins of over 20 or 30% for annual return on equity, thus doubling their equity every three years on average. Others have intentionally ceded the operating margins to their clients when they have gone over a certain limit; in line with their mission, they consider that they must finance their expansion via an alternative to charging their clients non-essential fees.

MFIs attract bank financing

Operating surpluses may not have been sufficient to meet all the growth requirements of the sector, but their levels have persuaded the local and international banking sector to grant loans at favorable conditions – bringing debt up to impressive levels (over 10 times the value of equity in the case of India). When institutions demonstrate their stability, commercial players such as banks are willing to consider them as a "credible risk", assessed on the basis of the scale and quality of their assets, institutional soundness and growth prospects. They may be using their involvement in the sector to strengthen their "social marketing", but they only envisage sizeable financing when they are confident in its security and profitability. The multiplier effect that MFIs can obtain from bank financing varies enormously; it is very high in India for example – where the State obliges the banking sector to be heavily involved in this type of financing – but is however inexistent (or even negative) in Egypt where the profusion of funds from USAID has allowed MFIs and banks to comfortably benefit from an "economic rent". In the case of Morocco, the banking sector, in an over-liquid situation, extends loans to MFIs – reputed to be among the best in the world – that can be up to seven times their total equity. Thanks to financing from banks or financial markets (bond issues or debt securitization), MFIs have been able to consider diversifying their resources and means of refinancing. This has also attracted investors motivated by the coexistence of social and economic objectives, but it has especially led public authorities to give them the capacity to raise deposits from the public. MFIs have consequently become fully-fledged financial intermediaries.

Michael Chu considers that "the only way to mobilize the money needed to meet the credit needs of the poor is to connect to the ocean of commercial money". On the other hand, Muhammad Yunus, founder of Grameen Bank, considers that "there is plenty of money in the locality – money is not the problem". The problem for many MFIs stems more from the legal framework they operate in; they should make it evolve so that they can become local microfinance banks with a capacity to mobilize deposits. Connecting institutions to the global financial market is not a satisfactory solution to meet their financing needs; on the contrary, it is necessary to reduce institutions' dependence on external financing as it can limit sector development and its capacity to satisfy the expectations of its clients. Mobilizing public deposits is all the more attractive for microfinance banks as it allows the poorest to benefit from an institutional service to manage their savings. Yet public authorities and national banking supervision authorities are reluctant to authorize the collection of public deposits as MFIs do not benefit from the supervision, governance, financial standing, possibilities of recourse, organizational base and tools required to secure deposits and guarantee access to them. It is consequently a question of establishing conditions for the capacity to collect based on legal, governance, capitalization and organizational requirements. But small-scale institutions rarely have the capacity to meet these conditions: this incapacity creates a divide between institutions destined to specialize in credit in a "professional" manner and those destined to focus on providing banking services to the excluded.

A period of change

Microfinance is gradually consolidating its basic services and organization, and is diversifying its range of services and making them widely available. It is firmly anchored into its social mis-

[1] Compartamos Banco was founded in 1990 in the form of an association and became a commercial bank in 2006. It is the largest debt issuer on the Mexican financial market.

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sion and uses tools and organizations inspired by a liberal market approach. Those who uphold the "social mission" dogma know that they cannot make microfinance sound, sustainable and of good quality if they do not accept to face the market. MFIs will generally resort to financing that will allow them to achieve their mission; the most "social" of them will have no problem counting hard-line capitalists among their funders if they consider that this strengthens their action. Those that are first and foremost motivated by maximizing their profits will ensure they do not "kill the goose that lays golden eggs" by adopting unsustainable processes and reflexes. The institutions that will manage to come through this period of change will be hybrid institutions meaning with a better combination between social vocation and economic approach, a mission of service and profitability targets. Once everyone's expectations have been clarified and everyone is satisfied, they will be viable and strong institutions. •

How to meet the financing needs of microfinance?

Swanson (2007) estimates the current portfolio of MFIs is worth 17 billion dollars, but estimates that 200 billion dollars of financing will be needed for microfinance in the long term. For their part, Chu and Yunus (2008) only count 500 million clients in the long term and expect total outstanding amounts in the sector to reach between 250 and 500 billion dollars. Whatever the case, we can imagine a reasonable scenario for 2020 whereby microfinance worldwide would rise from 100 million active clients to half a billion, with unit outstanding amounts in the region of 200 to 500 dollars – i.e. a total portfolio of 20 to 250 billion dollars, or an annual average growth rate of 25%. Grants are expected to make little contribution to the mobilization of the required amounts; they will be increasingly earmarked for intangible capital or development which is not part of the permanent portfolio. It is estimated that "intrinsic" equity will rise to 15 billion, made up of current equity (roughly 5 billion) and the surpluses that would be capitalized (10 billion). "Extrinsic" equity provided by national investors is also expected to be in the region of 15 billion. Total equity is expected to triple as a result of public deposits, i.e. 90 billion; 60 billion could be raised from loans from the banking system and issuances on the domestic financial market. The remaining 60 billion would have to be raised from international finance institutions (15 billion) and individual investors and foreign institutions (45 billion).

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The Abdul Latif Jameel Poverty Action Lab (J-PAL) was founded by the MIT in 2003. This laboratory has designed and implemented a randomized evaluation method for poverty reduction programs inspired by clinical trials used in medicine. Through its work J-PAL helps governments, donors and companies improve their actions to support the poorest. In this article, Esther Duflo and William Pariente describe the issues that are specific to the evaluation of microfinance.

Recent developments in the impact and mechanisms of microfinance

Microfinance has aroused widespread enthusiasm over the past 20 years. Its specific credit methodology (group solidarity, small loans, etc…) was thought to solve a number of informational problems on the credit market, promote access to credit and consequently help reduce poverty. Recent empirical research has given a better understanding of the mechanisms of microfinance and the impact it actually has on poverty.

By Esther Duflo, ***Co-Director of J-PAL (MIT)*** **and William Parienté,** ***UCL and J-PAL***

Esther Duflo
J-PAL

Esther Duflo is currently a professor of economics and Co-Director of MIT's Abdul Latif Jameel Poverty Action Lab (J-PAL). In 2008-2009 she has been the first person to hold the "Knowledge against Poverty" chair at the Collège de France – this chair is supported by Agence française de développement.

William Parienté
UCL et J-PAL

William Parienté is an assistant professor at Louvain Catholic University (UCL) and an associate researcher at J-PAL Europe. His research focuses on access to credit, and problems relating to poverty and health in developing countries.

Poverty reduction through credit is not a new idea. Considerable amounts of public credit have consequently been invested in developing countries to support the poorest populations via State banks – generally agricultural banks – which offered farmers subsidized credits aiming to increase their productivity. These policies were conducted between 1950 and 1980 and generally failed (Armendariz de Aghion and Morduch, 2005). Microfinance therefore partly came about as a result of the observation that classic financial institutions are unable to make an effective contribution to economic development and poverty reduction in these countries.

The creation of microfinance institutions (MFIs) led to the emergence of a banking system that provides poor populations with access to financial services. The most well-known form of microfinance – embodied by Grameen Bank – is mainly based on a solidarity group, with relatively small amounts of credit, weekly or monthly repayments, and relatively high interest rates. The effectiveness of this methodology gave rise to a great deal of theoretical interpretations, particularly in terms of the role of the solidarity group and peer monitoring in order to overcome informational problems. Yet this innovation alone cannot explain the high repayment rates. MFIs build close relations with their customers and have sound knowledge of local markets; they know how to implement effective selection and incentive mechanisms. The pressure exerted by the institution – added to that of the group members – is a determining factor.

Although these relatively general principles may have been well understood, a number of questions do still remain unanswered. The effect the structure of products has on informational problems and repayment rates has only just begun to be studied from an empirical perspective; recent studies show that demand for microfinance appears to vary enormously depending on the characteristics of loans; the impact that microfinance actually has on clients' living conditions still remains relatively underevaluated. All these questions have given rise to considerable debate among both practitioners and academics and today there are some signs of answers being formulated.

Loan characteristics and repayment rates

It would appear that the success of repayment rates in microfinance stems from the structure of microfinance loans and their capacity to solve informational problems. Several recent empirical studies have sought to identify the effects certain characteristics of microfinance products have on the repayment rate. For example, Karlan *et alii* (2006) evaluate the effect the solidarity guarantee has on the repayment rate thanks to an experiment conducted in partnership with a MFI in the Philippines. The experiment consisted in offering a loan with an individual guarantee to part (randomly selected) of a group of former clients that had made a renewal request – the other part of the group received a loan which kept the solidarity guarantee. At the end of the experiment, the differences in repayments between the two groups could consequently be attributed to the type of guarantee offered. After three years, the repayment rates are similar between the two groups; this would tend to demonstrate that the solidarity guarantee did not have the "pure" controlling effect that has often been attributed to it.

Recent developments in the impact and mechanisms of microfinance

By Esther Duflo, *Co-Director of J-PAL (MIT)* **and William Parienté,** *UCL and J-PAL*

Similarly, a study conducted by Pande and Field (2008) in India shows that the frequency of repayments does not have an effect on the repayment rate either. In this study, some randomly selected clients receive a loan with monthly repayments, while the others obtain a loan with weekly repayments. The clients with monthly maturities repay as well as those that have weekly maturities.

Finally, Karlan and Zinman (2006) attempt to measure, via an experiment conducted in South Africa, flaw factors on the credit market. The authors detected the adverse selection effects[1] by randomly offering contracts with high rates and low rates. They then analyzed the profiles of the borrowers that accepted these contracts. In the end, the presence of adverse selection is not confirmed: the high rates do not particularly seem to attract the riskiest or least effective borrowers. Finally, some of those who received a low rate are offered to keep the advantage of this rate if they repay the loans correctly: here, the incentive has a direct and significant effect on the repayment rate. This proves the existence of moral hazard[2]. In this context, the dynamic incentive policy – present in most microfinance contracts – constitutes an effective mechanism for improving the repayment rate. This initial research consequently suggests that in the specific contexts studied, the solidarity guarantee and the regularity of repayments do not have an effect on repayment, while the dynamic incentives are indeed effective.

Demand varies depending on loan characteristics

Microfinance loans are also characterized by high interest rates which can be explained by the high transaction and control costs. Interest rates vary enormously among MFIs; they may be lower than the rates charged by informal credit sources, but they can easily top the 20% a year mark, 50% rates are not uncommon. The specific nature of products and the interest rates charged can have an effect on the decision to take out a loan, even if the information about the interest rates may only be partially understood by the clients. In a situation where the interest rate is fully understandable and where the clients know the return rate on potential investments, the decision to take out a loan is the result of a comparison between costs and benefits. Little information exists on the investment rate of return for micro-enterprises, whereas this is a core factor for understanding the demand and repayment capacity of the population targeted by microfinance. To answer this question, De Mel *et alii* (2009) attempt to measure the rate of return on equity in micro-enterprises in Sri Lanka. The rate can be relatively high – roughly 5.7% a month –, well above the interest rates offered by the MFIs in the region. However, it is heterogeneous (especially high for men) and rapidly falls over time. This experiment also demonstrates that some micro-enterprises with high returns do not borrow from MFIs – whereas it would be in their interest to do so – probably due to a lack of information about existing credit sources or by risk aversion.

In a second phase, studies sought to assess the impact of interest rates (or the interest rates announced to clients) on the elasticity of credit demand. Karlan and Zinman (2006) show that a reduction in interest rates has little effect on clients in South Africa, whereas a rise to a rate above those normally charged does have a considerable effect on demand. These results suggest that the interest rates usually charged by local MFIs are optimal.

