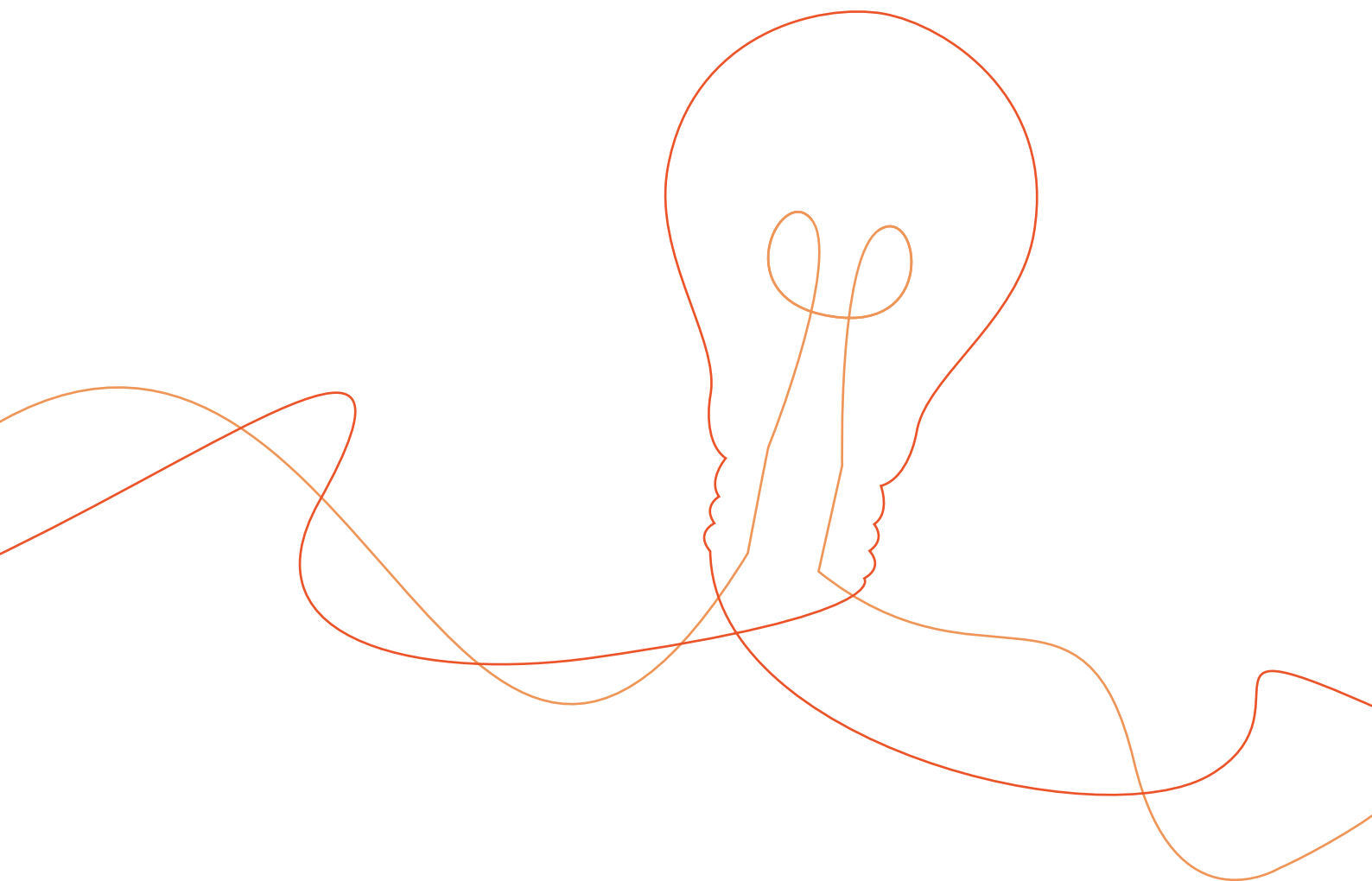


# THE IMPACT INVESTOR'S HANDBOOK

*Lessons from the World of Microfinance*

CAF Venturesome: Market Insight Series

February 2011, First Edition



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**Charities Aid Foundation (CAF)** offers a range of tax efficient giving, financing services and solutions for companies, individuals and charities that support and work in the non-profit sector. CAF believes that access to capital is vital for a healthy and thriving charitable sector. In 2010, CAF helped half a million donors give over £366 million to more than 45,000 charities, transforming lives across the world. CAF manages over £2 billion for charities and donors, with over 15,000 UK charity clients.

**CAF Venturesome** provides capital (debt and equity) to charities, social enterprises and community groups, operating in the space between providers of charitable grants and providers of bank loans at market rates. Since its launch by CAF in 2002, £20 million has been offered to 270 organisations. CAF Venturesome also operates the pioneering Community Land Trust Fund, working with community groups to develop affordable housing in rural areas. In addition to accumulating practical deal experience, CAF Venturesome has endeavoured to have a central role in building a responsible social investment market, adopting an open-book approach to share knowledge and build experience, but also ready to operate in competition so as to raise industry standards.

## Acknowledgements

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# Editor's note

“When you come to a fork in the road, take it”

*Yogi Berra*

Which way forward?

The road ahead for impact investing seems both confused and contradictory. While it is heartening to see more mainstream pools of capital seeking to engage in impact investing, there are also good reasons to be worried about how much of this capital will actually produce positive social change. Will investors choose speed of growth, rather than depth of impact? Will early failures be used as reasons to maintain the status quo? Will poor thinking and clumsy execution make our sector one of ‘feel good’ rather than ‘do good’? Will hype triumph over reality?

The history of the microfinance industry over the last 30 years provides insightful lessons for the development of the social investment market in the United Kingdom. Many of the challenges faced by social investors today were successfully overcome by the pioneers of microfinance.

The purpose of this handbook is to provide a roadmap. However, the future of the social investment market cannot be forecast, but rather it is created. What we, as impact investment practitioners, do today will decide the shape of things tomorrow - especially, the way we perceive the challenges and opportunities that await us, and the vision we develop for meeting them. This handbook offers some clues as to how we might act, how we might catalyse the social investment market into something more robust, and how we might distinguish true market signals from what is mere noise.

