FOCUS NOTE

Foreign Capital Investment in Microfinance: Reassessing Financial and Social Returns

Despite the financial crisis, in the past four years foreign investment in microfinance, including both debt and equity, has quadrupled to reach US$13 billion (Figure 1).[1] This growth has been driven as much by public institutions as by an increasing number of private institutional and retail investors. Indeed, microfinance investing has become the flagship of the rapidly growing impact investment movement.[2]

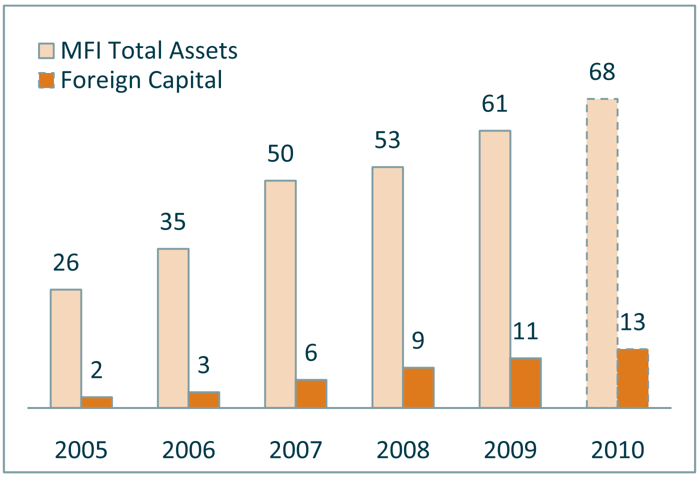
However, the deterioration in microfinance institution (MFI) performance and the rising risk of client overindebtedness in several markets have tarnished the sector's reputation. No longer can microfinance investment be assumed to be a do-good, low-risk, safe haven.

This Focus Note examines foreign investment in microfinance at a critical juncture in the industry, exploring the current investor landscape, including the role of development finance institutions (DFIs) and the growing interest of retail investors. Also highlighted are the decline in fixed-income returns, and the rise of equity investment, as well as the outreach and social performance achieved by foreign capital.

This Focus Note concludes by calling for more transparency on the performance of microfinance asset managers. In a more difficult and competitive market environment, foreign investors need to more carefully assess the capacity of fund managers, their commitment to social performance, and the quality of their investment processes.

The data and analysis for this Focus Note draw on the most comprehensive and up-to-date sources of industry investment data, including CGAP's annual survey on foreign investment and MIX (Microfinance Information eXchange) Market's new Funding Structure Database (see Box 1).

Figure 1: Foreign investment growth continues ($ bln)



Source: CGAP and MIX, numbers for 2010 are CGAP estimates.

1 Outstanding equity and fixed-income investments in microfinance held by foreign investors are from the CGAP Funder Survey 2010.

2 Impact investment, also referred to as *social investment* or *sustainable investment*, is defined as investment in businesses or funds that intentionally set out to generate social or environmental good alongside financial returns. It has been driven by the recognition that government and charities alone do not have sufficient capital to solve the world's social and environmental problems, so private capital investing in socially driven businesses is needed.

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Xavier Reille,
Sarah Forster, and
Daniel Rozas

Box 1: Data Sources

CGAP Funder and Microfinance Investment Intermediaries (MIIs) surveys are conducted annually by CGAP with public and private donors and investors, as well as MIIs. In 2010, data from these two surveys were combined, so as to better reflect the state of funding (as DFIs frequently channel funding via MIIs). The data include information on 61 donors and investors and 90 MIIs.

The MIX Funding Structure Database (FSDB) is a new data source that MIX compiled and launched in 2010. It includes 594 MFIs that report to MIX, representing 71 percent of total assets on MIX. FSDB offers a bottom-up view of the funding structure of MFIs, including information on outstanding debt and its origin. Most other funding data sources focus on supply-side funding flows, whereas FSDB allows for an exploration of relationships between funding sources and MFI attributes. As with all datasets, FSDB has its limitations—it does not capture funding structures of all MFIs or, in some cases, does so incompletely, and it does not capture the sources and types of equity. Not surprisingly, FSDB data and supply-side data do not match perfectly. For example, the foreign debt that FSDB captures accounts for roughly 70 percent of outstanding foreign debt captured in the CGAP Surveys noted earlier. However, cross-checking between the different data sources yields a more informative and accurate overall picture.

Symbiotics SMX is an index developed by Symbiotics, a Swiss boutique investment firm that specializes in microfinance. It provides up-to-date information on fund investments performance. Sym50 provides average financial performance indicators for 50 large MFIs that attract significant foreign investment.

The Investor Landscape[3]

This section presents the investor landscape, including investment volumes and key trends. Cross-border investors are grouped into three categories: public investors or DFIs, institutional investors, and individual investors. Given that about half of all foreign investment is channeled through intermediaries, the size and structure of MIIs are also highlighted.

DFIs: A Growing Source of Cross-Border Investment That Is Implementing New Approaches

DFIs provide more than half of all foreign investment (see Figure 2). Since 2006, they have increased their outstanding investment in microfinance by nearly 350 percent, from US$1.7 billion in 2006 to US$7.5 billion in 2010. Five DFIs—AECID, EBRD, IFC, KfW, and OPIC—have driven much of this growth, and today they account for 71 percent of all DFI funding.