In addition to interest rates, demand may also be affected by the very structure of microfinance products. Standard microfinance has developed rapidly, mainly in urban and periurban areas. It can indeed be difficult to establish in rural areas. Loan amounts and repayment methods may not be adapted to the cycles of agricultural activities. In Morocco, a study in dispersed rural areas (Crépon *et alii*, 2008) shows that in a context where formal credit is practically inexistent, the response of households to an offer of a microfinance loan remains limited – with a borrowing rate of under 20% over a year after it was introduced. Microfinance would consequently seem to be primarily intended for trade, service or livestock raising activities.

Assessment of impacts on living conditions

Microfinance may meet an obvious need for people who are excluded from the loan market, but its objectives go beyond simply developing economic activity. It also aims to improve the living conditions of its clients. While there is in fact little rigorous empirical evidence – due to the absence of really convincing evaluations –, the very principle of impact assessments has given rise to a great deal of debate among both practitioners and academics.

[1] Adverse selection or antiselection is a phenomenon by which an offer made on the market leads to results opposite to those desired because of information asymmetries.
[2] The notion of moral hazard designates a situation of risk in a relationship between two agents: one agent protected from a risk behaves differently than if it had been completely exposed to the risk.
[3] The "Second Best" theory refers to what happens when one or several optimal conditions cannot be satisfied in an economic model. If an optimal condition cannot be satisfied, it is possible that the "next best solution" may lead to changes in the other variables. Here it refers to the need to transfer the analysis to secondary objects since it is impossible to assess the direct impact on living conditions.

Recent developments in the impact and mechanisms of microfinance

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Indeed, some fundamentally question the interest of a specific assessment: microfinance is a market just like any other and consequently there is no particular justification to assess it. Others question the usefulness of assessments since there is no doubt about the impact of microfinance – given the high number of people that use microfinance loans and remain in the borrowing cycle. Some, finally, consider that it is methodologically too difficult to assess the impact of microfinance and that it is preferable to use "Second Best"[3] approaches by focusing on an analysis of the client base, the social performance of MFIs and an analysis of processes, rather than on the impact itself.

There are limits to these different arguments. Unlike other "markets", microfinance remains widely financed by public funds, particularly because donors consider that it has strong impacts on living conditions by, for example, fostering food security, autonomy for women, education or health. There are consequently real issues involving the assessment of this impact. Moreover, it would seem naive to make a positive measurement of the impact of microfinance based on the long-term presence of clients in the loan cycles, because the situation of these clients if they had not entered is not taken into account. Microfinance can have perverse effects such as overindebtedness or problems of debt swaps; finally, if a large number of clients remain in the credit process, a large number leave it. There is certainly a reason for this.

There is therefore very little rigorous empirical evidence concerning the impact of microfinance on living conditions. Some quasi-experimental studies, notably in Bangladesh (Khandker and Pitt, 1998 and 2003), were for a long time seen as being the most accomplished studies, even if their results were widely debated (Morduch, 1998; Morduch and Roodman, 2009). Several experimental studies that have just been completed or are ongoing will provide new elements concerning the impact of microfinance; one of them conducted in India (Banerjee and Duflo, 2009) concerns the expansion of the Indian MFI Spandana into the poor neighborhoods of Hyderabad. After two years, the results show that microfinance has a positive impact on the creation of activity; however, the effect on household consumption is extremely heterogeneous. Those that had an activity prior to the introduction of microfinance consume more durable goods but reduce their non-essential consumption; they see their profits increase. On the other hand, those that begin their activity reduce their total consumption in order to face the fixed costs required to start up their business. Finally, household consumption increases for borrowers who do not have an activity. The study also shows that there is no impact on non-economic variables such as education, health, or the power of women within the household. These results concern a specific context; they cannot be generalized to microfinance as a whole. However, a number of ongoing studies (in Morocco, the Philippines and Peru) will soon make it possible to complete these initial elements and will help give a better understanding of the effectiveness of microfinance.

A new generation of studies has made it possible to conduct a rigorous assessment of the mechanisms and impacts of microfinance for the first time. Today, we consequently know more about the actual impact its different components have on repayment rates for example. As for the first impact studies, they make it possible to estimate the contribution it makes to developing economic activities, combating poverty and improving living conditions. Together, this research can help make microfinance more effective. ●

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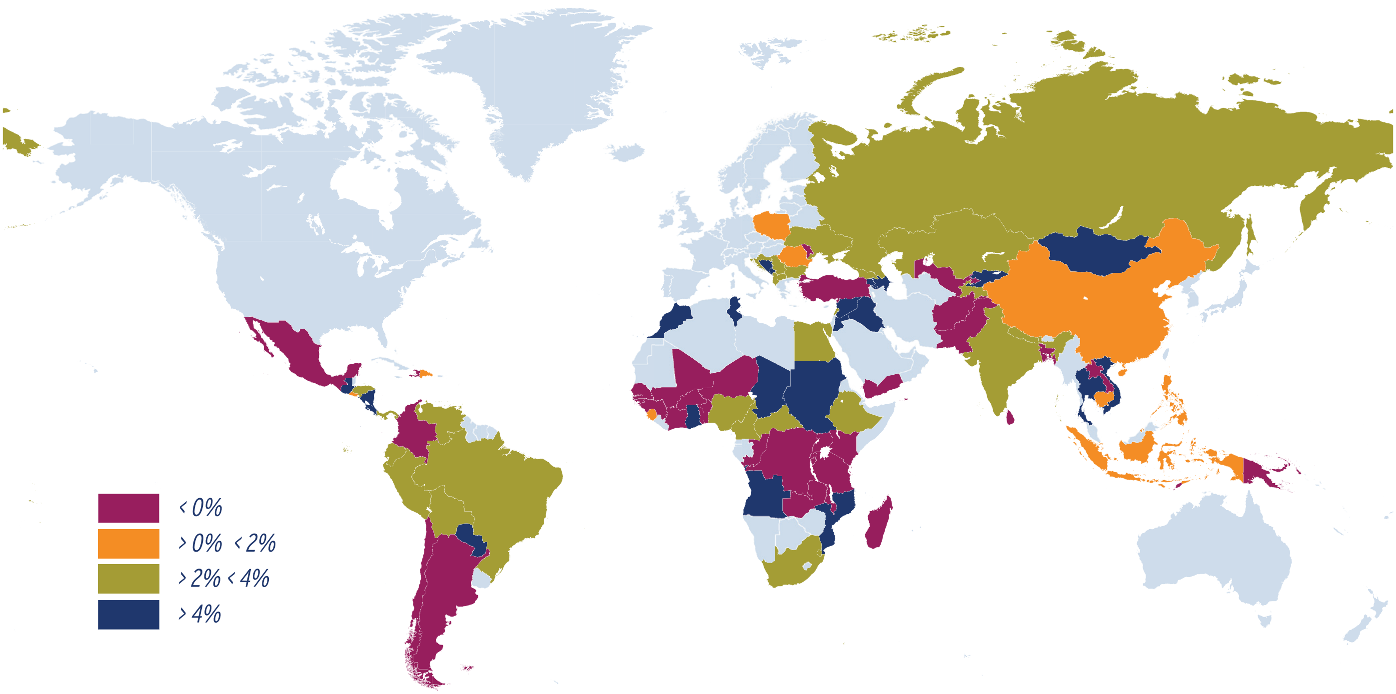
Private Sector & Development
PROPARCO'S MAGAZINE

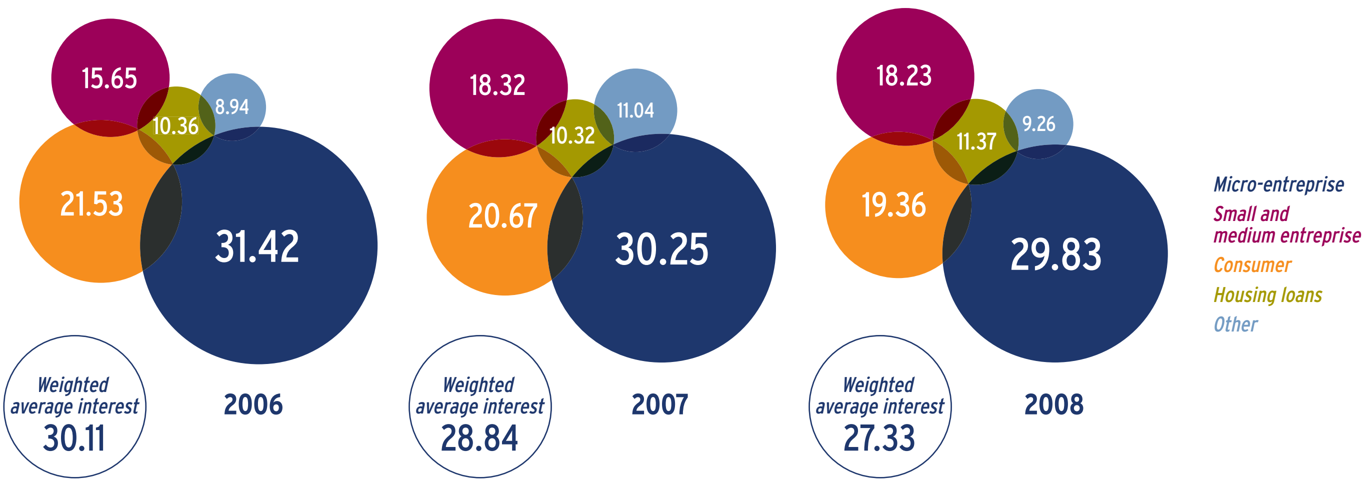
Although the microfinance sector generally appears to be quite profitable, and even more so than the banking sector, there are wide disparities between different regions of the world. The various types of clients make a very unequal contribution to the profitability of MFIs. Surprisingly, it is micro-enterprises – which are in principle fragile – that are charged the highest rates. This data makes it possible to assess profitability in the sector and gives a better understanding of the factors behind it.