We hope that this handbook provides some practical wisdom for impact investors everywhere. Abraham Lincoln put it best: *“The dogmas of the quiet past, are inadequate to the stormy present. The occasion is piled high with difficulty, and we must rise – with the occasion. As our case is new, so we must think anew, and act anew.”*

**Paul Cheng**  
Senior Investment Manager  
CAF Venturesome

*“Many of the challenges faced by social investors today were successfully overcome by the pioneers of microfinance”*

## Acronyms used in this handbook

BRAC	Bangladesh Rehabilitation Assistance Committee
CAF	Charities Aid Foundation
CDC	Commonwealth Development Corporation
CDO	collateralised debt obligation
CGAP	Consultative Group to Assist the Poor
CIC	community interest company (UK)
CIO	charitable incorporated organisation (UK)
CLO	collateralised loan obligation
CMEF	Council of Microfinance Equity Funds
DWM	Developing World Markets
EVPA	European Venture Philanthropy Association
FINCA	Foundation for International Community Assistance
GB	Grameen Bank
GIIN	Global Impact Investing Network
GIIRS	Global Impact Investing Ratings System
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPO	initial public offering
IRIS	Impact Reporting and Investment Standards
KfW	Kreditanstalt für Wiederaufbau
LABF	Latin America Bridge Fund
L3C	low-profit limited liability company (USA)
MFI	microfinance institution
MIV	microfinance investment vehicle
MIX	Microfinance Information eXchange
NESTA	National Endowment for Science, Technology and the Arts
NGO	non-governmental organisation
NPC	New Philanthropy Capital
OPIC	Overseas Private Investment Corporation
SEEP	Small Enterprise Education and Promotion Network
SROI	social return on investment
UC	Unitus Capital
USAID	United States Agency for International Development
VCS	voluntary and community sector (UK)
XBRL	eXtensible Business Reporting Language

All references to currencies are to US Dollars unless otherwise indicated.

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# Executive summary

The UK social investment market has now reached a critical juncture. Although there is some evidence of coordinated market-building efforts, the market remains fragile. By reviewing the development of the global microfinance industry, this handbook aims to equip practitioners in the social investment market with some of the analytical tools and insights for making the tactical and strategic decisions which may systematically advance our sector.

This handbook analyses the historic growth of the global microfinance industry - organised into three conceptual areas:

*“Although there is some evidence of coordinated market-building efforts, the market remains fragile”*

## 1. Proof of concept, donor support and model innovation

We point to the pivotal role of some leading pioneers in the microfinance industry who proved the concept of microfinance by demonstrating high repayment rates, replicability and market demand. The model was quickly exported and adapted to several geographies. Subsidies and guarantee funds provided these early pioneers with the flexibility and patient capital required to prove their business models. A process of transforming non-profit organisations into commercial businesses was a model promoted by some, which led to a wave of industry professionalisation.

## 2. Market-building activities

Following this was a busy market-building phase which saw the establishment of the essential elements of a functioning capital market. We highlight the role of information brokers in improving marketplace transparency and initiatives to provide standardised language and metrics for the industry.

We argue that the effective role of regulation and government intervention has been to allow for appropriate legal structures particularly suited to microfinance operations and business cycles; to provide for adequate consumer protection while at the same time allowing microfinance institutions to set commercially viable interest rates; and to supply ‘soft’ capital to investment funds that improves the attractiveness of such funds to commercial investors. We also consider the forms of structured finance that were built on the earlier foundations of subsidised finance. Some of these developments have raised an industry-wide debate about ‘mission drift’ and the strategic direction of microfinance itself.

The role of intermediaries and other sector-builders has been important for improving the demand-side absorptive capacity for microfinance investment. However, investment readiness remains a key challenge for the microfinance industry.

### 3. Movement-building and cultural factors

We believe that scaling of the microfinance industry has been significantly supported by proactive movement-building and cultural factors. Organised industry-wide networking bodies, conferences and media attention simultaneously raised the popular awareness, support and energy needed to both animate and catalyse essential elements of the market. Social investment practitioners should think strategically about ways to harness cultural factors to garner popular support, and trigger positive trends, for the social investment market.

We also highlight key points of similarity and difference between microfinance and other social investment mechanisms. We, therefore, caution against social investment practitioners adopting wholesale the microfinance story, or expecting that the scaling of the social investment market will necessarily mirror that of microfinance in all aspects.

Throughout this handbook, we use the term ‘social investment market’ to refer specifically to the range of impact investing in the UK (from capital/balance sheet-funding grants, debt, equity, quasi-equity and underwriting). The terms ‘social capital market’, ‘social finance market’ and ‘social finance sector’ are more generic and include the global microfinance industry as a subset. ‘Impact investing’ is rapidly gaining currency as the phrase of choice to describe all investment activity which has an expectation of both a specified social outcome and an explicit financial return.

A summary list of lessons drawn from the world of microfinance, and our recommendations for accelerating change towards a robust social investment market, are included at the end of this handbook.

We welcome your feedback for inclusion in future editions, and invite you to collaborate with us in moving the sector forward.

*“scaling of the microfinance industry has been significantly supported by proactive movement-building and cultural factors”*

# Introduction

## The Impact Investor's Handbook

*“Social investment in the United Kingdom has reached an inflexion point”*

Social investment in the United Kingdom has reached an inflexion point. In recent years, a number of innovative organisations have emerged to support charities, social enterprises and other social purpose organisations through providing access to effective and appropriate financing. As track records are established and a body of expertise develops, we are seeing a move away from ad hoc innovation towards more coordinated market-building efforts. For example, the UK Charity Commission has recently released proposed guidance expressly permitting charities to invest for social, as well as financial, returns in certain circumstances. Furthermore, the Big Society Bank, which will release private capital derived from unclaimed bank deposits to social investment intermediaries, is expected to launch in 2011.<sup>1</sup>

We are seeing initial moves towards the creation of infrastructure and products that have the potential to both reduce transaction costs and support greater deal flow. However, the market remains fragile and the actions of practitioners in the field could still damage this emerging industry either through carelessness or misdirected effort.