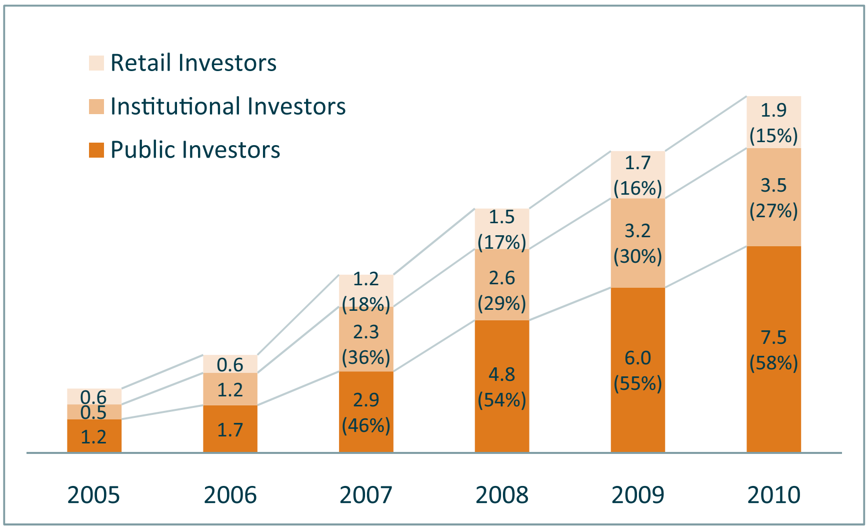
DFI investments are concentrated in the largest, well-established, top-tier institutions in Eastern Europe and Central Asia (ECA) and Latin America and the Caribbean (LAC).[4] Most investments have been in hard currency, fixed-income (debt) instruments.[5]

However, new institutional incentives to increase outreach and add value are pushing DFIs to focus more actively on frontier markets. AfD, FMO, IFC, and KfW, for example, are all investing more in Sub-Saharan Africa, including through dedicated funds such as REGMIFA, a new regional investment fund specifically created to spur funding for micro- and small enterprises in the region. Several DFIs, such as IFC, are also focusing on the large growth markets in BRIC countries, including Brazil, China, and India, which are attractive because of their potential scale and absorptive capacity.

DFIs are also starting to build their equity portfolios. DFIs increased their direct equity investment portfolios by 57 percent in 2009. The

3 Unless noted otherwise, data in sections "The Investor Landscape" and "Financial Performance of Microfinance Investments" refer to CGAP Funder and MIV surveys.
4 As of December 2009, more than 40 percent of the loan capital that DFIs provided was concentrated in 15 profitable MFIs (six of them from the ProCredit Group), all of which also received funding from private sources.
5 Eighty-four percent of DFIs' direct fixed-income investments in MFIs are in hard currency (CGAP 2009a).

Figure 2: All funder types have recorded investment growth ($ bln)



Source: CGAP Funding Surveys; 2010 data are CGAP estimates.

move into equity investment is a means both to build the capital base of existing MFIs and to provide start-up capital for new MFIs.

Box 2: Greenfields

Half of foreign DFI equity investment is placed in the holding companies of microfinance banks and used to finance the start-up of new ("greenfield") subsidiary banks. There are seven such holding companies with total assets of US$1.2 billion. The first generation was set up by large consulting firms from the north, such as Procredit, a holding company established by the German consulting firm, IPC, which has established 19 microfinance banks worldwide. The second generation of holding companies was set up by successful MFIs from the south, such as ASA and BRAC in Bangladesh, ACLEDA in Cambodia, and Xac Bank in Mongolia, that are replicating internationally. Greenfields have certain advantages, including sound governance structures and strong business processes, and they begin with a bank legal structure that allows them to offer a wide range of financial services, including savings. DFIs have facilitated the creation and the growth of greenfields by providing a significant amount of technical assistance and financing during the start-up phase.

Institutional Investors: A Diverse Group with Varied—and Changing—Strategies

Institutional investors provide 30 percent of the stock of foreign investment. They are the fastest growing investor group, having increased their outstanding investment in microfinance from US$1.2 billion in 2006 to US$3.5 billion in 2010. This group includes a broad range of institutions and funds, including international banks, private equity funds, pension funds, and insurance companies. Though microfinance represents a very small percentage of their portfolios, these investors have a growing influence on foreign investment in microfinance.

Institutional investors are attracted by three features of microfinance, namely its social value, its perceived attractive risk-adjusted returns, and its potential decorrelation from other asset classes.[6] While new investors are continuing to enter the market in pursuit of these goals, many have been reevaluating these promises and scaling back their investment as a result.

6 Several studies have demonstrated that microfinance investment returns are apparently not correlated to mainstream investment indices. See, for example, Krauss and Walter (2008).