Levels of ROA per country (2006-2008)



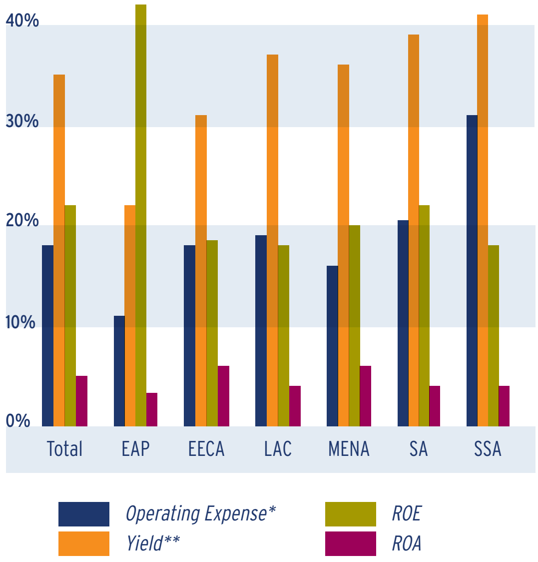
Source: calculations made by the redaction based on the MIX data (www.themix.org)

Interest rate by credit product



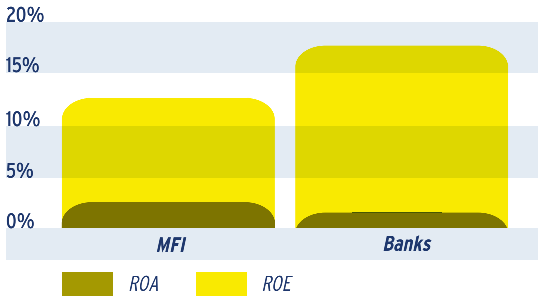
Panel: microfinance institutions of SMY50 index
Source: Symbiotics (http://www.symbiotics.ch/en/mfi_data/microfinance-benchmarks-peergroups.asp)

Microfinance key ratios by regions (2006)



** as a percentage of total portfolio ; ** effective interest rate*

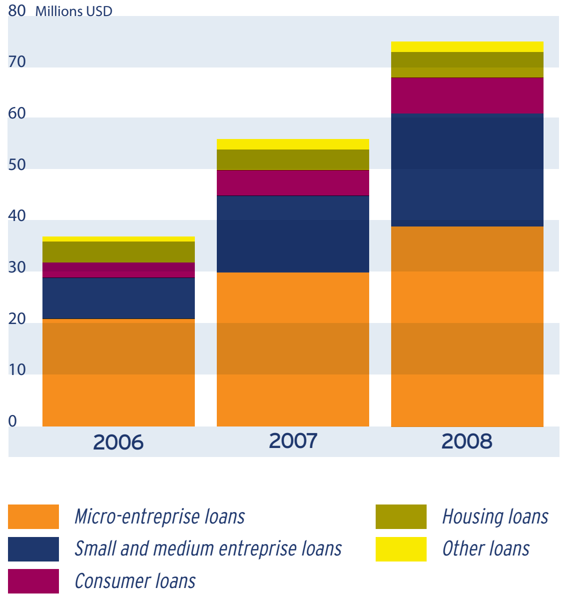
Returns on average assets and equity - MFIs vs banks (2006)



*Source : Gonzalez, A., Narain, S., Rosenberg, R., 2009.
The New Moneylenders : Are the Poor Being Exploited
by High Microcredit Interest Rates ?, CGAP, Occasional Paper 15.*

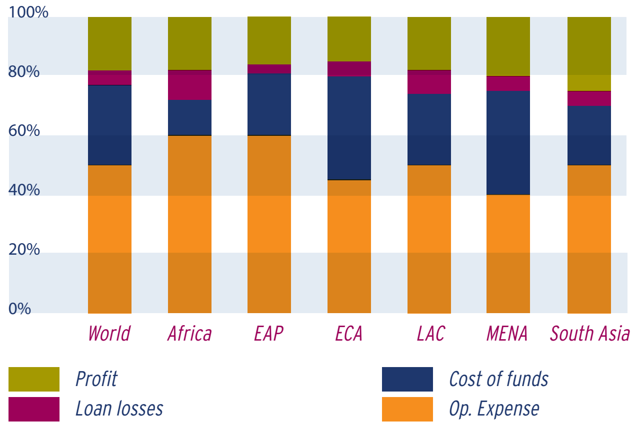
*ROE: return on equity, ROA : return on assets
MFI: Microfinance Institution
EAP: East Asia and the Pacific,
EECA: Eastern Europe and Central Asia,
LAC: Latin America and the Caribbean,
MENA: Middle East and North Africa,
SA: South Asia, SSA: Sub-Saharan Africa.*

Breakdown of MFI portfolios by credit product



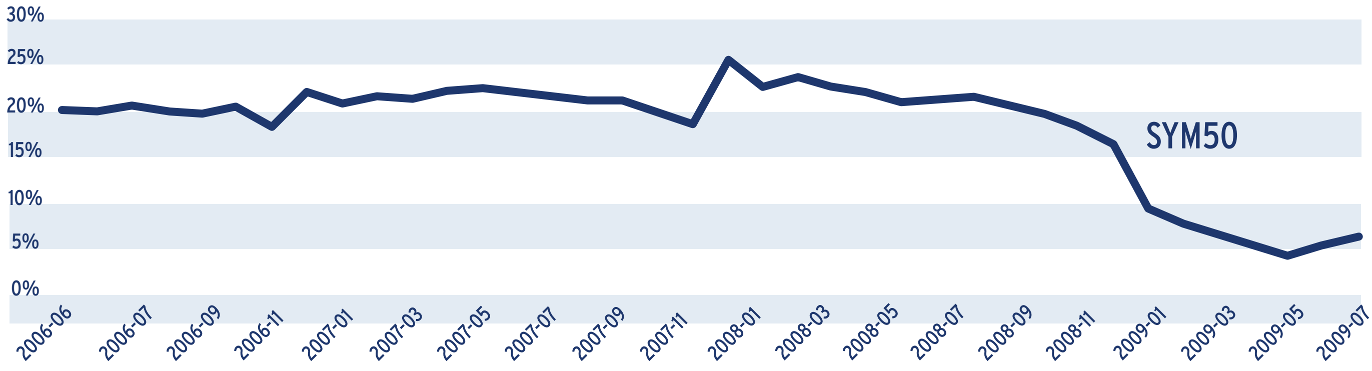
*Panel: microfinance institutions of SMY50 index
Source: Symbiotics (http://www.symbiotics.ch/en/mfi_data/microfinance-benchmarks-peergroups.asp)*

Average costs and profits as percentage of Income MFI by Region (2006)



*Source : Gonzalez, A., Narain, S., Rosenberg, R., 2009.
The New Moneylenders : Are the Poor Being Exploited
by High Microcredit Interest Rates ?, CGAP, Occasional Paper 15.*

Symbiotics microfinance index (SYM50)



The SYM50 index corresponds to the simple monthly average ROE of the 50 institutions that make up the SMY50 index. *Source : www.symbiotics.ch*

WHAT BALANCE BETWEEN FINANCIAL SUSTAINABILITY AND SOCIAL ISSUES IN THE MICROFINANCE SECTOR?

Proparco's assistance to the development of the microfinance sector is in line with its strategy to support financial systems in developing countries. At the end of June 2009, Proparco had committed some 50 million euros to finance microfinance projects. Drawing on this experience, Élodie Parent, an investment officer specialized in the microfinance sector, analyzes in this article how the interest rates charged by MFIs are calculated and puts forwards solutions on how to optimize them while maintaining a moderate profitability.

Striking a balance between affordable rates and satisfactory profitability in microfinance institutions

The interest rates charged by microfinance institutions (MFIs) are calculated on the basis of their financial situations and profitability targets. To make these rates more affordable for their low income clients, MFIs can conduct an analysis of their financial situation using four key criterias – the aim is then to optimize them. MFIs' profitability targets are set by their shareholders and could be better assessed and more transparent – this can ultimately lead to a readjustment that will bring down rates while maintaining an "adequate" level of profitability.

By Élodie Parent, ***investment officer at Proparco***

Élodie Parent
Proparco

Élodie Parent began working at Agence française de développement in 2004 in Morocco where she was in charge of developing microfinance activity. She is now an investment officer at Proparco where she coordinates the microfinance unit which has committed some 50 million euros of financing to the sector.

Microfinance institutions traditionally target people that are "vulnerable" because they come from the poor populations of a country. Yet the interest rates on the microfinance loans that are extended to them are often high: although the median stands at 26% a year, the average is more in the region of 35%. This apparent contradiction – poor populations, high rates – gives rise to a lively debate on the level of interest rates in the microfinance sector.

The interest rates charged by a MFI are mainly calculated on the basis of its financial situation and profitability targets[1]; to get a better understanding of the levers it can use to lower them, it is first and foremost necessary to analyse its financial model. The second stage involves examining the profitability levels of MFIs. Indeed, it is estimated that the 10% of the most profitable MFIs have a return on equity (ROE)[2] of over 34%; this figure must be compared with the average bank ROE[3] which is below 18%. This issue has become particularly sensitive in the context of the current financial crisis, and the first signs of a possible bursting of a "microfinance bubble". The situation is made even more complex by the arrival of the private sector which, while channelling increasing amounts of capital towards MFIs, sets them profit constraints that are higher than those of donors. All these reasons clearly explain why the issue of profitability levels is so important. Finally, once the issue of both "affordable rates and sufficient profitability" has been addressed, it is necessary to specify what balance there can be between them.

Financial performance: a requirement

MFIs have some levers at their disposal that they can use to offer more affordable interest rates; by using them they do not make their clients pay the price of non-optimal management. Cases of "abuses" are not unusual and are encouraged by the lack of regulation and client protection, but also by a lack of available data on the extent to which the profitability of the microenterprises financed is sensitive to the rates charged.

The analysis may first aim to identify and isolate factors that MFIs have no control over. For example, the macroeconomic environment has a direct impact on the financial structure of a MFI and it cannot escape this; the cost of human resources aligned with local standards of living, the cost of refinancing, or the status and taxation that apply to MFIs are consequently factors that it cannot control. As these exogenous factors have a direct impact on its financial performance, the MFI will have to charge rates that are high enough to cover its costs relating to "structural" constraints.

Once these exogenous factors have been identified and isolated, the only way to identify the actual levers the MFI can use to improve its performance is through a financial analysis. One possible financial approach involves focusing the analysis on four key elements that make it possible to conduct a rapid assessment of a MFI's performance whatever its status. This approach is simplified and highlights the key points – the analyst must of course also make a more in-depth analysis. The level of

Striking a balance between affordable rates and satisfactory profitability in microfinance institutions

By Élodie Parent, *investment officer at Proparco*

rates charged to the clients can – theoretically – be justified when the four objectives are reached or about to be reached.

• The share of the loan portfolio (as a percentage of total assets) devoted to financing income-generating activities for microenterprises and, possibly, VSEs and SMEs must be above 70% of the total balance sheet. This ratio indicates that the MFI is focusing on its core business which is its most profitable activity.

• Its portfolio must be of sufficient quality with a PAR30[4] below 3% in general and at a maximum of 5%. Indeed, the PAR of MFIs that have a bank status stands at 2% and for the 45 biggest MFIs at 3.7% at the end of 2007. The main area of expertise of a MFI remains its sound knowledge of its clients; when it moves away from this, it takes a risk and causes provisions to put pressure on its profitability.

• The cost of financial resources (equity, debt, deposits) must be optimized by trying to give priority to deposits, which are often the cheapest resources. If this is not possible, a MFI should optimize the debt/equity leverage effect in order to avoid financing growth exclusively at the exorbitant cost of accrued income. Indeed, in this case it can only achieve a sufficient level of net income by charging high rates, which in turn will raise the level of equity so as to boost growth – or at least not to curb it. The weight of the return on capital – dividends – must be a specific focus. It will be more difficult to bear if the debt/equity ratio is not optimized.

• Operating expenses, which are by nature high[5], must be controlled. The aim is not to try to reach bank operating ratios at all costs – this could easily lead to a loss of control (too many clients per loan officer, increase in the unit amount of loans without checking how the funds are used, etc.) – but simply to rationalize certain costs when this makes sense.

All of these criteria must of course be analyzed in the light of the local economic context. But any inefficiency relating to one of them will put a strain on the profitability of a MFI. This will automatically raise its interest rates to allow it to maintain a sufficient level of profitability. This increase may be a real temptation, since clients are not always aware of it (by lack of education, lack of communication by the MFI). Some studies, including that of Karlan and Zinman (2008) or of Porteous (2006), confirm that there is a relatively low level of elasticity of client demand in terms of the rates charged.

Profitability level: a rigorous monitoring

Once the performance of the institution has been analyzed and optimized, the next step is to look at the other factor which has a decisive effect on the rates charged: the MFI's profitability target. It is set by the shareholders and must meet both their own profitability targets and also the institution's need to strengthen the equity of the structure. Today it does not seem clear how the level of profitability expected by shareholders is defined. Yet when the issue is to choose between transferring a financial advantage to clients (by improving performance for example) and increasing profitability for shareholders, a natural trend prevails: the exclusive quest for profit. This sketchy area can only be dealt with by designing and implementing specific tools and defining levels of profitability in a more rational manner.