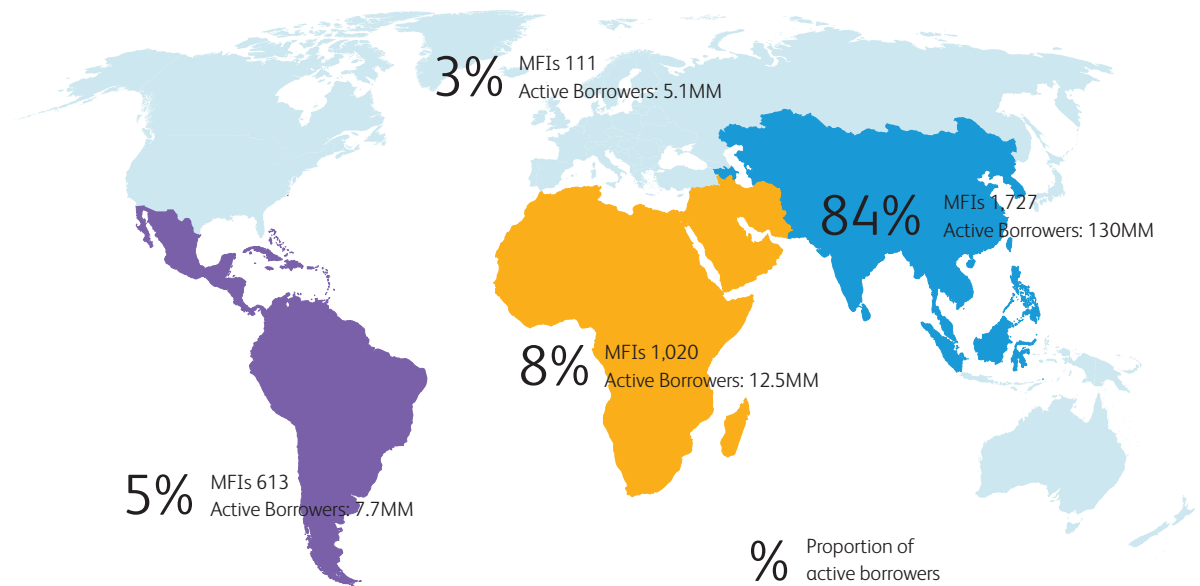
CAF Venturesome offers this comparative study of the microfinance industry as a contribution to the evolution of a robust social investment market.<sup>2</sup> Our purpose is to collect useful insights to equip others to make tactical and strategic decisions that will systematically advance this sector. We hope that it will be used by practitioners and key decision-makers as a reference handbook for taking strategic action to build the market – truly The Impact Investor's Handbook.

Microfinance can be understood as a section of the broader impact investing marketplace. Although a conclusive definition of microfinance is not universally agreed, it generally refers to financial mechanisms and arrangements that offer “poor people access to basic financial services such as loans, savings, money transfer services and microinsurance”.<sup>3</sup>

From its beginnings as a fringe, non-profit activity in the international development sector, the reach and impact of microfinance today is now global (although it remains small relative to the overall size of international development aid). More than 150 million families have received a loan from a microfinance institution (MFI), with more than 500 million people reached. Currently, there are more than 3,500 MFIs around the world<sup>4</sup> (see Figure 1).



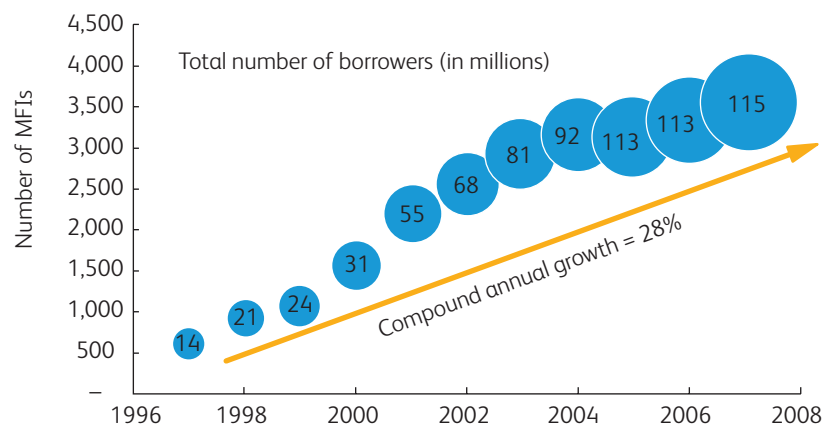
Figure 1: Global geographical spread of MFIs and microfinance borrowers



Source: Data obtained from the Microcredit Summit Campaign Report (2009).

Accelerated growth has been particularly evident over the last 12 years (from 1998 onwards): the number of microfinance beneficiaries has increased more than 12 times and the number of organisations providing microfinance services more than 10 times (see Figure 2). On the investment side, microfinance investment intermediaries have developed from nothing in 1994 to an estimated 122 investment vehicles and other actors in 2009, representing an asset class worth approximately \$8.2 billion.<sup>5</sup> This includes participants such as the online peer-to-peer funding platform Kiva, which has placed approximately \$175 million in loans since 2005.<sup>6</sup>

Figure 2: Annual growth of MFIs since 1996



Source: Data obtained from the Microcredit Summit Campaign Report (2009)

Relative to other social finance mechanisms, microfinance is a mature model that is increasingly successful in attracting funds from a wide variety of investors, and in connecting this funding to appropriate investments through effective intermediation. While there are significant differences across microfinance segments, and between microfinance and the social investment market, this handbook draws out relevant lessons for supporting the growth of the UK social investment market.

## The social investment market: What we know is missing

CAF Venturesome and other commentators have identified several key components required for a rational social investment market. A recent Social Investment Taskforce review notes that the UK market is still experiencing significant challenges, namely: impact investment funds<sup>7</sup> remain small with limited track records; market function, impact and terminology remain opaque; and major market infrastructure remains wanting, including advisory services, corporate finance functions, investment banking, secondary markets, and benchmarks.<sup>8</sup> Meetings of impact investors convened by the Rockefeller Foundation have identified particular challenges around deal sourcing, impact measurement, standardised terms and performance targets, and support from an organised investor network.<sup>9</sup>

*“impact investment funds remain small with limited track records”*

## Four pillars

CAF Venturesome has previously put forward four pillars critical to the development of a robust UK social investment market.<sup>10</sup> These are:

### i) Confident and informed demand from the voluntary and community sector (VCS)

VCS organisations fail to adequately distinguish between revenue and capital; rather they tend to focus on income and costs, with a corresponding lack of knowledge about, or confidence in, asset management (especially in relation to their balance sheets), capital investment and identifying financing needs and options. VCS organisations have a perceived cultural aversion to debt funding.<sup>11</sup>

### ii) Efficient matching of supply and demand

With a lack of effective intermediaries, inefficiencies in social capital markets inhibit matching of supply and demand.<sup>12</sup> A recent Monitor report highlights that social capital markets are often still defined by ‘fragmented demand and supply, complex deals, and a lack of understanding of risk’; compounding this is the typically small deal size.<sup>13</sup>

### iii) Variety of investment mechanisms

The range of funding and investment mechanisms in the UK social investment market is limited, and remains dominated by a static grant funding pool; this reflects a lack of established relationships between risk, return and pricing for the sector.

### iv) Resilient supply of finance

A mix of private, commercial and public funding from both retail and wholesale sources is needed for a robust marketplace.<sup>14</sup>

## Other infrastructure issues

Interwoven with the above are other ‘infrastructure’ needs for a fully functioning social investment market:

- **Need for a unified voice, perhaps in the form of industry bodies or associations, to lobby for regulation and build public recognition**

Differences of opinion and confusion surround new legal structures (CICs, CIOs, L3Cs etc), the role of public funders, the potential for commercial returns and other issues. While this debate is healthy, the sector also needs some level of coordination to present a reasonably united front and make lobbying efforts more effective.