International banks were the first institutional investors to start investing in microfinance in the late 1990s. With more than a decade of experience in microfinance, many are now rethinking their approach. Some banks, such as HSBC, are re-evaluating their microfinance investment strategy. Others, such as Société Générale and BNP Paribas, are looking at offering microfinance products directly through their own banking networks in emerging markets. Several emerging market, corporate fixed-income funds managed by banks, such as Morgan Stanley, are looking for microfinance investments in local currencies in markets with a potential for foreign exchange appreciation. Finally, others, such as JP Morgan, are broadening their investment strategy, actively seeking out other impact investment opportunities in sectors such as agriculture, health, and renewable energy.

In more recent years, commercial private equity funds have invested in microfinance in a few countries, such as India and Mexico, with well-functioning stock markets and vibrant microfinance sectors. Some of these funds, such as Sequoia and Legatum, have brought a more aggressive, commercial high-risk/high-return investment strategy to the industry. These investment models have helped spur the fast growth of MFIs in India, but have also attracted considerable scrutiny and criticism in recent months amid negative public perceptions that these MFIs (and their investors) are more interested in short-term financial profit than in sustainable growth.

Over the past two years, sovereign wealth funds have also begun to invest in microfinance with a focus on equity. Examples include Temasek, a Singapore sovereign wealth fund, which has made several strategic equity investments in holdings of MFIs in Asia, and Aabar Investments of Abu Dhabi, which has invested more than US$30 million in the Blue Orchard Private Equity Fund.

Nevertheless, suitable investment opportunities for institutional investors currently appear limited. During 2006–2009, large pension funds, such as ABP, PGGM, and TIAA-CREF, each allocated US$100 million to US$200 million to microfinance investment. However, the lack of investment opportunities meeting their risk and reward thresholds has meant that only about half of these allocations have so far been committed to microfinance.

Retail Investors: Small in Volume, but Big on Social Value

Retail investors, including small retail investors and high net worth individuals with a strong social focus, have been investing in microfinance since the 1970s. Retail investments in microfinance have tripled during the past four years to reach US$1.8 billion in 2010.

Retail investment is mainly raised through financial cooperatives, such as Oikocredit in the Netherlands, and public placement funds, such as responsAbility in Switzerland. Retail investors represent only 16 percent of the total stock of cross-border investment today. Although retail investor demand for microfinance is strong, its growth has been hampered by financial market regulations that do not allow microfinance investment funds distribution to the retail market in the United States and Europe.[7]

Internet-enabled retail fundraising platforms have also taken off over the past five years and provide a means for the general public to invest in microfinance in small amounts. The U.S.-based online lending platform Kiva.org has now been replicated in several countries, including Babyloan in France and MyC4 in Denmark. Despite their rapid growth, online lenders represent a tiny share of foreign microfinance investment (less than 0.5 percent). However, these online platforms are among the most prominent means of raising microfinance awareness among the broader public in the West.[8]

A recent Credit Suisse survey[9] of retail investors in Switzerland found that for 63 percent of microfinance

7 Except in the Netherlands and Switzerland for the responsAbility global microfinance fund.
8 Kiva.org claims over 570,000 individual lenders (http://www.kiva.org/about, accessed 5 April 2011).
9 The survey results were presented at the ALFI conference in Luxembourg on 17 March 2011.

investors, doing good and social performance are their first investment motivations. Only 11 percent of the investors surveyed ranked financial return as their primary investment motivation. Most survey respondents were looking for an annual financial return in the range of 2 to 4 percent.

Given their investment motivations, retail investors are concerned by recent developments in the industry and the lack of robust metrics to track social performance. Following the India crisis and the negative press it spawned, an increasing number of retail investors have been redeeming their microfinance fund shares. However, new subscriptions still exceeded investor redemptions during the first quarter of 2011.

Microfinance Investment Intermediaries: A Fragmented Asset Management Industry

About half of all cross-border investment in microfinance is channeled through financial intermediaries. MIIs include a diverse range of organizations, such as specialist microfinance funds or microfinance investment vehicles (MIVs), holding companies of microfinance banks, such as the German-based Procredit, and nongovernmental organization (NGO) funds.

MIVs constitute the largest group of MIIs. The number and size of MIVs have grown quickly. MIV investment levels quadrupled between 2006 and 2008, and today, 95 MIVs manage total assets of nearly US$8 billion. The top 10 MIVs account for 67 percent of the total MIV assets and represent a mix of institutional types: financial cooperatives, structured finance vehicles, and registered mutual funds (see Table 1).

Specialist microfinance asset managers have brought about the impressive growth of MIVs (see Table 2). There are about 20 boutique investment firms promoting and managing microfinance investments. But this emerging sector is relatively fragmented, with the top five firms accounting for less than half of the total assets under management.