Each MFI could begin by analysing the sensitivity of ROE to the overall effective rate (OER) – which includes all the direct costs relating to the loan – charged to its clients so that the shareholders can be aware of the leeway they have to adjust the rate charged to the client more accurately in line with their profitability strategy. For example, in 2006, if Compartamos had simply kept ROE at 15% instead of 56%, it could have lowered the rates charged to its clients by 29% (they would have fallen from 85% to 56%). In view of the stakes involved in serving the poorest populations, ROE could also be managed by the type of product offered according to the target client base.

Moreover, it would seem that benchmarks are required for MFIs' levels of ROE. The comparison with the banking sector is enlightening, but can only be made in the case of mature MFIs that have been profitable for several years and have an activity that has reached a certain critical size. The

[1] *For the sake of simplicity, the "competition" aspect which can exert pressure on rates to be lowered has not been included.*
[2] *ROE indicates the level of profitability of equity capital; it is measured as the ratio between net income and equity capital.*
[3] *This is the average ROE of banks in countries that have at least one MFI registered on the MIX Market microfinance portal (www.mixmarket.org).*
[4] *The "portfolio at risk over 30 days" (PAR30) corresponds to outstanding loans with a maturity overdue by over 30 days.*
[5] *For the 45 biggest MFIs, average operating expenses as a percentage of the portfolio stand at 19.4%, against 7% for banks.*

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average ROE of banks in countries that have at least one MFI registered on the microfinance MIX Market portal stands at roughly 18%. This average bank ROE is higher than the average ROE of MFIs in these same countries which stands at 13% (2006). This observation may initially appear "counter-intuitive". MFIs register a net interest margin four times higher than banks (24% against 6% for banks) and their portfolio is generally of an excellent quality. If the considerable weight of MFIs' operating expenses partly explains why ROE is lower than in banks, this situation would appear to be mainly due to the fact that proportionally they have more equity than banks. In other words, their debt/equity leverage effect is lower.

On the basis of this observation, the analyst must adjust a MFI's solvency ratio[6] so that it tends towards that of local banks in order to make the ROE of the two sectors comparable. In view of the social mission of a MFI, it could be considered that the adjusted ROE of a mature MFI should generally be lower than the average ROE of the relevant country's main banks. If a MFI had a much higher ROE than local banks it would be necessary to try to understand why. However, within a group (like ProCredit or Advans), ROE can be managed at a consolidated level. In this case, as the profitable subsidiaries can "subsidize" the most fragile, ROE can be locally higher than that of banks established in the same country. Whatever the case, it is always essential for a MFI to conduct reflection on its ROE targets and the subsequent rate policy. This is always a constructive exercise for a MFI and its shareholders, particularly in order to justify the investments being classed as socially responsible assets.

To preserve an instrument to combat poverty

All microfinance players – both donors and the private sector – declare that they are convinced that it is important for MFIs to continue to be a tool to combat poverty. Faced with such a consensus, stakeholders must conduct an in-depth reflection process that will allow them to establish a "fair" rate to charge clients based on "moderate" profitability. This process is all the more important because we are aware of the risks of overindebtedness that are intrinsic to the sector and of the poorest being decapitalized. Donors and the private sector must continue to develop partnerships so that a common approach to investment in microfinance can be built, while respecting their respective risk management constraints and profitability targets. ●

Comparaison between average ROE of banks and MFIs

AVERAGE ROE (%)	BANKS	MFIs
Average MIX-listed countries	18	13
Average Africa	19	17
Côte d'Ivoire	13	-
Ghana	38	13
South Africa	21	-
Central and Southern America	15	17
Mexico	20	20
Bolivia	15	14
Colombia	18	9
Central Asia and Caucasia	6	20
Georgia	10	17
Mongolia	15	22
Southeast Asia	10	43
Cambodia	25	14
Vietnam	17	2

The regional averages for banks are calculated using the 500 main private banks. The national averages are calculated using the country's 10 most effective private banks. The averages for MFIs are calculated using a sample of data tracked by CGAP.
Sources: Bankscope and CGAP (2007-2008 data) and author's calculations.

[6] *Solvency is measured as the ratio of equity to total assets at risk.*

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WHAT BALANCE BETWEEN FINANCIAL SUSTAINABILITY AND SOCIAL ISSUES IN THE MICROFINANCE SECTOR?

PlaNet Finance is an international solidarity organization that provides microfinance institutions with technical assistance and financial support. In this article, Jacques Attali, its President and founder, explains that the development of microfinance must not be to the detriment of its social mission. In the face of the first signs of things veering off track, he advocates the implementation of new tools to enhance the way social performance is measured and managed in the sector.

Managing the social performance of microfinance institutions

Microfinance is booming. Beyond financial performance, it is essential for the sector not to lose sight of its social objective. The most innovative MFIs are reacting quickly to the first cases of abuse, implementing tools to manage and increase the sector's necessary social footprint. Such endeavours need to be underwritten by the regulators, who have a critical role to play – particularly in terms of increasing the transparency of lending conditions.

By Jacques Attali, ***Chairman of PlaNet Finance***

Jacques Attali
PlaNet Finance

Jacques Attali is a French economist, writer and senior civil servant. He was an advisor to former President François Mitterrand, and Chairman of the European Bank for Reconstruction and Development (EBRD). He is the founder and Managing Director of PlaNet Finance – a pioneering international solidarity foundation active in the field of microfinance.

Microfinance can succeed only if it does not lose sight of its social objective. For a few years, some have believed that microfinance would be the proverbial silver bullet: a tool through which Wall Street could be kept satisfied and world poverty could be eradicated simultaneously – all of this while looking only at financial indicators as a criterion of success. In the euphoria that followed the International Year of microcredit and the awarding of the Nobel Peace Prize to Muhammad Yunus and Grameen Bank, inevitably simplistic slogans – "Loans that change lives", "Access to credit for all" - have at times been so feted as to almost become substitutes for sound management principles. Some of these institutions have forgotten that for a loan to "positively change" a life, it needs to be granted with much caution and rigorous analysis. Credit is not a right - it can actually be a hazard for those with too little secure income and those already drowning in debt. It also has become particularly clear that loans that aren't applied to supporting income-generating activities are embedded with real dangers for vulnerable people.

The sector's coming of age has, in certain areas, led to increased competition on the market for the supply of credit to the poorest. It has also favoured the appearance of the now ubiquitous "microfinance avenues", where four, five or ten MFIs are lined up over a few hundred meters in some of the commercial districts of large cities in developing countries. Vulnerable people are therefore highly enticed, and often tempted to take up loans. Unfortunately, this vulnerability also invites abuse. The few cases of clear abuse – as evidenced by the charging of extortionate interest rates, insolvencies caused by debt, and, in some of the worst cases, coercive and illegal debt recovery practices – serve as a reminder that neither social nor financial performance are coincidental by-products of business. Indeed, what would financial performance be without the armies of accountants, controllers, internal and external auditors who work for their companies, produce financial indicators and ensure their reliability? What would financial performance be without the circumspection of controllers and other risk managers, without the constant attention of executive managers and performance analysts, without the study and circulation of best practices by consultants and researchers? While none of this guarantees that businesses won't ever fall prey to accidents or bad decisions, such management processes at least allow *bona fide* actors to do everything within their means to deliver financial results in line with the expectations of all the stakeholders involved.

Microfinance stakeholders, confronted to the first signs of trouble, are proving their ability to react promptly. They are demonstrating their commitment to the dual objectives of financial and social sustainability. Indeed, for a number of years already, some of the stakeholders anticipated the troubles mentioned earlier. As a result, the sector has started fine-tuning and reconfiguring the different components that make up the microfinance ecosystem. Such measures will, ultimately, allow the sector to manage both its financial and social performance.

Some specific tools currently being developed include:

• Focused impact studies, conducted in an efficient manner, helping to understand how the social impact of microfinance services can be op-

Managing the social performance of microfinance institutions

By Jacques Attali, *Chairman of PlaNet Finance*

timised : Which target-groups enjoy the most benefits from credit or savings services? At what level of interest rate does the cost/benefit ratio make it difficult for a microentrepreneur to make use of microfinance services? Are joint guarantees effective?

• Surveys conducted with current and past customers to understand what services people actually need, by speaking to the supposed beneficiaries themselves.

• Donors specialised in microfinance, or holding a "socially responsible" label, are defining standards of transparency; standardised financial performance indicators are being established.

• Ethics charters and consumer protection codes are appearing, their implementation could be certified and will make it possible to draw a clear distinction between socially responsible microfinance institutions and loan sharks, pawn shops or consumer credit organisations.

• Monitoring and evaluation methods on social performance that will guarantee the comparability of efforts realised and results obtained in the social arena. Such appraisals will allow for priority investments in the most efficient organisations, or for assistance to underachieving institutions.

More or less accomplished forms of these tools are already available thanks to the often collective endeavours conducted by ground-breaking MFIs and their technical and financial partners. Those MFI managers who consider their social objectives to be at least as important as their financial bottom line can readily use these tools. Such increased attention for the well-being and satisfaction of their customers should translate into more sustainability - something that can only be achieved through a better overall command of credit risk, an easier prediction of possible reputational risks, and increased competitiveness of their services. The most advanced MFIs in this area advocate better management of social performance and alert the stakeholders – discreetly but sometimes also publicly – on the possibility of abusive practices.

Regulators have, of course, an important role to play in this regard: they have to set the ground rules in a manner that respects the fundamental rights of all consumers. There is a pressing need, among other things, to set standards on the transparency of terms and conditions of microfinance services. Of late, there has been clear evidence that the absence of transparency on loan conditions has sometimes led to the development of toxic products (such as subprime mortgages). Establishing credit bureaus capable of limiting cases of insolvency is an equally crucial need for the sector.

It is of prime importance, finally, to remember that the fight against poverty is also closely linked to the development of democracy. Failing that, no amount of social or financial regulation can escape a certain level of arbitrariness. Microfinance most certainly contributes to the development of democracy, by helping citizens to take control of their lives. ●

WHAT BALANCE BETWEEN FINANCIAL SUSTAINABILITY AND SOCIAL ISSUES IN THE MICROFINANCE SECTOR?

The International Finance Corporation (IFC) has been supporting the development of microfinance since the 1990s. In this article, André Laude shows how donors can influence governance in the sector (as IFC does). Indeed, these institutions are in a good position to ensure a balance is maintained between profitability levels and the social mission of microfinance organizations.

The role of development finance institutions in good governance for microfinance

Development finance institutions, via their involvement in the sector, give microfinance greater access to private financing. They also play a decisive role in the governance of microfinance institutions (MFIs) by helping to build a coherent shareholding, sitting on supervisory boards, and providing tools for internal governance processes. They also contribute to ensuring there is a balance between the social mission and the level of profitability. Moreover, they must be able to withdraw from the MFI's shareholding at the right moment.

By André Laude, ***Chief Investment Officer for microfinance investments at the International Finance Corporation***

André Laude
International Finance Corporation

As Head of investments of the "Global Financial Markets" Department at the International Finance Corporation (IFC), André Laude is in charge of the specific support provided to the microfinance sector. Prior to holding this position, he worked for IFC in the financial sector in Southern Europe and the Middle East, after over fifteen years' experience of financial markets in Wall Street, London, Mexico and Casablanca.

The International Finance Corporation (IFC) – like all development finance institutions – must strike the right balance between development needs and profitability for its investment projects. IFC meets the requirement of a "triple return", i.e. a social, financial and ecological return. No project is exempt from this. The financial dimension is in line with its mission to promote the private sector; IFC supports projects that meet the requirements of a "return on investment" plan, calibrated on the basis of a prior risk analysis.