- **Standardisation of products, benchmarking, language and metrics**

Extensive debate surrounds definitions, terms, impact measurement, and all other aspects of this market. Products and offerings remain highly tailored to individual situations. Uncertainty is typical of nascent markets, but scaling requires the efficiency and cost benefits of standardisation. Potential examples of the need for standardisation in the UK include identifying pathways to broader applicability of social impact bonds beyond the pilot launched by Social Finance Ltd, or the basic vehicles and common terms used to invest in social enterprises.<sup>15</sup>

- **Clearer social metrics in order to ensure that the financial versus social return ‘trade-off’ is more transparent**

When is an investment ‘social’, and when is it not? How are social impact and trade-offs measured? These issues are ongoing sources of debate, and relate to the issue of standardisation mentioned above.<sup>16</sup> The lack of information on the successes or failures of social investments inhibits the flow of capital into the sector, and forces both investors and investees to rely on anecdotes and case studies to demonstrate social impact. Better methodologies, consistently implemented, are needed.

- **Support organisations, ratings agencies, knowledge centres and other**

A robust social investment market needs the entire supporting infrastructure available to the broader financial market place. This includes established thought leadership, external rating and audit expertise, advisory services, and more.<sup>17</sup>

This handbook examines how microfinance overcame nascent market obstacles that were similar in some, though not all aspects, to those now faced by the emerging UK social investment market. We revisit the key components identified above in the concluding section of this handbook, with brief commentary as to the applicable lessons to be drawn from the microfinance industry.

*“Uncertainty is typical of nascent markets, but scaling requires the efficiency and cost benefits of standardisation”*

# The Success and Mainstreaming of Microfinance

*“an arduous task that required visionary leaders, patient funders, and a willingness to challenge assumptions”*

A number of inflexion points led to the consolidation and scaling of the global microfinance industry. For the sake of convenience, we have broadly categorised interconnected and evolutionary developments in microfinance into the following conceptual areas:

- 1 Proof of concept, donor support and model innovation
- 2 Market-building activities
- 3 Movement-building and cultural factors

In order to achieve success, microfinance first needed to prove the concept worked; an arduous task that required visionary leaders, patient funders, and a willingness to challenge assumptions. Following this was a busy market-building phase which saw the establishment of the required elements of a functioning marketplace, while ‘movement-building’ and cultural factors simultaneously catalysed the support and energy needed to animate this structure.

## 1 Proof of concept, donor support and model innovation

### 1.1 Initial proof of concept: Yunus and Grameen

Although debate remains regarding the origins of microfinance, few doubt the pivotal role of Professor Muhammad Yunus and the Grameen Bank in Bangladesh. Firmly rooted in the belief that social impact must come before profiting from the poor, Yunus has dedicated over 30 years to advocacy of the benefits of microfinance. Grameen Bank pioneered the ‘group lending’ approach, and the late 1980s saw the creation of Grameen Trust, an organisation dedicated to promoting and replicating microfinance globally.<sup>18</sup> By 2008, the Grameen model had been exported to over 40 countries.<sup>19</sup> Grameen and its founder were instrumental in proving that the poor could be reliable borrowers and a good credit risk – and while their work was painstakingly difficult in the early days, reports of high repayment rates and scores of anecdotal success stories eventually kindled the beginnings of an industry. From the Latin American perspective, ACCION’s role was similarly central to proving the concept of microfinance (see section 1.4).

### 1.2 First followers: BRAC, BancoSol, ASA, Rakyat

These organisations<sup>20</sup> contributed to proving the concept of microfinance, and pushed the movement forward with new developments and improvements. The fact that microfinance was replicable and that there were soon many organisations with successful programmes allowed the donor community to channel more resources towards expansion. These early pioneers proved that demand for microfinance was deep and widespread.

## Grameen Bank's first two decades – The role of subsidies and soft capital

Grameen Bank (GB), formally constituted as an independent bank in 1983, was the first organisation to implement the group lending methodology conceived by Professor Muhammad Yunus in 1976. GB's repayment rates have always exceeded 97%, except during a repayment crisis in 1995 due to severe flooding in Bangladesh.

With one exception, GB has always registered a profit. Questions have been raised regarding the legitimacy of these profits given GB's receipt of substantial subsidised funding, estimated to be \$175 million between 1985 and 1996, not accounting for further soft loans and guarantee funds. Other early access to capital came from the Bangladeshi Government at an approximately 40% discount to market rates.

The importance of achieving scale is seen in the evolution of GB's dependence on subsidies. In 1985, with 172,000 beneficiaries, the average subsidy as a fraction of the loan portfolio was over 20%; in 1994, with client numbers over 2 million, this had reduced to 7%. GB thereby leveraged an initial subsidy to gradually increase the number of clients served and decrease its relative dependence on subsidies.

GB's growing scale also meant it was able to seek other funding, issuing 2, 5 and 10-year bonds in the late 1990s all guaranteed by the Bangladeshi Government. Other tranches of debt funding in that decade came from the International Fund for Agricultural Development, the Ford Foundation and the governments of Norway, Sweden, and the Netherlands, each discounted rates ranging between 0% and 3%.

**Lesson 1: To prove a concept and reach scale, new social investment models first need significant subsidised financial support that traditional commercial sources are unlikely to provide.**

Source: *Jonathan Morduch, The Role of Subsidies in Microfinance: Evidence from the Grameen Bank (April 1999).*

### 1.3 The role of donors, subsidies, and guarantees

Governments and the donor community – including multilateral and bilateral organisations, development banks, development agencies, private and public foundations, and NGOs – provided technical and financial resources, useful for improving absorptive capacity<sup>21</sup> while increasing available capital. Notable players that initially supported the movement in the Western Hemisphere were the US Agency for International Development (USAID) and the Inter-American Development Bank; and in Asia, FMO (the Dutch development bank) and the Asian Development Bank. By the mid-1990s, the International Finance Corporation (IFC), KfW, and OPIC had also become very active.

For more than two decades, microfinance was completely dependent on subsidies, and only in the last 15 years have some organisations reached the scale and efficiency needed to become self-sustaining. For all its success, the microfinance movement continues to receive hundreds of millions of dollars of subsidies.<sup>22</sup>

*“new social investment models first need significant subsidised financial support”*

Without this risk-absorbing capital provided by such donor organisations, microfinance would arguably never have proliferated.<sup>23</sup> Such subsidies are legitimate provided that they act as a catalyst for eventual self-sustainability, and not merely to prop up poorly-run, loss-making organisations.