Table 1: Top 10 MIVs by Microfinance Portfolio

MIVs	Microfinance Portfolio December 2010 (US$ million)	Microfinance Portfolio December 2006 (US$ million)
Oikocredit	516	192
European Fund for South-East Europe (EFSE)	482	179
Dexia Microcredit Fund	438	108
responsAbility Global Microfinance Fund	395	86
SNS Institutional Microfinance Fund I	258	created 2007
ASN-Novib Fund	158	46
SNS Institutional Microfinance Fund II	131	created 2008
responsAbility SICAV Microfinance Leader Fund	127	27
responsAbility SICAV Micorfinanz Fonds	125	created 2008
Microfinance Enhancement Facility	101	created 2009

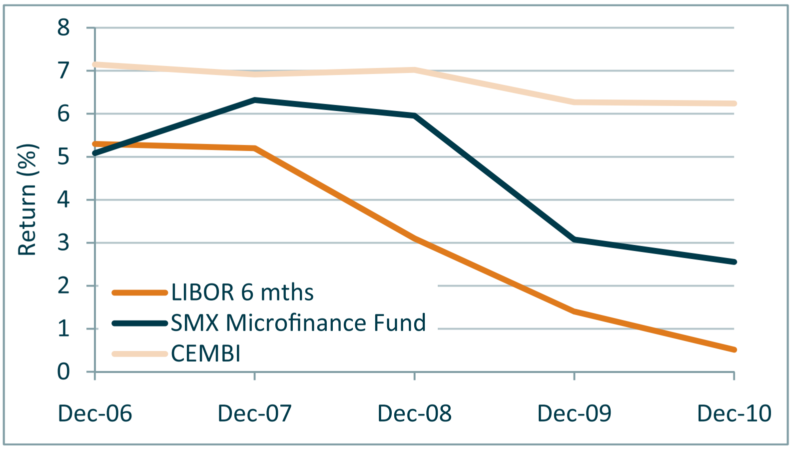
Sources: CGAP (2011); self-declared microfinance portfolio (not including small and medium-size enterprises [SMEs]).

Table 2. Top 5 Asset Managers as of 2009 (by total assets under management) *(US$ millions)*

Oppenheim Asset Management Services (EFSE)	$907
BlueOrchard Finance SA	$866
Credit Suisse Microfinance Fund Management Company (RespA)	$801
Oikocredit	$770
SNS Asset Management NV	$375

Source: CGAP 2010 MIV Survey.

Figure 3: Fund returns are declining



Sources: Symbiotics and JP Morgan.

The competition among microfinance asset managers is intensifying. Today, more than 20 asset managers are developing parallel international networks to source and monitor investments—a costly and ineffective approach for both investors and MFIs. In January 2011, responsAbility announced its acquisition of PlaNIS, the asset management arm of PlaNet Finance, setting the stage for the consolidation of microfinance asset management firms. This should help bring down transaction costs and create efficiency gains for investors and investees.[10]

Financial Performance of Microfinance Investments

This section covers the financial performance of both fixed-income and equity investment, the two main forms of investment in microfinance. The financial performance of microfinance investments and the outlook for investors are examined.

Fixed Income: Negotiating the Downcycle[11]

To date, fixed-income investment—the provision of debt-based products—has been the mainstay of microfinance investment. Debt accounts for 85 percent of all MIV investment and 70 percent of DFI direct investments. And despite a recent shift toward local currency funding, most cross-border debt—65 percent—is still denominated in hard currency.

After years of financial returns of more than 5 percent, MIV returns dipped first in 2008, and then continued in a downward trend throughout 2009. At 2.5 percent, MIV returns reached a historical low in 2010. They are more than 350 basis points below the JP Morgan corporate bond benchmark in emerging markets (CEMBI), despite the higher country risk and counterparty risks attached to microfinance investments. Nonetheless, 2010 returns remain positive and are 200 basis points above the LIBOR six-month rate.[12]

Several factors explain the drop in MIV returns. MFI demand for foreign debt is stagnating. After an exceptional period of growth during 2005–2008, MFIs worldwide have scaled back on their growth in many markets. Lower MFI demand for foreign debt and abundant supply from cross-border investors have affected pricing. The average interest rate that an MFI pays to an MIV dropped by 250 points in 2009, and reached an historical low of 7.9 percent in May 2010. High-performing

10 The regulatory framework for microfinance funds and asset management in Europe will be affected by the new European directive for Alternative Investment Managers and Funds (AIMF) that imposes tighter rules for fund managers.

11 Unless otherwise stated, data in this section are from the 2010 MIV and Funder Surveys.

12 CEMBI is a global index that tracks U.S.-dollar-denominated corporate bonds issued by emerging markets corporate entities. It provides a useful financial performance benchmark for U.S.-dollar fixed-income investments in microfinance as a fixed-income index with a moderate risk premium. LIBOR is a variable index, with a very low risk premium.

MFIs now have the upper hand. They are making lenders compete and are driving hard bargains on terms. As one MFI manager stated, "There is a lot of competition among foreign lenders to provide us with capital. This means we're in a position to negotiate hard with investors and ask for lower interest rates."[13]

Lower levels of demand are leaving MIVs with more uninvested assets that yield very little income.[14] Some MIVs are also having to make significant loan loss provisions against possible defaults by MFIs in troubled markets.[15] The higher provisions are also consistent with the decline in MFI portfolio quality observed during 2009–2010, with SYM50 reporting portfolio at risk (PAR) at 30 days rising from 2.9 percent in 2008 to 4.5 percent in 2010. The combined effect of the drop in income and higher loss provisions have resulted in lower MIV fixed-income returns, down to 2.5 percent in 2010.