This framework obviously also applies to microfinance projects. Microfinance is a priority sector for fighting against poverty and must have the capacity to mobilize long-term resources. To achieve this, IFC provides and promotes investments that meet the criteria for financial health and returns, in the same manner as any other project. In doing so, IFC has managed to make microfinance more visible, particularly regarding its role as a socially responsible player. Without the prospect of returns, it would have been impossible to attract investors that are first and foremost commercial[1]. The financial profitability of microfinance guarantees a sustainable mobilization of resources from the private sector.

This fact does not reduce the need for social and environmental returns; on the contrary, the more a project is profitable, the more it appears possible to guarantee its social impact. This is in any case the lesson that can be learned from IFC's creation of "de novo institutions"[2]. These MFIs have been established in countries where there was not yet a response to the demand for financial products for the poor. The "de novo" model requires a MFI to rapidly develop in order to scale up its socioeconomic impact nation or regionwide. The only way to deploy agencies, diversify products and mobilize the required commercial financial resources is through its intrinsic profitability.

A prerequisite: gather shareholders with common objectives

The creation of a MFI, its transformation into a financial company, or even the launch of a microfinance investment vehicle require putting together a group of shareholders that share similar objectives. This coherence among shareholders is essential; without it things can veer dangerously off course and give rise to stormy debates within supervisory boards. To meet this essential requirement, IFC willingly plays the role of "go-between" and does not hesitate to prompt or strengthen the necessary affinities. For example, in the 1990s IFC convinced Internationale Projekt Consult (IPC) – as well as KfW Bankengruppe, Commerzbank and many others – to invest alongside it in a holding company which ten years later was to become ProCredit. More recently, it also worked with institutions such as the bank J.P. Morgan and Standard Chartered Bank which today have become convinced by a mission to "create social value".

The role of development finance institutions in good governance for microfinance

By André Laude, *Chief Investment Officer for microfinance investments at the International Finance Corporation*

A basic consensus among founding shareholders remains one of the best ways to make sure things do not veer off track[3]. In this respect, it is important to form a coherent and clear majority that ensures the technical partner has control of operations in the field. It is useful to define ... ... specific "locking mechanisms" in shareholder agreements, especially if they subordinate basic modifications – for example, concerning the statutes, the social object, the mission – to special majority voting. The statutes of a MFI must also be as clear as possible in terms of its social object and mission; all shareholders must also be involved in defining them – even in formulating them – so that they are drafted in a clear, collective and consensual manner. In view of the importance of this stage, IFC for example asks its investment officers and its credit, social and environmental authorities to conduct an in-depth analysis of agreements made between shareholders. If the opinion is unfavorable, the investment is systematically refused or suspended until it is restructured.

What guarantees against abuses and needs for measurements of social and environmental impacts

IFC generally appoints representatives to the supervisory boards of the MFIs it supports, at least when its shareholding is of a strategic nature. These representatives carry out their duties by giving priority to their responsibility as a trustee[4] of the MFI or investment vehicle. Their role within these boards is almost like that of an "activist" constantly working for a dual social and financial requirement. In practice, it is not unusual for the social mission to be guaranteed by the investor/operator; for example, it can help lower the minimum loan size and consequently make financial services more widely available to the poor. Thanks to its successful business model, ProCredit has often promoted this virtuous circle within the MFI community.

IMF governance must ensure that they accomplish their missions and avoid any derailment. For instance, by separating governance from portfolio management, the MFI can make sure that its does not gradually drift away from its social mission. At IFC, for example, the officer in charge of the portfolio cannot be responsible for project appraisal – and even less for internal governance. The officer can consequently unbiasedly monitor operations and issue independent ratings on the financial situation of the investment, and on its social and environmental performance. These assessments can be made via a pre-established matrix supplied with quarterly reports on, for example, the increase in the number of borrowers or loans allocated to women, the average loan size and portfolio segmentation, the estimated number of jobs created, the added financial value and the economic return by taxation. Although considerable progress still needs to be made in this area, all projects must at least satisfy a minimum financial and social assessment grid established during the due diligence phase of project processing. These tools aim to assess the stimulating effect credit has on the economy as well as the role MFIs play in improving local production methods. Finally, investment projects can also be subject to an independent ex-post evaluation; at IFC, the Independent Evaluation Group is in charge of this. In this capacity, it makes a global review of the impact of an investment based on a matrix of indicators established during the due diligence phase for new projects.

Timely shareholder exit is key to avoid prejudice

Alongside "classic" good governance mechanisms, an arsenal of both legal and "moral" provisions may prove very useful to an institutional investor such as IFC. It will include, for instance, a "right of inspection and objection" for any strategy change. Such mechanisms are efficient for dealing with sudden changes in orientation, or those caused by the sale of shares to a new shareholder (transfer of majority, withdrawal of a strategic partner, etc.). The transfer of a strategic part of the shareholding can be blocked via a pre-emptive right or a "right of first refusal". Buyback mechanisms are also a deterrent and at the minimum provide a way to exit in case of disagreement with the orientations of the MFI, without this being too detrimental to its growth – a departure that marks the end of the implicit moral support provided by the development organization. These mechanisms also make it possible to keep out investors with ambiguous motives. The vagueness surrounding the definition of certain terms in shareholders agreements de facto gives development institutions considerable worth, the role of a guarantor – or even a power to block. Nevertheless, these agreements must authorize an exit by "mutual consent" when the founders consider that the institutional development mission of an entity has effectively been completed.

However, what happens in the case of a MFI that gradually veers away from its initial objectives or

[1] *For example, the European Fund for Southeast Europe (EFSE) – one of the biggest funds operating in the microfinance sector, and one of the first public-private partnerships of its kind – which provides long-term financing to MFIs in Southeast Europe.*

[2] *De novo institutions have been the main instrument by which IFC, thanks to its experience with ProCredit in Eastern Europe, has developed microfinance on the African continent by creating institutions such as MicroCred Madagascar, Advans Cameroun and Ghana, Access Liberia. These institutions combine a strong technical partner and founding institutional shareholders who share the same philosophy for developing financial services for the poorest populations.*

[3] *Lessons learned by ProCredit in the Philippines, or by Access in Mozambique, are good examples of how important coherence among shareholders is. It is core to making the strategy sustainable on both a social and commercial basis. In the case of Mozambique, the "forced" exit of Access led the holding company to ensure it always had majority control within each local establishment.*

[4] *Representatives appointed by IFC always act in a personal capacity in order to give priority to the specific interests of the institutions where they are directors, even when this position leads them to take decisions that may be in conflict with the interests of IFC itself.*

[5] *For all these reasons, it would appear difficult to recommend to a MFI not to keep its biggest clients and limit the size of the loans it allocates.*

The role of development finance institutions in good governance for microfinance

By André Laude, *Chief Investment Officer for microfinance investments at the International Finance Corporation*

its target market? In the face of such derailments, there are still extremely few fully satisfactory levers – experience also shows that shareholders are not always aware of how serious the situation is. To deal with this possibility, it would seem wise to recommend a minimum level of flexibility in the rotation of directors. A new opinion may indeed prove to be beneficial for both the MFI and investors. By bringing in new players, it is sometimes possible to give new impetus to the "militancy" of a director. But there should not be an excessive focus on the hypothesis of a "gradual loss of control"; during a phase of economic growth, it is normal for a MFI to grow and evolve with its client base and to try to attract an ever-wider public. Marketing tailored to SMEs or certain retail products and a more sophisticated segmentation must be implemented, and this includes helping to look for business beyond the initial area of the MFI's operations. Indeed, it may well remain true to its original social and environmental mandate and, at the same time, develop related activities (loans to SMEs for example) and look for new clients. Any MFI that reaches a critical size and financial self-sufficiency will then be able to widen its core business to such activities. It will consequently be able to evolve towards the function of a specialized commercial bank, capable of providing a wider range of products to its clients (documentary credit, treasury management, etc.) insofar as the latter require larger-sized loans and more sophisticated services[5].

A MFI that develops – especially if it has a bank status – diversifies its activities and reaches a sort of "age of reason". At this stage, it is time for the development finance institution to withdraw. One might think that the role of the development institution should continue beyond this stage, particularly if the MFI extends its operations to new socially disadvantaged levels. The debate remains open but if a MFI has the capacity to mobilize resources from financial markets by the quality of its financial statements, the aim of the development finance institution may be considered as having been reached. It is then desirable for it to recycle its equity investment and allow its client to bring in carefully selected private institutional investors. This will undoubtedly make the mission more sustainable. •

ProCredit: a precursory model

The model of ProCredit, an unquestionable precursor in commercial microfinance, drastically changed the situation of a sector which prior to the 1990s was mainly based on solidarity credit. ProCredit improved the technology for loan allocation by analysing and setting parameters for individual microenterprises: financial modeling, analysis of treasury flows, attitude towards debt. This model is built on the postulate of the intrinsic profitability of a microfinance portfolio, based on rapid organic growth and expansion. In this context, it is essential to provide theoretical and practical training in this very specific technology (origination, analysis, validation and close client supervision). This initial development phase is the only one to use technical assistance funds that are required to train executives and loan officers – the target remains commercial profitability within two to three years. Finally, this model also aims to reach self-sufficiency in resources by using public savings and payment services, current accounts and transfers. This model has had considerable influence and has been reproduced many times (for example, Advans, MicroCred, Access). In some ways, it has helped adapt the know-how and banking technology of major corporates, so that they are accessible to and serve the needs of the unbanked and/or informal sector of society.

WHAT BALANCE BETWEEN FINANCIAL SUSTAINABILITY AND SOCIAL ISSUES IN THE MICROFINANCE SECTOR?

Symbiotics advises microfinance investment vehicles (MIVs) in their choices by conducting audits, financial assessments and targeted studies. In this article, the analysts Jérôme Audran and Yannis Berthouzoz identify the reasons why private players invest in this sector; they consider that a greater involvement – while remaining "responsible" – of the private sector is necessary in order to continue the fight against banking exclusion.

Microfinance, an opportunity for socially responsible investment

Microfinance used to be seen as a simple development tool, but now provides private investors with attractive investment opportunities. It creates social benefits by helping to democratize access to financial services in developing countries and offers a stable return with little correlation to financial markets. By making the sector accessible to private investors, microfinance investment vehicles (MIVs) have managed to substantially increase funds available. However, amounts are still limited and banking exclusion consequently remains high. This can only be remedied with wider and more responsible private sector involvement.

By Jérôme Audran and Yannis Berthouzoz, ***analysts at Symbiotics S.A.***

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Yannis Berthouzoz graduated in Economic and Social Science from the University of Geneva and takes a particular interest in socially responsible investment. Prior to joining Symbiotics, he worked at UNCTAD and in the pension fund industry.
Jérôme Audran and Yannis Berthouzoz are analysts at Symbiotics S.A., a consulting company for microfinance investment vehicles.

The microfinance sector has radically changed over the past decade. Its financing was traditionally based on public funds, but has gradually opened up to commercial financing. This has helped bring in large numbers of private investors who now see microfinance as a viable sector with high potential and attractive investment opportunities. This change is a clear sign of progress in fighting financial exclusion on a large scale, but has however led to new issues concerning the social vocation of the sector.