Beyond grants, guarantee funds have also been utilised to expand loan portfolios and programmes. Guarantee funds have supported various approaches to development finance for decades, and began to be applied to microfinance in the 1990s. The first bond issues and financial products such as CDOs and securitisations were at least partially guaranteed by development institutions<sup>24</sup> (see more detail in section 2.3). Therefore, guarantee funds have greatly assisted industry development by facilitating the entry of other investors and intermediaries through reducing their risk exposure, building confidence, and leveraging the limited resources of governments and donors.

#### CASE STUDY

### The Latin America Bridge Fund – The facilitative role of guarantee funds

The Latin America Bridge Fund (LABF) was first established in 1984 by ACCION with the support of USAID, and was later sustained by support from private philanthropic and socially responsible institutions. It was created in response to traditional lenders' perceptions of high risk and the need to expand microfinance programmes. Investors place money in the guarantee fund at very low rates of return, and these funds are used to guarantee loans for ACCION-affiliated MFIs in Latin America.

These were the first private investors willing to bear credit risk in microfinance so that LABF could guarantee 100% of all loans in order to convince banks to lend. No investor has lost money in 25 years, and with time to develop a track record of repayment, most of the MFIs graduated to the point where they could access bank loans without further guarantee support.

The key lessons from ACCION are:

- (1) Assemble a diverse investor base in the guarantee fund
- (2) Prudent stewardship of investment funds
- (3) Careful approval processes
- (4) Risk-sharing mechanism between the fund and the MFIs – e.g. Guarantees are set to cover only part of the loan, rather than 100%, so that both organisations are assuming some portion of risk and interests are aligned (thereby reducing moral hazard)
- (5) Manage currency exchange risk
- (6) Reduce costs through network affiliation, shared office spaces etc, to keep the reserve fund operationally sustainable

**Lesson 2: Guarantee funds can be successfully used to attract commercial funding into the sector before eventual withdrawal as repayment reliability is proven.**

*Source: Further discussion and explicit description of processes and impacts can be found in Cesar Lopez and Jorge de Angulo, ACCION, 'Bridging the Finance Gap: ACCION's Experience with Guarantee Funds', Insight, No 15 (September 2005).*

*“Guarantee funds can be successfully used to attract commercial funding”*

Finally, the role of private donors and forward-thinking philanthropists has been significant for not only providing access to capital, but also for bringing into the sector skills and expertise gained from the mainstream finance industry. For example, the founding shareholders of Unitus Capital came from the private equity and investment sector, and were drawn to the idea of a boutique investment bank for MFIs through their prior involvement with Unitus' microfinance work (see section 2.4).<sup>25</sup>

## 1.4 An alternative vision: Commercialisation as the key to sustainable scale

### “commercialising and professionalising microfinance”

ACCION and its 'financial systems approach'<sup>26</sup> emerged in the early 1970s, with a strong focus on promoting financial inclusion and bridging the gap with the private sector in a financially sustainable manner. ACCION played a major role in commercialising<sup>27</sup> and professionalising microfinance, and in advancing a 'downscaling' approach whereby emerging market commercial banks extend existing operations to serve a poorer client base. In 1991, ACCION's flagship project in Bolivia, BancoSol, was the first organisation to successfully transition from an NGO to a commercial bank, inspiring a number of followers.

#### CASE STUDY

### The conversion of Prodem to BancoSol – Microfinance begins to commercialise

Prodem was founded in 1987 in Bolivia by local business people and philanthropists as a non-profit microfinance lender, with the support of ACCION. Though successful, the NGO was unable to secure commercial loans to expand using its own loan portfolio as collateral. It was considered too high risk, and lenders were concerned about the social consequences and legal difficulties of ever having to take legal action against an NGO.

While Prodem did achieve some early access to commercial loans due to the guarantee fund work of ACCION (profiled in section 1.3 above), this required reliance on a nearly dollar-for-dollar guarantee.

Separately, Canadian Martin Connell founded the Calmeadow Foundation, which eventually came to focus on commercial microfinance. Connell worked closely with ACCION to convince Prodem's board that a switch to commercial status was needed. Prodem became BancoSol in 1991, the first such MFI conversion to take place.

With this commercial status, BancoSol graduated to point where it could access capital independently, providing an enormously successful model for MFIs around the globe to follow.

**Lesson 3: Adopting a commercialised business model was a precursor to being able to access capital from commercial sources.**

**Limitations: As discussed in section 2.3 of this handbook, industry leaders are far from unanimous in their support for commercialised microfinance due to the slippery slope towards prioritising financial outcomes over social ones.**

Source: *Elizabeth Rhyne, Mainstreaming Microfinance: How Lending to the Poor Began, Grew, and came of Age in Bolivia (2001).*

With BancoSol a clear success according to supporters of the ACCION approach, the early 1990s saw commercialisation begin in earnest. The main motivation was access to alternative funding sources, including institutional capital and deposit-taking from local populations (in many countries only regulated organisations were permitted to take deposits). Many funders and investors were also wary of extending loans to institutions not subject to banking regulation, and therefore not incentivised to achieve efficiencies of scale and operations. Likewise, the sheer scale of demand faced by Mexican MFI Compartamos made this institution's growth imperative so strong that the transition from a non-profit to commercial model was the only way to access sufficient growth capital .

MFIs adopting commercial models saw some the following operational improvements:

- Greater focus and success in attracting and retaining qualified staff with business skills;
- Increased sophistication of systems due to enhanced reporting requirements. This led to the creation of management information systems particularly tailored for this segment, standard reporting practices, sound financial indicators and sector benchmarks;
- Creation of credit scoring systems to reduce risk and cost;
- Increased accountability due to the level of professionalism associated with the amount of information gathered;
- Access to more diverse sources of capital (deposit taking, access to credit lines, bond issuances and ultimately potential to access to the IPO market);
- Streamlined operational processes: For example, in India, SKS Finance led the movement to rapidly scale microfinance by streamlining the group formation process, which served as the alternative form of 'collateral' for microfinance lending in that context.<sup>29</sup>

Given the immediate potential for large injections of funds and other advantages noted elsewhere in this section, commercialisation represents an attractive path to scale. However, local market conditions may affect the route and nature of that path. David Roodman notes that "in Bangladesh, BRAC leveraged steady donor support for a portfolio of activities reaching beyond microfinance, while ASA expanded through recycling of profits from its efficient operation...but, by and large, the pursuit of scale takes changes in form".<sup>30</sup>

Although microfinance institutions and investors span a wide variety of models, philosophies and local contexts, the commercialisation model has demonstrated the greatest success in linking MFIs with global flows of capital investment. While successfully increasing the flow of funds to the industry, this approach is drawing increasing scrutiny in relation to striking an appropriate balance between financial and social returns, triggering some to argue that a 'microfinance schism'<sup>31</sup> has emerged (see discussion on 'mission drift' in section 2.3 below).