However, some MIVs are doing better than others. The net return for fixed-income funds that Symbiotics tracked in 2010 ranged from 1.4 percent to 3.2 percent. And there is a widening gap between the best and worst performers. Asset managers with sound investment policies and strong systems and processes are providing more value to investors in this more complex and risky microfinance environment.

Outlook for Fixed-Income Investment

Overall, the outlook for fixed-income investment in terms of financial returns appears less promising than it did a few years ago. Credit risk is increasing significantly and, for the next two years, investor net returns are not expected to bounce back to the historical levels of 4–5 percent. In addition, demand is likely to be weak for foreign debt funding over the next year as MFIs look for more domestic funding opportunities, including local commercial debt and mobilizing savings, where possible. During 2008–2010, the share of foreign debt in MFI funding liabilities that SYM50 tracked fell from 51 percent to 33 percent, while the share of savings increased from 43 percent to 57 percent. This trend is set to continue. In this environment, fixed-income investments may not provide attractive risk-adjusted returns for commercial investors, particularly institutional investors with high fiduciary standards.

To better respond to MFI needs and to generate demand, lenders will need to increase their share of local currency investments. MIV local currency funding increased by 56 percent in 2009, while overall microfinance investment increased by only 18 percent. Some of this increase has been facilitated by the recent launch of microfinance hedging facilities, such as TFX and MFX, that provide new hedging opportunities for developing country currencies and, in doing so, help them to manage foreign exchange risk.[16] Some MIVs are also lending in local currency; this strategy seeks speculative exposure in emerging market currencies with an upside outlook in relation to the U.S. dollar.

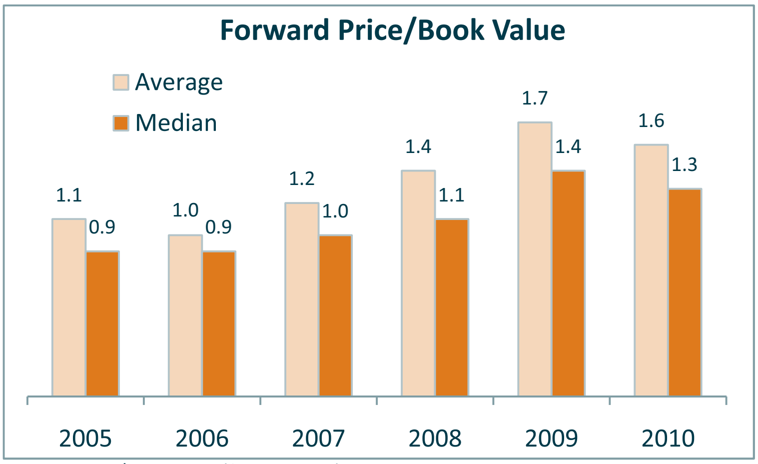
Equity Investments: From Sprint to Marathon

Foreign equity investment in microfinance has been booming—growing at a compounded annual growth rate of 60 percent over the past four years. Equity now accounts for US$2 billion or 18 percent of foreign investment. And over the past three years, eight specialized equity funds have been created with total assets of more than US$500 million under management.

Foreign equity investment is important because there is a lack of risk capital to advance financial inclusion in many emerging markets. Equity investments are helping to expand access to financial services in frontier markets through the

13 Interview with an MFI manager from Bosnia-Herzegovina.
14 The level of cash and liquid assets reached 17 percent in the MIVs that Symbiotics tracked in December 2010.
15 The average loan loss provisions represent 2 percent of the MIV fixed-income portfolio.
16 As of December 2010, MFX Microfinance Currency Risk Solutions (http://www.mfxsolutions.com), one of the two local currency hedge providers, had transacted a cumulative US$51 million in swaps.

Figure 4: Valuation growth trend has reversed



Source: CGAP/JP Morgan (forthcoming).

establishment of new financial institutions and the expansion of existing ones.

However, the pool of investment-ready MFIs is small and is not expanding at the speed of the supply of equity investment. According to 2009 MIX data, there are 419 regulated commercial and shareholder-owned MFIs with a total equity base of US$7.8 billion that are in a position to take equity investment. Only socially focused investment funds, such as Oikocredit and Alterfin, are investing in young and promising MFIs with an investment size below US$500,000.

During 2006–2009, the abundant supply of equity in this relatively narrow market boosted prices for investment-ready MFIs with high growth prospects. MFI valuations grew by more than 50 percent during this time, to reach an average of 1.7 times forward book value (Figure 4). However, as with fixed-income investment, the recent market situation has also affected equity valuations, and the upward trend in valuations has been reversed, albeit slightly. Until 2009, valuations were also driven up by the successful and lucrative initial public offerings of Compartamos in Mexico and SKS in India.

There is still a lack of available data on the internal rate of return of microfinance equity portfolios. Most microfinance equity funds are young (below five years), and few of them have completed an investment cycle to provide meaningful return benchmarks.

Outlook for Equity Investment

The crises in several markets, such as Bosnia-Herzegovina, India, and Nicaragua, and the overall slowdown in the sector are causing equity investors to revise their return expectations downwards. MFI valuations in India are already coming down as predicted by CGAP and JP Morgan.[17]

New investment opportunities for equity investors are in smaller MFIs earlier in their development cycle; other opportunites are in developing new MFIs in countries with large markets and less microfinance penetration. Such MFIs require investors that are prepared to take a long-term, hands-on approach.