Growth of microfinance investment vehicles

Microfinance investment vehicles (MIVs) appeared in the 1990s and have been instrumental to the rapid growth of the sector. These independent investment entities invest public and private investors' equity in microfinance institutions (MFIs) or in other MIVs. The Consultative Group to Assist the Poorest (CGAP) – the main organization in charge of promoting microfinance – counted 103 MIVs at the end of 2008. They were then managing 6.6 billion dollars of assets, mainly invested in the form of debt in Latin America and Eastern Europe (75% of the total portfolio)[1]. Their strong growth in 2008 both in the amount of entities (+11) and in asset volumes (+31%) demonstrates investor interest in microfinance. This interest has not dwindled despite the crisis; for example, the assets of Luxembourg-based MIVs rose by 8% in the first half of 2009 (see graph below).

This growth can be explained by the predominance of private equity in the financing structure of MIVs since 2005 – despite the increasing commitment of investors. The International Year of Microcredit 2005 and the attribution of the Nobel Peace Prize to the Grameen Bank and Muhammad Yunus in 2006 show the interest this sector arouses. To date, according to CGAP, only 21.3% of money invested in MIVs comes from public financing. The rest comes from private investors: 33.5% from private individuals, 33.3% from institutions (banks and pension funds), 8.8 % from parapublic organizations (foundations, NGOs and networks) and 3.2 % from MIVs with a "fund of funds" structure.

Attractive and accessible investment opportunity

Microfinance provides a new investment opportunity for private investors. Its inherent characteristics make it attractive, and MIVs make it accessible by facilitating investment. It generates social benefits by helping to provide access to financial services and, in doing so, contributes to the global effort to combat poverty. It also offers attractive and stable returns that make it possible to diversify investment portfolios. Managers specialized in microfinance are gaining expertise with in-depth knowledge of markets using adapted rating systems and can consequently make efficient investments in the sector. The different missions, structures and investment strategies of MIVs (debt, equity, guarantees) also give investors several investment options depending on their profile and targets. The development of MIVs (15% of them have now topped the 100 million dollar mark) and their increased professionalization are attracting more and more institutional investors.

La microfinance, une opportunité d'investissement socialement responsable

Par Jérôme Audran et Yannis Berthouzoz, *analystes chez Symbiotics S.A.*

Stable and attractive financial returns

Trends in the SMX index[2] (see graph below), which has been tracking the monthly performance of five MIVs[3] mainly investing in the form of debt, confirm the fact that microfinance offers stable and attractive returns. Indeed, the index has been constantly rising since January 2004 and has only recorded positive monthly returns. Over the past four years, the funds have generated an average return of 5.4% a year, and in 2008 returns reached 6%. This yield was on average 106 basis points higher than the USD one-year interest rate SWAP. Moreover, the volatility of the past five years has remained low at 0.5%.

The good performance is due to the stability of interest rates for loans allocated to MFIs (9% on average), mainly with fixed coupons. The repayment rate is near the 100% mark which also means the funds have no investment losses. Finally, the absence of a secondary market ensures the value of the debt, recorded at its historical cost, remains stable. These elements explain why the SMX index is stable, particularly in 2008, while over the same period JP Morgan's EMBI index[4] - which tracks the yields of debt instruments exchanged on emerging markets - fell 11%.

However, the slight fall in yields during the first half of 2009 (1.7%, i.e. a 3.4% annualized yield) shows that MIV performance was affected by the financial crisis. The high volatility in exchange rates observed at the beginning of 2009 increased foreign exchange hedging costs and generated losses for the MIVs that had taken foreign exchange positions. Moreover, there was a fall in demand for financing from MFIs which had anticipated a slowdown in their activities. The resulting rise in liquidities brought down MIV yields. The crisis consequently encourages their managers to find new investment opportunities within a context of greater competition.

Viable well-managed MFIs

The good performance of MIVs is particularly based on the financial soundness and repayment capacity of MFIs. Out of the 10,000 MFIs identified around the world, some 300 meet the financing criteria of MIVs. Most of them are regulated and record good performance in terms of both the scope and quality of loan portfolios, governance, and profitability. Between 1,000 and 2,000 other MFIs have strong growth potential and represent new investment opportunities in the medium term.

The fundamentals of the sector remain sound despite the crisis. According to SYM50, a comparative indicator (developed by Symbiotics) that tracks the financial performance of fifty MFIs which are representative of the sector, their portfolio at risk has risen from 2.8% to 4.8% in a year (see table below). This can be explained by the drop in borrowers' incomes as a result of both a fall in the profits generated by their activities and a decrease in money transfers from abroad. The resulting rise in provisioning costs, to which is added the cost of foreign exchange hedging, has had an adverse effect on the profitability of MFIs. With a slightly lower financial lever, the average return on equity fell to 5.5% in June 2009 against 21.3% a year before.

However, the portfolio at risk - the main indicator for the quality of underlying assets - does remain at an acceptable level and is often well below that of classic banks. Despite a slowdown in activity, total assets, the loan portfolio and the number of clients are still growing. MFIs remain self-sufficient from an operational and financial point of view and their profitability remains positive. Thanks to a marked improvement in governance systems, they have been able to face the crisis and adapt their activities. They are tightening their loan policies, focusing on less risky products and reviewing their business plan in order to optimize the management of their liquidities.

Towards massive financial and responsible inclusion

MIVs have contributed to the development of MFIs by facilitating financial intermediation. The convincing results of this financial innovation has

Performance of SYM 50 MFIs

Indicator	*1 year trend*	*June 09*
Total assets ($ ml.)		101.58
Gross loan portfolio ($ ml.)		75.28
Number of active borrowers		46,633
Average loan ($)		2'095
Debt/equity ratio		4.36
Loan portfolio yield		29.12%
Operational expense ratio		14.66%
Operational self-sufficiency		109.31%
Return on equity		5.54%
Portfolio at risk (PAR > 30)		4.76%

Source: Symbiotics

[1] *These MIVs sometimes take very different forms and include both debt investment funds (e.g. ResponsAbility Global Microfinance Fund), structured products (e.g. Microfinance Loan Obligations), private equity funds (e.g. BlueOrchard Private Equity Fund), holding companies (e.g. Procredit Holding) and also non-profit investment funds and cooperatives (e.g. SIDI, Oikocredit).*
[2] *Symbiotics Microfinance Index.*
[3] *The asset classes of MIVs tracked by the index are ResponsAbility Global Microfinance Fund B Cap; Dexia Micro-Credit Fd Sicav BlueOrchard Debt USD Cap; Finethic Microfinance SCA SICAR USD; ResponsAbility Microfinance Leaders Fund; EMF Microfinance Fund AGmvK, Class T (since March 2009); Dual Return Fund Vision Microfinance USD Cap (up to February 2009).*
[4] *Emerging Markets Bond Index*

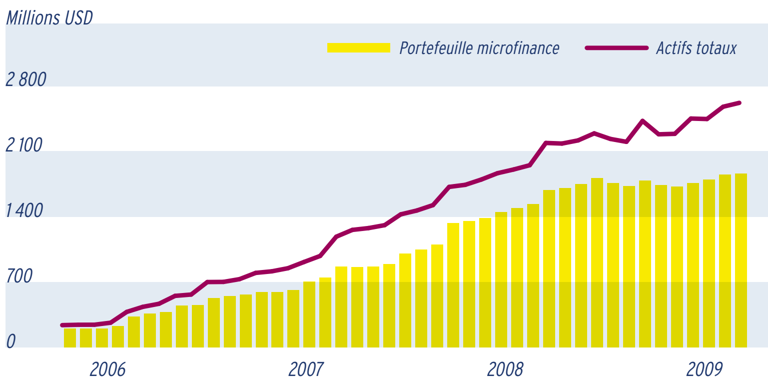
Microfinance, an opportunity for socially responsible investment

By Jérôme Audran and Yannis Berthouzoz, *analysts at Symbiotics S.A.*

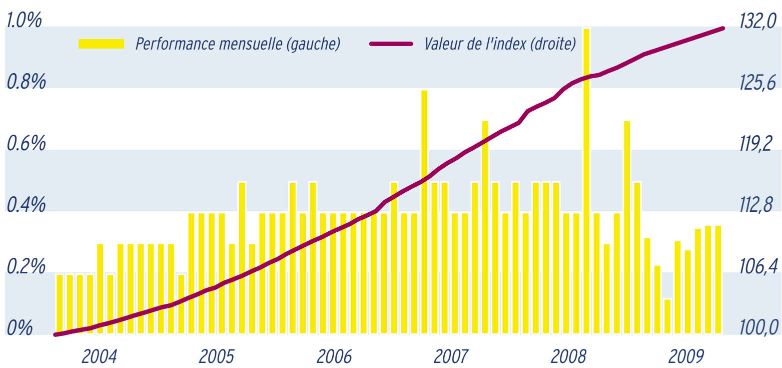
made it possible to increase financing sources. However, despite the sector's growth, banking exclusion remains high throughout the world. Out of the billion and a half microentrepreneurs estimated by Deutsche Bank, only 10% benefit from services provided by MFIs. Microfinance is consequently a long way from reaching its full potential; wide-scale inclusion will only come about with greater private sector involvement to boost sector development. The use of new technologies to lower transaction costs will help MFIs penetrate new markets while remaining profitable. They will also be able to improve the way they operate thanks to good governance, product innovation and the creation of local industries. This will make microfinance even more attractive.

To be sustainable, this growth must ensure continuous healthy practices; risks of abuse that are specific to the free market economy must be avoided. Indeed, the issue of overindebtedness and client protection is decisive for avoiding a "microfinance bubble". This is also the case for issues concerning the way employees are treated and the cost of products. By integrating these issues, the sector will generate high social impacts and will also limit the reputation risk. From this perspective, several initiatives are promoting healthy and responsible practices to MFIs and MIVs. For example, the Social Performance Task Force standardizes social performance measurement in the sector. The Client Protection Campaign increases the awareness of the different players to the issue of client protection. These initiatives also make it possible to implement rating systems (for example, those of Incofin, Oikocredit and Symbiotics) that assess the social performance of MFIs. It is consequently possible to improve the selection by using social criteria. These initiatives contribute to the development of microfinance as a socially responsible asset that judiciously combines financial interests and social targets. ●

Assets evolution of Luxembourg-based MIVs[5]



SMX USD index evolution



Source: Symbiotics

[5] *It should be noted that MIVs can also make marginal investments in sectors other than microfinance (fair trade, SMEs). This explains the differential between "Total assets" and "Microfinance portfolio". To be considered as a microfinance fund, the fund must invest at least 50% of its portfolio in the sector.*

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WHAT BALANCE BETWEEN FINANCIAL SUSTAINABILITY AND SOCIAL ISSUES IN THE MICROFINANCE SECTOR?

ProCredit Holding is the major shareholder of 22 microfinance banks present on three continents and a key player in the sector. In this article, Dr. Claus-Peter Zeitinger, Chairman of the Supervisory Board, presents the tools that are available to fight against any loss of control in the sector that would cause microfinance to lose sight of its social mission. He emphasizes the key role of communication and also reminds us that shareholders must respect the specificities of the microfinance sector.

How can a MFI manage to have a commercial status and still target "vulnerable" people as a core client group?

When loans are extended to "vulnerable" people, too many of them are left overindebted – this could lead to a highly risky credit crisis. If microfinance institutions need to develop into fully-fledged banks – particularly in order to mobilize deposits from the public – they must also first and foremost help make the sector more responsible. By strengthening and clarifying the way they are organized, implementing real collective discipline, while not forgetting their business culture based on ethical values, they will be able to motivate their employees, satisfy their customers and, at the same time, achieve commercial success.