*“the pursuit  
of scale takes  
changes in form”*



## Recommendations

*“Microfinance required risk-taking, significant guarantees, subsidies and interventions to begin building a track record”*

**i) Embrace and support sector pioneers.**

Muhammad Yunus was instrumental in establishing Grameen and microfinance, but his strong allies both inside and outside of Bangladesh assisted in exporting microfinance to the world. While ACCION and BRAC deserve credit for advancing a highly scalable model of microfinance, early visionaries such as Martin Connell, Calmeadow and international aid organisations also poured in financial resources, and secured hard-won early victories, to prove the concept.

**ii) Co-ordinate sources of early grant capital in order to prove experimental models.**

Grant funding was critical for absorbing the early stage risk of high potential microfinance models that remained too uncertain and unknown to attract alternative sources of financial support. Governments, foundations, and other grant funders should be the primary drivers of change in creating beacons of success and momentum for models that need time to both reduce costs and increase scale.

**iii) Demonstrate demand.**

The argument for funding microfinance was made much easier by the fact that there was significant, demonstrable, pent-up demand. Similarly, the social investment market could be aided by mechanisms and regulatory measures that require tracking the demand for capital from charities and social enterprises. An instructive comparison is the requirement for banks in the United States to track their rates of lending to individuals and businesses from low and moderate-income neighbourhoods pursuant to the Community Reinvestment Act – providing regulators with a useful measure of basic demand for capital. Given the high cost of due diligence relative to the size of social investment deals, social investors should also make greater efforts to share due diligence and collaborate in providing follow-on funding to each other's deals.

**iv) Demonstrate impact.**

The social impact of investments must be clearly articulated (both quantitatively and qualitatively) to encourage an early wave of philanthropic or socially-oriented investors. Moreover, outcomes beyond funding must be properly and consistently tracked. Given that in many (and possibly the majority) of cases, the risk-adjusted rate of return of social investments (as currently understood) is never likely to achieve commercial thresholds, the appropriate early investors are those willing to trade-off some or all financial returns for social impact.

**v) Create beacons of success by doing deals that prove the impact investing concept.**

Microfinance required risk-taking, significant guarantees, subsidies and other interventions to begin building a track record of successful organisations, funds and investment portfolios. The social investment market needs a similar push to demonstrate more proof-of-concept cases.

*“it is critical to have clearly communicated business models”*

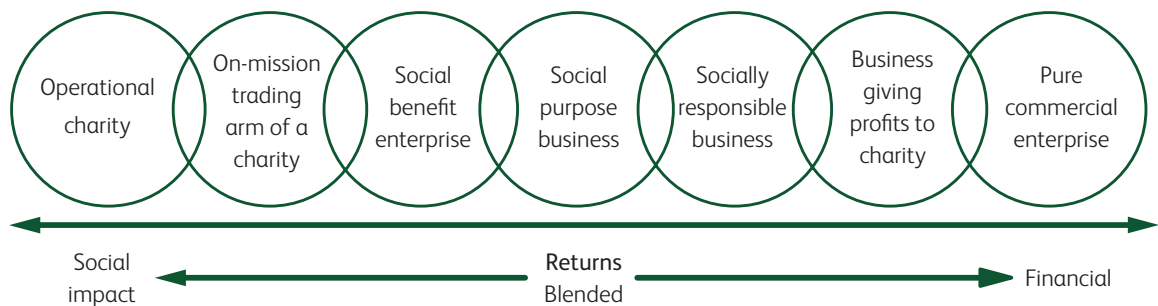
vi) **Be clear about your business model in order to drive replicability.**

Innovation and trial and error are important in the early stages of any industry development. But as this sector transitions to a more mature market, it must seek opportunities to replicate successful models. Proving replicability demonstrates potential to both scale and to drive down development, transaction and implementation costs. For this to happen, it is critical to have clearly communicated business models which staff, clients and investors can all understand.

vii) **Recognise a range of organisational models that underlie the spectrum of investment returns.**

Commercialisation created apparent divisions within the microfinance industry. Tensions have revolved around the relative importance of sustainability and scalability versus a primary focus on reaching the ‘poorest of the poor’ through subsidised services. A similar debate within the social investment market can be futile as different types of funding, each with its appropriate business model, all have their particular role. Furthermore, there is a need to fully appreciate the different organisational models that underlie the much-abused term ‘social enterprise’ (see Figure 3).

Figure 3: Categorisation of different ‘social enterprise’ organisational models (a diagram refined by CAF Venturesome over several years)



Source: Adapted from CAF Venturesome, *Financing the Big Society* (September 2009)

## 2 Market-building activities

As the microfinance industry evolved beyond improvised innovation and opportunistic development, organisations poised for growth needed a more robust market infrastructure to tap larger sources of funding.<sup>34</sup> These processes saw microfinance emerge as an independent ‘asset class’. A recent JP Morgan report on impact investing identifies the following elements that define an asset class:<sup>35</sup>

- adoption of **metrics, benchmarks and ratings** that standardise performance and risk measurement – for microfinance, this handbook examines the importance of information transparency in section 2.1;
- **structures on the buy side** that organise around and allocate capital to these skilled professionals – see section 2.3;
- demand for **professionals** with a unique set of investment/risk management skills – for this handbook, the role of intermediaries is implicit in section 2.3, and we examine the role of other sector-builders in section 2.4;
- **industry organisations** and networks dedicated to the investment class – see section 3.

We further examine the role of government and regulation to achieve scale in the microfinance industry, in section 2.2.

### 2.1 Information transparency and standardisation

Two key characteristics of mature markets are access to transparent information and standardised products. Microfinance ‘grew up’ collecting the information needed to please their donors’ demands, with many organisations initially developing different metrics. Expansive growth, together with the vast number of actors involved, prompted professionalisation and standardisation. This meant the emergence of some degree of standardised terminology and language such as that translated into six languages by the Consultative Group to Assist the Poor (CGAP) in an effort to ensure consistency,<sup>36</sup> the creation of reporting systems, IT tools to improve the efficiency of operations, and control mechanisms to enhance accountability and reporting.