Concerns about MFI corporate governance are highlighting the important role that equity investors can play.[18] It is estimated that MIVs have more than 140 board seats in MFIs. Unfortunately, many foreign equity investors have not been especially strong on this front; governing and representing shareholder interests 10,000 miles away have proven challenging at best.

17 See Reille (2010).
18 See Silva (2010), based on research of failures in Latin American MFIs.

In more mature markets, domestic equity investors are expected to become more active. Already large commercial banks are expanding downmarket by acquiring MFIs. Recent examples include the acquisitions of Opportunity Bank Montenegro by the Austrian Erste Steiermaerkische Bank, Finsol by Financiera Independencia in Mexico, and Edificar by Banco del Credito in Peru. The Spanish BBVA has also acquired seven MFIs in Argentina, Chile, Peru, and Puerto Rico to operate a network of microfinance banks. Mobile network operators are also looking at strategic partnerships with financial institutions, including MFIs. For example, Telenor, a leading mobile network operator in Pakistan, has acquired 51 percent of Tameer Microfinance Bank. Telenor and the bank are now working together to offer multiple financial products, including savings services, that seek to scale up through the use of mobile banking technology.

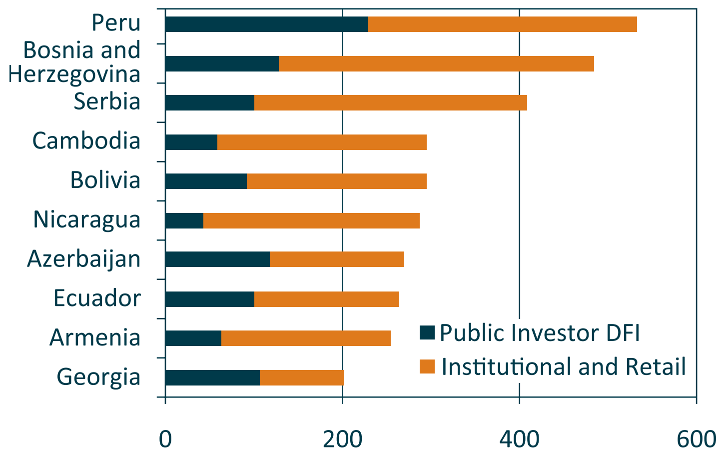
Social Performance and Responsible Finance[19]

Most foreign investors were attracted to invest in microfinance because of its social value. An important metric for measuring such value is increasing financial inclusion, that is, extending credit, savings, and other financial services to currently unbanked populations. It is from this perspective that the role of foreign investment is examined.

At the country level, foreign investment is, to a large degree, still focused on a small number of countries in LAC and ECA, with only moderate levels of financial exclusion. Ten countries with a combined population of 100 million receive over 60 percent of all foreign lending, including 30 percent of total DFI investment in microfinance (see Figure 5).[20] Moreover, with an average per capita gross domestic product of US$6,562,[21] these 10 countries sit squarely in the middle-income brackets, with only Cambodia classified as low income.[22] Their financial inclusion levels are also in the middle of the range, with an average of 515 commercial bank deposit accounts per 1,000 adults (the median for all countries is 530)[23] (see Figure 6).

This concentration largely reflects the history of microfinance development. Latin America was one of the cradles of microfinance development during the 1980s. International microfinance donors and networks, particularly ACCION International, helped establish and develop MFIs with a strong

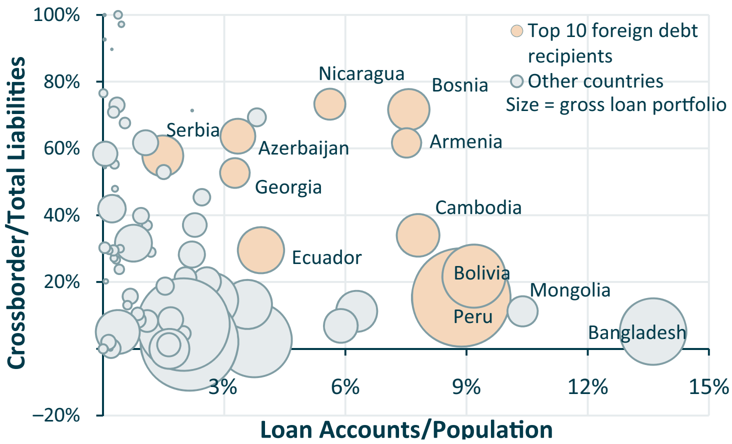
Figure 5: Top destinations for foreign debt (US$ M)



Sources: MIX FSDB and CGAP (2010a, 2009a).

19 Unless stated otherwise, data cited in this section refer to MIX FSDB.
20 Analysis of public investor and donor funding (El-Zoghbi 2011) shows a geographic distribution largely similar to this, though with slightly lower concentration and somewhat greater emphasis on low-income countries.
21 IMF 2009 data, calculated at purchasing power parity. The global per capita income is $10,250.
22 Based on World Bank definitions of country income groups. According to El-Zoghbi (2011), the top 10 DFI- and other public donor-funded countries have a nearly identical income profile, with only one additional low-income country in the list.
23 See IMF (2010).