By Dr. Claus-Peter Zeitinger, *Chairman of the Supervisory Board of ProCredit Holding AG*

Before sharing my thoughts on how a microfinance institution (MFI) can be profitable while targeting "vulnerable people" as a core customer base, please allow me to clarify two points:

First, any MFI wanting to be more than a donor-driven NGO or a funding organisation backed by sponsors in developed countries should attempt to acquire a banking licence or register as a regulated non-banking financial institution. By taking such a step, a MFI can attract local deposits and thus achieve a certain degree of independence and sustainability. In the case of ProCredit institutions, customer deposits exceed the loan portfolio in most of our branches in Latin America and all of those in Africa. The exception is Eastern Europe, where the pace of market expansion has been exceptionally strong over the last few years. The challenge in these markets is not so much the lack of savings, but rather the relative institutional weakness of the banking sector and the absence of a long-term vision. This weakness, rather than the lack of money, is the true missing link in these markets.

The second point that requires clarification is the term "vulnerable" when applied to customers. A financial institution that intends to generate even a modest profit could, of course, extend loans to the truly downtrodden, but that does not mean that they should. Many players in the microfinance sector have been pulling the wool over the world's eyes for a long time with claims that they could eliminate global poverty if only they were given sufficient means. But I would strongly argue that the most vulnerable groups in society do not, as a priority, need loans: they need governments to invest in better infrastructure, schools, health and clean water. Very often the "poorest of the poor" are not running viable enterprises and they are very vulnerable to consumer debt they simply cannot afford.

As soon as an institution begins providing credit to micro-enterprises it already has one foot in the quicksand of consumer lending. The owners of very small businesses do not usually draw a clear line between working capital and family expenses. The old-school practitioners of microfinance have always been aware of this grey area and deal with it sensitively as part of their credit analyses. Bolivia, with its well-developed microfinance sector, provides a good and positive example of this approach by drawing a clear line between microenterprise and consumer finance.

Recently, however, MFIs have become socially acceptable for a growing number of institutions. The United Nations dubbed 2005 the International Year of Microcredit, and the Nobel Peace Prize was awarded to a pioneer in this field

How can a MFI manage to have a commercial status and still target "vulnerable" people as a core client group?

By Dr. Claus-Peter Zeitinger, *Chairman of the Supervisory Board of ProCredit Holding AG*

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in the following year. This surge of interest soon prompted "real banks" to offer assistance and support: Citibank, Deutsche Bank and Credit Suisse, among others, started providing funding to the microfinance sector. In short, the capital market and the MFIs threw themselves at each other like two young lovers. The banks were enticed by the prospect of high returns, while the MFIs were basking in the light of their newly-found recognition and respect from the major banks – not to mention of course the fact that finance was suddenly much easier to obtain and came with fewer strings attached.

At the same time, the industry discovered the "working poor" as another potential customer base in addition to micro-entrepreneurs. By now, MFIs have both feet caught up in the quagmire of consumer lending. My fear is that the end result of this shaky relationship with the working poor will be a subprime crisis in the microfinance sector. Given that the majority of MFIs are not subject to strict accounting and banking requirements, things may carry on in this way for some time to come. In their quest to reach a large number of poor people and families with no regular income, many MFIs have showered their customers with consumer loans, in many cases making them too indebted to repay all of their obligations. To be fair, it should be added that these developments have mostly taken place in Eastern Europe and Latin America.

Rather than talking about "vulnerable" people and microfinance, which is in any case a term that different people can associate with different things, I prefer to talk in terms of developing "responsible banking" for ordinary people. It is less spectacular, and certainly not as popular. Moreover, it requires a lot of staying power: I believe the two essential ingredients for success are structure and discipline. Never mind if my choice of words on this point exposes me as a German. It is important to reflect on how to build commercially viable financial institutions committed to traditional business concepts such as efficiency, growth and customer service, but not driven by concepts like bonuses and short-term profits, because I do not believe that the latter are compatible with serving "ordinary" people in a responsible way.

Structure begins at the shareholder level and should be reflected in the composition of the management and the organisation as a whole. With a clear structure in place, the result is a high degree of transparency in the institution. Discipline is more than a secondary virtue, it is an approach to life that implies a broad range of values and their dissemination at all levels of the organisation.

The shareholders of a responsible bank should be investors with a long-term vision whose interest in making a profit is balanced by a strong commitment to economic development. Those who think they need an exit option after 5-7 years should not even consider entering a market that is characterised by steady institutional growth over the long term. This tends to rule out those players in the private capital market dominated by short-term "shareholder value" thinking. One needs to find socially responsible private investors who are looking for sustainable, reliable long-term returns. My own personal experiences with public shareholders have been good.

The management team of a responsible bank should be guided by a competent supervisory board. Competence, in this particular sense, refers more to life experience and an adherence to ethical principles than to any specific technical knowledge. In order to ensure that they truly share a commitment to the institution's mission, the members of the supervisory board should only have their out-of-pocket expenses covered.

The question of salaries is of no less importance at the management level of such a bank. I believe that very high salaries and performance-related bonuses are completely inappropriate, particularly in financial institutions that claim to be driven by ethical values; here they would do nothing less than poison the heart of the organisation. Of course I am in favour of commercial success (which is not the same as profit maximisation), but I do not support the idea of motivating managers with pay bonuses just because it is difficult to think of any other way to inspire them or to engage in meaningful communication. After all, in order to lead a responsible, target group-oriented financial institution, the first requirement is a team of managers

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who are open and able to deal with shareholders as well as their employees, who have strong communication skills, and whose motivation is rooted to some extent in ethical principles – all criteria which typical bankers are only rarely able to meet. Based on this observation, there is no reason why others should follow their way of doing business.

Below management level, autonomy and decision-making skills should pervade the organisation all the way down to its lower levels. When lending to micro, small and medium-sized enterprises, a bank must always take individual circumstances into account and build a close relationship with its clients. This entails a high degree of personal contact, a significant investment of time and the compilation of detailed information about each client. It is a strategy which can only be carried out by adopting a decentralised approach to doing business and establishing a similarly decentralised decision-making process. That said, it would be naïve to think that each branch will inevitably act in the best interests of the institution. A sound internal control system, including credit control and an internal audit department, is therefore a vital component alongside clearly defined standards set by the management and a common business philosophy among all staff members. These measures might be expensive and drive up the cost-to-income ratio, but they are indispensable. To reduce expenses and generate a higher level of income, an exclusive focus on one core group – such as micro-enterprises – should be avoided. ProCredit banks are characterised by a portfolio which, in addition to loans to micro-enterprises, also contains a significant volume of loans to small and medium enterprises. These clients represent a considerable source of revenue as they subscribe to a broad range of banking services. From a development perspective, they are also a vital force in the creation of jobs and prosperity in a country.

I have just outlined the type of structure that is needed within an institution but it goes without saying that its soul is also a key factor. This is a combination of the corporate spirit, the image that staff have of themselves and role models. In saying this I have other organisations in mind such as Germany's Sparkassen, Austria's Raiffeisen banks and the French Credit Agricole Group. These are all companies with a long history, established traditions and a strong sense of identity yet lost much of their original soul (and a lot of their money) when they decided to become "real banks".

A company only has a soul if the majority of its staff are truly committed to a vision and take an active part in achieving that vision. I consider it less important for employees to hold shares in the company they work for, even though I personally favour the idea. What seems more crucial to me is that they are able to take part in the decision-making process. It is precisely for this reason that discipline is needed, as mentioned earlier. For staff to develop the ability to make decisions effectively, they should be trained in technical areas and, moreover, empowered to do so in a humanistic sense. I do not believe in financial incentives to urge staff to behave in a certain way but in the power of intelligent communication and the use of rational arguments and relevant examples to convince them. The self-centered, neo liberal man [of the post-modern era] has proven to be quite vulnerable from an anthropological and sociological perspective, and in my opinion the financial crisis has buried this model once and for all.

In our day-to-day work we follow the admittedly time-consuming processes of developing insight through critical thinking and putting shared values into practice. Being disciplined involves fully understanding your own role and being able to assign a role to your colleagues; in no way does it equate to following orders. Communicating with your staff in this way fosters a strong identification on their part with the institution and with its core target groups – and it is to our customers in particular that our banks should demonstrate a high degree of social responsibility. As far as we are concerned, this is the only way to achieve commercial success and personal fulfilment at the same time. ●

The Consultative Group to Assist the Poorest (CGAP) gathers bilateral, multilateral and private donors and has a mission to contribute to the development of the financial sector that targets the poorest populations. In this article, Elisabeth Littlefield, its Chief Executive Officer, and Luc Rigouzzo, Chief Executive Officer of Proparco, together address the issue of overindebtedness. In addition to a review and analysis of the situation, they go through the reforms that need to be implemented and possible solutions for fighting against abusive practices.

Microfinance: on the road to responsible finance?

Although serious abuses may be in the minority, the microfinance sector is not without flaws – or temptations. Some highly competitive markets put considerable pressure on costs to the detriment of service quality, while others that are less competitive tend to overbill their clients. It is essential for the sector to come back to the fundamentals of the profession based on a sound knowledge of counterparts and "long-term" relationships with clients. It must also be a priority to protect the latter. The action of CGAP and Proparco provides an example of how donors can support existing initiatives in this field and promote their dissemination – this will create the conditions for the development of responsible finance.

By Elizabeth Littlefield, ***CEO of CGAP,*** **and Luc Rigouzzo,** ***CEO of Proparco***

There is much talk about "responsible finance" these days. Within the microfinance industry, there's been a tendency to believe that "irresponsible finance" was confined to mainstream financial markets. But in 2009, the microfinance sector has come under more intense scrutiny than ever before, and some are asking whether providers of microfinance—a vast majority of which were created specifically to serve the poor and provide them with better options than money lenders do—might have been lured away from their original missions by the temptation to become larger and more profitable.

Some outside observers and the media are openly wondering if some areas of microfinance aren't guilty of the same excesses of unrestrained mainstream financial markets — reckless and predatory lending practices that over-indebt the poor, products that lack transparency on pricing and lending conditions, pressures on loan officers and other staff to cut corners and put short-term gains before their client's interests, and too much investment money pressuring providers of microfinance to pursue unrealistic goals in terms of growth and return[1].

What's the reality? Does microfinance exemplify "responsible finance" or does the sector need to take action now to ensure transparency, fairness, and services to low-income clients that improve their welfare rather than undermine it? We would argue that the problems that received most of attention and that raised the biggest concerns — namely over-indebtedness and the subordinating of client interests to growth and greed—are not widespread in the microfinance industry worldwide. Most microfinance providers offer financial services that deliver substantial benefits to their users and are highly valued by clients. Lack of access to basic financial services, rather than excessive access, remains the larger problem. This is certainly the case for credit services and even more so for financial services, such as deposits and payments services that do not raise the same risks for poor people as taking on debt.

On balance, access to microfinance is a good thing, but this does not mean it should be endorsed unreservedly. In some markets, escalating competition and very rapid growth have created pressures to cut corners. This deserves careful analysis, and action. While there is little evidence that microfinance is causing widespread insolvencies, there are many reasons to shift the focus, once again, on sound underwriting. Microlending should be built on the premise of knowing the customers , carefully analyzing their ability to reimburse loans and to satisfy other obligations, It should also be measured against its capacity to provide well-structured loans, and lay the foundations for a mutually beneficial long-term relationship[2].