For example, several early and active industry pioneers had a common understanding of microfinance as lending that is not collateral-oriented, and which was therefore available to non-traditional borrower groups.<sup>37</sup> Additionally, the Boulder Institute of Microfinance has trained industry practitioners for 16 years, with alumni now placed in leading organisations globally – this has made a significant contribution to promoting a common language and standardisation in microfinance.<sup>38</sup>

*“Two key characteristics of mature markets are access to transparent information and standardised products”*

*“transparent information about all aspects of a fund’s business model not only builds trust, but also reduces the risk of bad practices”*

Important examples of pioneers of standardisation include:

- **MicroRate:** The first organisation to develop scoring and rating models to help investors assess the risk profile of various MFIs.
- **MixMarket** and the creation of the *MicroBanking Bulletin*: The first organisation gathering standardised sector-wide data and generating benchmark reports.<sup>39</sup>
- Technology innovations such as **Mifos**, an open source management information system that aims to improve information management, reporting and comparability.

The standardisation process is by no means complete across the microfinance industry, and differences in terminology and products hinder their comparability by investors. Oversight of transparency measures is not universal, either at national or international levels, and most information is still disclosed on a self-reporting basis.<sup>40</sup> Nevertheless, the guiding principle is that transparent information about all aspects of a fund’s business model not only builds trust, but also reduces the risk of bad practices (or worse, fraud). Sunlight is indeed the best disinfectant.

#### CASE STUDY

### MicroRate – Enhancing industry transparency (i)

Founded in 1996, MicroRate increases the flow of funding to microfinance through enhanced transparency and improved ability to judge the risk and return of investments. “At the time, we saw that the funds raised by an MFI were directly related to their marketing machine – not necessarily their performance. We wanted to highlight who was using the funds the most efficiently,” explained Sebastian von Stauffenberg, the CEO of MicroRate.

MicroRate started with ‘independent evaluations’ which eventually became ‘performance ratings’ of institutions. A holistic analysis of an institution’s portfolio quality, operations, management and governance, in addition to financial aspects, distinguishes them from usual ‘credit ratings’.

Such services necessarily contributed to the ongoing professionalisation of MFIs, and to investor education about the tools, data and transparency relevant to this sector.

Initially, such services were utilised by Development Banks and the donor community to show that donor funds were being effectively deployed. As demand for information radically increased with sector growth, other specialised microfinance rating agencies emerged, including Planet Finance, Microfinanza and M-CRIL. They have traditionally required subsidies to operate.

“In the early days, all these networks of donors and foundations were directly involved in the sector and understood the fundamental principles of microfinance,” said von Stauffenberg. “Today, all types of investors are involved, and they need third party experts to help them make sense of the data”.

MicroRate was an early rating agency for Compartamos before its 2004 and 2005 bonds issues, at which point traditional rating houses became involved. Today there are more than 15 rating agencies, including the commercial bodies Standard & Poor’s and Fitch.

**Lesson 4: Information and reporting should reflect the language of commercial market practices as far as possible to garner the trust of mainstream investors. As the investor base broadens, information providers will be increasingly relied upon to interpret data for those less familiar with the asset class.**

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Sources: *Interview with Sebastian von Stauffenberg, Managing Director & CEO, MicroRate, 24 November 2010; Elisabeth Rhyne, Microfinance for Bankers and Investors: Understanding the Opportunities and Challenges of the Market at the Bottom of the Pyramid (2009).*

#### CASE STUDY

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### Microfinance Information Exchange (MIX) – Enhancing industry transparency (ii)

MIX was founded by CGAP in 2002 as a non-profit organisation to be a common information platform for microfinance, providing data and benchmark reporting tools to investors. It is the most respected provider of sector-wide information, with over 1900 MFIs reporting information.

MIX uses validated source documents (e.g. audits) to collect financial, operational, social and funding information according to global reporting standards (e.g. IFRS and Social Performance Taskforce ), which in turn allows comparisons between regions and organisations. Related to this, MIX has developed a technology platform that is consistent with emerging data standards for financial reporting (e.g. XBRL – the business reporting language) to foster faster processing and improved comparability of data.

The significant user groups of MIX information services are microfinance institutions, development finance institutions, investors, rating agencies and regulators. Local associations in individual countries/regions, as well as multi-national networks, also use MIX information. Investors use MIX information in the preliminary stages of investment due diligence.

MIX has partnered with the Global Impact Investing Network (GIIN) in linking its data to GIIN's data collection (through the Impact Reporting and Investment Standards (IRIS)) so that both systems can exchange data.

One of its challenges is donor dependency, which at times has limited its ability to grow and gather deeper and more accurate data.

**Lesson 5: Availability of comparable data facilitates the entrance of new investors as it assists with risk management and creates sector-wide expectations on both the demand- and supply-side of capital as to what information can and should be reported.**

**Limitations: For information to be useful, capital markets must believe in its accuracy and quality. This remains challenging for a sector with high levels of informal activity.**

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Sources: *Conner Brannen, 'Microcapital Brief: Microfinance Information Exchange (MIX) and Global Impact Investing Network (GIIN) to Share Data With \$187,000 Grant From Rockefeller Foundation', Microcapital.org, 30 June 2010; Elisabeth Rhyne, Microfinance for Bankers and Investors: Understanding the Opportunities and Challenges of the Market at the Bottom of the Pyramid (2009); interview with Marten Leijon, Executive Director, Microfinance Information Exchange, 3 December 2010.*

*“For information to be useful, capital markets must believe in its accuracy and quality”*

Ultimately, transparent information and standardisation assist investors to function as they do in the mainstream capital marketplace. Such investors need “a marketplace in which investment opportunities are transparent; performance data is accessible, credible, and comparable; investors can access ratings agencies, syndicators, clearinghouses, auditors and other necessary market intermediaries [operate]; and co-investors are easily identified”.<sup>45</sup> Thus, with the development of information standardisation, capital flows are better able to match information flows. The risk with accelerating capital flows in the sector is the propensity for boom-bust cycles to start to occur as ‘less educated’ capital follows other investors. Therefore, globalisation of information and capital flows needs to be matched by some degree of coordinated oversight, operating with a similar level of scope, to temper short-term behaviour.<sup>46</sup>

## 2.2 Regulatory structures

Microfinance has grown within various cultural, legislative and policy contexts, making it difficult to reach consensus on the general role governments have played in the industry’s development. Most practitioners agree that governments should not directly provide microfinance services themselves at the retail level, but should play a major role in establishing a regulatory framework that is conducive to building inclusive financial systems for the poor.<sup>47</sup>

Positive government interventions include:

- **Facilitation of appropriate legal and regulatory environments**  
Governments can encourage the provision of microfinance and foster competition in the industry, while promoting transparency and responsibility. In general, CGAP argues for “‘light-touch’ consumer protection policies and market conduct regulation, such as disclosure requirements, protections against over-indebtedness, and simple, accessible recourse mechanisms, coupled with client financial education”.<sup>48</sup> This protects consumers, but also builds investor confidence and market credibility.