Figure 6: Top 10 foreign debt recipients are among the most penetrated microfinance markets



Source: MIX FSDB.

focus on professionalizing and commercializing microfinance. ACCION's flagship project in Bolivia, BancoSol, was the first NGO to transform to a commercial bank. Furthermore, ACCION established Profund as the world's first commercial investment microfinance fund with a mission of demonstrating in 10 years that investing in microfinance could be profitable. This pioneering fund was successful and played an important role in proving that microfinance was a commercially viable investment opportunity, thus helping to catalyze the flow of private foreign investment to the sector.

Similarly, in the former communist countries in ECA, microfinance was an important component of efforts by donors and DFIs to assist these countries in their transition to a market economy, thus laying the groundwork for commercial investment. The most notable case of such donor activity was post-war Bosnia-Herzegovina, where a World Bank-led apex institution helped develop a pool of investment-ready MFIs.

As a result of donor support, these markets feature large mature institutions that can absorb large amounts of foreign investment. Indeed, 52 percent of all foreign debt is channeled to only 25 MFIs, out of a total of 524 MFIs that receive foreign debt finance. Of these 25, seven are ProCredit Bank subsidiaries, with the rest being nine banks, seven nonbank financial institutions, and two NGOs. Moreover, these top recipients rely heavily on foreign debt that, on average, accounts for more than half of their loan portfolios.

Foreign investment has supported the growth of investee MFIs and helped them to scale up and to increase their client outreach, particularly in select LAC and ECA countries. Now, foreign investors need to do more to invest in underserved markets in Africa and Asia, if the social objectives communicated by investors are to be met.

Has Foreign Funding Been Responsible?

Foreign investors have different degrees of social commitment, depending on their missions and perspectives. However, a "do no harm" standard represents a reasonable lowest common denominator of social commitment. Among other things, this would include avoiding flooding markets with excess capital, thus abetting reckless competition and over-lending by MFIs that often leads to client over-indebtedness—an outcome that a large number of investors have signed up to avoid as part of the Smart Campaign, the industry platform to advance consumer protection.

Unfortunately, investors have not always successfully followed these principles, and, in at least a few markets, too much capital and insufficient oversight have been the result. Two prime examples are Bosnia-Herzegovina and Nicaragua, the second and sixth largest recipients of foreign microfinance investment, respectively. Following years of exceptionally rapid growth, these two markets have recently undergone some of the largest crises in the history of the modern microfinance sector. The fact that both markets featured heavy dominance of foreign debt (more than 70 percent of MFI liabilities) suggests that foreign investment drove much of the overheating in these countries. Some MFIs in Bosnia-Herzegovina have said that the entry of foreign commercial investment intensified the profit motivation in the sector and that they became focused on lending volumes rather than focusing on responsible lending that met the needs of borrowers with the capacity to repay.

The examples of Bosnia-Herzegovina and Nicaragua demonstrate that foreign investors failed to ensure that sufficient controls were implemented either by the MFIs individually or at the sector-level, to prevent the negative consequences of such rapid and unbalanced growth.[24] The downsides of rapid growth through foreign investment have not been limited to only these two countries. Many of the top 25 MFI recipients of foreign loans described earlier have also been victims of their own fast growth—in 2009, for example, 10 of the top 25 MFIs reported combined PAR 30 and write-off levels above 10 percent. BANEX in Nicaragua failed outright, unable to survive a government-supported repayment strike that amplified the weaknesses of its rapidly built portfolio. It is also possible that one or two other MFIs from among these 10 may yet meet the same fate.

Notably, while the share of foreign capital is high for the top 25 MFIs, in general, for these 10 struggling institutions, foreign capital has been especially dominant, comprising an average of 63 percent of their loan portfolios. This suggests a degree of responsibility for foreign lenders that is difficult to ignore. The same also applies to equity investors, which have been important—and often even dominant—shareholders of MFIs in Bosnia-Herzegovina and Nicaragua. Moreover, given their greater control over investee organizations, equity investors share an even greater degree of responsibility for ensuring responsible growth.

Despite the weaknesses in unsustainable growth and some of the subsequent crises, foreign investment has also played an important stabilizing role, even in markets where local funding is well developed. In times of crisis, MFIs can be adversely affected by liquidity squeezes, which not only strain their cash positions, but also may directly undermine portfolio performance if borrowers perceive the institution as being unstable. However, not being part of the banking system, nonbank MFIs have no access to central bank funding in liquidity emergencies. The role of "lender of last resort" has been taken on by foreign lenders, specifically DFIs, as demonstrated by the rollout of the US$500 million Microfinance Liquidity Facility[25] in February 2009—about four months after the collapse of Lehman Brothers.