At this particular juncture, there is a strong case to strengthen that foundation and adopt the same 'back to the basics' policy that produced decades of strong loan recovery rates. Clients in many markets are under higher pressure as a result of the global crisis. Remittances are down in many coun-

[1] *The Wall Street Journal, for example, recently warned of a brewing credit crisis in microfinance as a result of poor neighborhoods in India being «carpet bombed» with loans [13 August 2009], and France 24 accused microfinance providers in India of causing over-indebtedness for borrowers through multiple loans that failed to take account of borrowers' capacity to repay.*

[2] *It is also important to note that multiple lending—where a client has loans outstanding from multiple providers—is not the same as over-indebtedness. Often, in fact, the client can afford more debt than any single provider is willing to offer. Here the problem might be rigid products rather than debt-stressed clients.*

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tries, and costs of living are up. Performance of microfinance portfolios is slipping in some markets, particularly those experiencing fierce competition or economic stagnation. In most markets, there is a dearth of new capital to finance growth in the microfinance sector, but this can also be welcomed as an opportunity to strengthen basic operations. The subprime credit crisis is a grim reminder of the dangers of irresponsible finance—for consumers, providers, and entire financial markets.

To avoid over-indebtedness, providers need to take the lead in strengthening their credit operations, by carrying out a top-to-bottom review of their credit policies, staff training and compensation policies, loan monitoring and collections, as well as client communications. Not only should microfinance providers take these actions within their own structures, they should also enter into partnerships at sectorial level in order to improve credit information sharing, educate their clients, and coordinate expansion strategies and the establishment of branches. National microfinance associations in countries ranging from Mexico to Uganda to Pakistan are developing strong codes of conduct and pushing their members to implement these codes of conduct in an effort to improve policies, products, and practices.

Ensuring that clients can handle the loans they are provided with is not the only dimension of responsible finance. Around the world, providers of microfinance are beginning to enhance client protection, transparency, and fair treatment, on an individual basis as well as a sectorial basis. They are taking steps to make their pricing more transparent, fully inform clients about their rights and responsibilities, ensure that collection practices are appropriate, improve clients' access to redress when things go wrong, and train and reward staff to display the highest level of personal integrity.

CGAP joined with ACCION International and others to translate these commitments and initiatives into six core client protection principles and create the Campaign for Client Protection in Microfinance. To date over 450 institutions—retail microfinance providers, national associations, international networks, donors and investors—have endorsed the principles and committed themselves to practical steps in order to translate them into real improvements in policies, products, and practices. For example, in Nicaragua, Banex has made significant changes in its internal processes, including implementing a code of ethics for collectors and attorneys, training them on customer rights, avoiding forced loan recoveries whenever possible, adding an ombudsman to protect the customer, and informing customers about their rights in writing.

Microfinance providers and their backers must be held accountable for translating these lofty principles into actual practice. We need robust, field-tested tools (such as the Beyond Codes Self-assessment Guide[3] that enables microfinance providers to make a clear and honest assessment of how they measure up to each of the principles) that lay out very clearly what improved policies and practices should look like for retail providers. Thorough and straightforward reporting (e.g., the new MIX Social Performance Standards Report[4]) is part of the solution as well.

Considering that some of these responsible finance measures are difficult to take, especially in competitive environments, providers will also need incentives. This is why CGAP has taken the lead in reaching out to the microfinance investor community and mobilizing an initiative to integrate the Client Protection Principles into every step of the investment process, from due diligence to financing agreements to monitoring. To date, more than 85 investors and donors of all types—small and large, public and private, debt and equity providers, funds and fund managers—have endorsed the principles and committed themselves to action. We want investors to ask tough questions. We want them to work with their partners to identify areas for improvement; we want them to support vigorous efforts to address them. And we want them to reward those microfinance providers that can demonstrate particularly strong performance on client transparency and fair treatment—with more financing, financing on better terms, and visibility.

Proparco and AFD have benefited of the CGAP experience when redefining their strategy in microfinance in 2006. AFD Group accepted genuinely to be part of a peer review leaded by CGAP. This gave the Group a clearer view of its comparative advantages and areas of progress. Being part of this "global team" helps Proparco to select MFIs with a proven track record and which have developed a recognized responsible model for financial service provision to the poor. First of all, this means that the institution will need to be able to provide clear evidence of its strategy in terms of its profitability targets and how these targets are moni-

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tored. Proparco doesn't want to provide finance to institutions which are over profitable as a result of charging their clients with unreasonable interest rates. Secondly, in these turbulent times of "irresponsible finance", it is more crucial than ever before to expect rigorous, transparent and sound financial management of MFIs. Moreover, Proparco will insist on "best practices" in terms of environmental, social and anti-money laundering issues. The assessment of each of the above focus points is made all along the appraisal process, before the investment actually takes place. If critical issues are identified, Proparco will weigh the opportunity to invest against the positioning of the MFI management team and its shareholders, and their willingness to undertake effective measures to fix such issues. Being most of the time minority shareholders, another crucial element for Proparco is then *affection societatis* and the choice of partners made by the MFI under consideration. Then, it will be ensured that partners share the same approach on microfinance investments.

Donors have important roles to play at the institutional level as well. They can support responsible finance initiatives of providers and their associations, identify trouble spots and determine practical actions to fix them. They can support appropriate consumer protection policy initiatives and invest in helpful market infrastructure (such as credit information reporting, a powerful tool to help borrowers and lenders guard against over-indebtedness). Donors could also make critical contributions to an essential element of responsible finance—ensuring that the clients themselves are equipped with the knowledge, skills, and attitudes to protect themselves, make informed choices, and hold up their end of the responsible finance bargain. "Financial capability" initiatives are in their infancy for low-income consumers in low-income countries. Well-designed external support could play an important role in assessing priority issues, building knowledge about what does and doesn't work, and scaling up cost-effective programs.

Consumer protection regulation is also part of the solution, if it is designed and implemented with financial inclusion goals in mind. CGAP is identifying and analyzing regulatory approaches from around the world that appear to be striking the right balance. Setting basic standards and market conduct "rules of the game" protects clients. These rules can also protect responsible finance providers against unfair competition.

The time is right for the microfinance sector to rededicate itself to its original mission of providing diverse, high-quality financial services—not just credit—to the poor. This needs to be done in ways that protect clients' interests, offer good value for money, and mitigate risks appropriately. This is, ultimately, the essence of responsible finance. •

[3] The Self-Assessment Guide is a manual designed to make a thorough assessment of MFIs' client protection performance. It can be used by MFIs to assess their own performance and may also be used to develop third-party assessment tools. The guide takes users through a process whereby they collect the information required to evaluate a MFI's consumer protection practices.

[4] This report collects information on 22 core indicators and focuses on the MFI's mission, products and services, social performance and outreach, client and employment outreach, social and environmental responsibility, child education and poverty levels.

Lessons-learned from this issue of *Private Sector and Development*

By Bérengère Basset and Julien Lefilleur

Although microfinance has enjoyed exceptional growth in recent years, sector players are unanimous in saying that its development potential remains high. And to pursue this development, considerable amounts of financing are required. Public funds provided by governments and international donors may have widely contributed to the emergence and strengthening of the sector, but they are no longer sufficient today. In view of the amounts that are needed, this growth cannot be exclusively financed by the cumulated incomes of microfinance institutions (MFIs) – not to say that such a strategy would be a sign of weak financial management and might well encourage client overbilling.

To satisfy its growth ambitions, the microfinance sector must turn towards private investors. Although it would seem preferable to have recourse to local financing rather than international financing in order to protect the sector against volatility and make it sustainable and independent, the markets in which microfinance operates very often lack the maturity required to readily catalyze sufficient amounts of long-term resources. These constraints tend to make MFIs open up to international private financial markets. These markets may have reacted well by providing sizeable amounts of financing – encouraged by the high media profile of the International Year of Microcredit in 2005 and the Nobel Peace Prize being awarded to Muhammad Yunus in 2006 – but private sector intervention has sometimes been to the detriment of the social mission of MFIs. Indeed, in a sector that is currently being structured and is not sufficiently regulated, irresponsible practices can easily lead to situations of overindebtedness and loans being overbilled. Average rates for microfinance loans may be on a downward trend, but they still remain high and partly reflect sometimes excessive profitability requirements. There is indeed clearly an imbalance between the position of private players – familiar with all the intricacies of the business world – and that of microfinance clients who are often vulnerable, generally not really sensitive to the rates of loans, and in all cases have little power to negotiate. As clients cannot act as a "counterbalance", market logic is inefficient and prices are naturally adjusted to the advantage of the lender. MFIs target a specific type of client base; it is necessary to take its specificities into account.

In this context, the sector needs a stronger institutional framework or to be self-regulated by sector players – or both at the same time. The institutional environment for microfinance may be strengthened if MFIs transform into banks in order to benefit from a comprehensive regulatory framework and competent supervisory authorities. This will ultimately protect the client. However, this solution does have the drawback of neglecting the specificities of the microfinance profession what could lead MFIs to adopt bank practices and, in doing so, disregard their social mandate. The sector may also seek to develop its own tools – codes of ethics, consumer protection guides, transparency norms, etc. – that would gradually establish a corpus of best practices that MFIs would have to pay heed to (like the Equator principles for banks and environmental preservation). Development financial institutions and public authorities have an important role to play in this by initiating and coordinating these initiatives. However, it is unlikely that these efforts alone will suffice to structure and build a framework that will ensure the social mission of microfinance is preserved. Indeed, if developing countries can manage – although often with difficulty – to make sure existing regulations are complied with, they have practically no means to put pressure on players to adopt this type of "best practices". In addition, this type of constraint could well have a counter-productive effect by putting off investors. In order to preserve the social mission of microfinance, it is consequently first and foremost necessary to rely on the responsibility of all sector players – all the more than the latter have every interest to regulate themselves if they want to preserve their specificity and if they do not want to jeopardize the sustainability of their activities.

Les enseignements de ce numéro

Par Bérengère Basset et Julien Lefilleur

Indeed, microfinance owes much of its success to its social vocation. This target has made it attractive to both private investors – seeking to give a socially responsible image – and public authorities as well as development institutions – keen to support this new poverty reduction instrument. The sector would obviously be less attractive if it lost this vocation. And if it did nevertheless continue to appeal, it is likely that repeated abusive practices would "decapitalize" the poorest and kill the microfinance market. Sector players consequently have every interest not to lose (or even to consolidate) their proximity to their clients by paying attention to their financial situation, training them and giving them the technical assistance they need. The aim is to strengthen borrowers' capacities to develop sustainable income-generating activities. In doing so, MFIs meet the social mission that is part of their mandate and, at the same time, develop their own market: they consequently have a twofold interest to adopt responsible practices. Yet this is only possible if their shareholders are fully aware of how important the social dimension of their profession is.

The key to success consequently lies – perhaps more than anywhere else – in governance, which explains why development institutions focus so much on it. The latter may have a very limited role from a financial perspective, but their added value lies more in their "moral" involvement within the investor community to ensure that the social mission of MFIs is preserved. When donors withdraw from the capital of a MFI on justified grounds, it may mean the end of implicit moral support; this is where they have real clout (and responsibility). However, it is not enough to adopt best practices; they must also be recognized and made public so that the investor community can differentiate between MFIs according to their social performance. The social impact of a MFI must become a "market value" that is easy to quantify and measure (like financial performance); this requires designing, developing and implementing measurement tools that today are still too few. It is subsequently necessary to define social ratings based on these impact measurements that will be publicly disseminated and will support investors in their decision-making. These efforts in terms of transparency will allow the latter to valorise the social performance of the MFIs in their portfolio and possibly even gain real benefits for their image. If all these conditions are met, then social performance may become a real market value. Here again, development financial institutions have a role to play by helping to roll out these impact measurement tools, disseminate information and publicly promote MFIs that uphold responsible practices. •

In our next issue

What are the positive and negative impacts of the expansion of the mobile phone sector on the economic and social development of low-income countries?

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