And such actions are not limited to DFIs. MIVs backed by institutional and retail capital have also helped cash-constrained MFIs with countercyclical funding. A good example is the 2010 Andhra Pradesh crisis in India, where local bank lending all but ceased and social investors stepped in to try to fill the void.[26] Moreover, during 2008–2009, when commercial investors were fleeing en masse to the safety of government bonds, microfinance

24 See Chen, Rasmussen, and Reille (2010) for further analysis of the factors underlying the crises in these countries.

25 Later renamed the Microfinance Enhancement Facility. Although its creation had been motivated by concerns of a liquidity crunch, in the global microfinance sector the liquidity crunch proved short-lived, and the facility's services were proven to be not needed as much as originally conceived.

26 See http://www.microfinancefocus.com/content/ujjivan-microfinance-raises-88m-through-ncds.

funds saw minimal redemptions, far below the level of new investment inflows.

Bucking the Trend: Socially Oriented Responsible Investors

Despite somewhat disappointing outreach averages and investor responsibility levels, investment strategies are not all alike. A number of foreign investors make special efforts to reach poorer, more financially excluded countries and work with less developed MFIs to achieve these objectives. The CGAP MIV Environmental, Social and Governance (ESG) awards have recognized several of these investors.

For example, Oikocredit leverages its worldwide network in 33 countries to help maintain its focus on small MFIs that serve the poor, with an emphasis on rural areas and women. With 543 MFI investees, Oikocredit alone has more MFIs in its portfolio than all foreign-funded MFIs in the MIX FSDB, with Tier 3 as the largest group (29 percent of total portfolio).[27] And as one of the largest microfinance funds, Oikocredit proves that going down-market can be done at scale. Like Oikocredit, another ESG winner and a major fund in its own right, the Triodos-Doen Fund emphasizes Sub-Saharan Africa more than other foreign investors. The Triodos-Doen Fund designates 13 percent of its portfolio to the region, versus the MIV average of 6 percent.[28]

Besides broadening their market and institution concentrations, these social investors have also been at the forefront of implementing the Smart Campaign's client protection principles. Another ESG winner, Incofin, makes its equity investments contingent on modification of MFI shareholder agreements to explicitly include client protection principles. It also includes verifications in its annual due diligence to ensure that the principles are being followed, such as interviewing branch managers about the level of multiple borrowing among clients, and monitoring to ensure that the portfolio yield margin does not exceed 10 percent.

These microfinance investors demonstrate that reasonable steps can be taken to ensure that growth is responsible and sustainable, and focused on social outcomes.

Conclusion

A prominent microfinance fund manager likened the past half decade of microfinance to a period of adolescence.[29] And befitting that life stage, the sector has shown boundless optimism for growth with not enough consideration of the attendant risks and the need for a continual focus on social outcomes.

The experience of 2009–2010 has been a critical, if also difficult, milestone for the global microfinance sector. It has highlighted some of the serious weaknesses in several markets, above all the excessive focus on rapid scaling, often based on a credit-only model. The problems of over-lending and the associated risk of over-indebtedness in some of the fastest growing markets—Bosnia-Herzegovina, Nicaragua, and, most recently, India—have seriously tarnished the industry's image and have led to a re-evaluation of some of the fundamental practices of microfinance.

Three lessons emerge for investors from this research, as follows:

1. The risk-adjusted return on microfinance investments should be reassessed in the context of these crises. Investment in fixed-income funds appears less attractive for purely commercially oriented investors than in prior years. Meanwhile, equity investments are more appealing both on social and financial grounds, but they require long-term focus with more realistic return expectations.

27 See Sinha (2010). Tier 3 defined as MFIs with total assets of $10 million or less.
28 See CGAP (2009b and 2010c).
29 Interview with MIV manager December 2009.

2. Asset managers are not all alike. Some MIVs are weathering the crisis well. Asset managers with sound investments strategies, robust investment processes, and a commitment to social performance are delivering better performance to their clients. Investors should place greater stock in MIV and asset manager selection. Building on the MIV disclosure guidelines,[30] asset managers will have to improve transparency, to provide a better basis for investors to compare funds. MIV ratings that provide an in-depth evaluation of fund operations from both a financial and social return perspective should play an increasingly important role.
3. Many funds are diversifying into the broader impact investment asset class. Faced with increasingly competitive markets and a desire to have a greater impact on poverty, several asset managers are seeking to diversify beyond traditional microfinance. Some are building capacity to invest in SME finance and are syndicating loans with DFIs, such as EBRD, which has a long history of SME finance. Others are looking for investment opportunities in sectors such as fair trade, health, education, agriculture, and renewable energy. Such shifts represent a welcome trend to broaden the marketplace and diversify investment portfolios and risk. However, they also come with the uncertainty of uncharted territory. Successful SME and impact investing requires a different set of evaluation techniques. This foray may ultimately prove disappointing relative to the more predictable returns from sound MFIs.

30 See CGAP (2010b).

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CGAP
1818 H Street, NW
MSN P3-300
Washington, DC
20433 USA

Tel: 202-473-9594
Fax: 202-522-3744

Email:
cgap@worldbank.org

The authors of this Focus Note are Xavier Reille of CGAP, Sarah Forster, and Daniel Rozas. This Focus Note was written with research support from Adrian Gonzalez from MIX and Yannis Berthouzoz from Symbiotics. The authors would like to thank Alexia Latortue, Deborah Burand, Mayada El-Zogbi, and Jasmina Glisovic for extensive comments and guidance.

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