Furthermore, most financial regulatory systems are geared towards the banking sector, which is unsuited to the operational realities of many MFIs. In some contexts, this calls for the development of special vehicles so that MFIs can take deposits without being subject to restrictive banking laws.<sup>49</sup> Other examples of relevant considerations around banking regulations are summarised below:

*“Facilitation of appropriate legal and regulatory environments”*

Standard Banking Regulations	When Applied to Microfinance
Minimum capital requirements	Need to balance promotion of microfinance with the realistic capacity to supervise
Capital-adequacy ratios	May need more equity because of repayment volatility
Limits on unsecured lending	Impractical for character-based lending
Registration of collateral	Too expensive for tiny loans
Requirements for branches: security standards, working hours, daily clearing of accounts, limitations on location	May interfere with innovations that reduce costs and bring more convenient services to clients
Standard loan documentation requirements	May be too expensive and time-consuming for tiny loans

Source: Cited in Brigit Helms, Consultative Group to Assist the Poor, *Access for All: Building Inclusive Financial Systems (2006)*, 86.

*“Governments must be careful to withdraw such supportive measures once the market stabilises – otherwise market distortion and institutionalised inefficiencies may arise”*

- **Increasing funding to MFIs through wholesale capital facilities and reducing risk for early investors**

This can include guarantee funds or ‘first loss’ tranches in investment structures,<sup>50</sup> to optimise the amount of capital available and reduce the risk exposure of commercial investors. This approach is particularly helpful in a sector that targets social benefit, yet has limited track record and high perceived risk. An example of the latter is Opportunity International’s €30 million Eastern European Fund, which had its top tranche guaranteed by the European Investment Fund (a European Union agency) in order to reduce risk and entice commercial investors.<sup>51</sup> Governments have also created ‘second floor’<sup>52</sup> (wholesale) institutions to facilitate discount loans to MFIs. For example, the Colombian Government created Banco de las Oportunidades to provide cheap funding for MFIs, rather than direct loans to individual borrowers. Governments must be careful to withdraw such supportive measures once the market stabilises – otherwise market distortion and institutionalised inefficiencies may arise.

- **Providing a clear process for commercialisation**

Regulation could provide for a structure or series of intermediary structures that enable MFIs to transition from a non-profit model to a banking/commercial model, rather than requiring MFIs to ‘leap’ straight from the non-profit sector to the banking sector.<sup>53</sup>

*“Inefficient, subsidised lending programmes generate market distortion, encourage corrupt practices”*

Potentially harmful government interventions include:

- **Hard interest rate ceilings**

Microfinance operations have high transactions costs and, if they are to seek self-sustainability, should be free to set interest rates that cover costs. Historically, limited competition and small scale at the early stages of industry development has led to higher interest rates. However, evidence from Bangladesh, India and Bolivia shows that rates significantly reduce over time once organisations have reached scale, and the industry is characterised by efficiency and competition.<sup>54</sup> Further, this issue needs to be treated with the sophistication appropriate to its complexity – often interest rates are cited as ‘high’ without the necessary contextual data (local market lending rates for comparable loan sizes, cost of capital, operating margins, etc.) to objectively prove that the rates are, in fact, exploitative.

- **Subsidised lending programmes**

Inefficient, subsidised lending programmes generate market distortion, encourage corrupt practices and undermine MFI sustainability. It is impossible for private funders to compete with public funders whose cost of capital is virtually zero.

Recent controversies arising in India will likely move regulation up the agenda for stakeholders in the microfinance industry, particularly in the areas of interest rate controls, consumer protection and centralised credit bureaus.

#### CASE STUDY

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### Andhra Pradesh – Microfinance becomes politically explosive

In October 2010, news broke of ‘chaos’ in the microfinance industry in Andhra Pradesh – a relatively poor state of India where microfinance has achieved historically high penetration rates. In response to claims that exploitative interest rates and predatory lending practices were linked to over 70 borrower suicides, local political leaders, looking to curry favour with the public, encouraged borrowers to default on their micro-loans. Repayment rates dropped and a credit freeze set in across the industry. By mid-December 2010, similar accusations were starting to set off related problems in Bangladesh.

A number of complicating factors include the lack of distinction between micro-lenders and ‘loan sharks’; absence of a centralised credit bureau or system to help MFIs ensure that borrowers do not have multiple loans (and are using the loans to fund income-generating business, rather than consumption); allegations of coercive debt collection processes; corrupt local politics, and a regulator with obvious conflicts of interest (as many state governments do, because they fund and manage ‘self-help groups’ that compete with MFIs in giving loans to the poor).<sup>55</sup> There have been allegations that the effort to quickly scale micro-lending meant that insufficient training on repayment requirements and financial literacy was provided to borrowers, and that a blind eye was turned to potential problems of over-indebtedness.



*“funds should be as transparent as possible about their business model and practices”*

At the time of writing this handbook, the ultimate consequences of the Andhra Pradesh and Bangladesh microfinance crisis are far from clear. Our interviewees expected that these high profile events would prompt a regulatory response in parts of the industry. This may take the form of consumer protection principles, codes of conduct or complaints mechanisms.<sup>56</sup> Calls for interest rate controls have also emerged. But the danger is that poorly conceived government responses may simply end up hurting all microfinance beneficiaries by making the business of microcredit financially unviable. As John Hatch, the founder of FINCA, once remarked, “No one ever ended poverty by going bankrupt.”

A wave of regulatory reform may signal a new stage of maturity in the industry, where scaling now requires appropriate regulatory limits and safeguards. Or it may prove damaging and heavy-handed. As one commentator has explained, microfinance “developed its lending methodologies at a time when it was tiny – nobody had to worry about over lending... It’s like a car with no brakes”.<sup>57</sup> But others caution against a knee-jerk reaction to over-regulate and choke the industry through limiting its access to capital or capping interest rates at unsustainable levels – thereby deterring future investors.

**Lesson 6: In order to reduce the risk of misguided political interference, funds should be as transparent as possible about their business model and practices.**

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Sources: Eric Bellman and Arlene Chang, ‘India’s Major Crisis in Microlending’, The Wall Street Journal, 28 October 2010; Amy Kazmin, ‘Microfinance: Small loan, big snag’, Financial Times, 1 December 2010; Amy Kazmin, ‘Bangladesh joins microfinance backlash’, Financial Times, 7 December 2010.

The ACCION-founded Smart Campaign is actively promoting standardised consumer protection across the industry through six Client Protection Principles.<sup>58</sup> Although this is a civil society initiative that directly targets MFIs, it is also an attempt to head off potentially more restrictive government regulation.

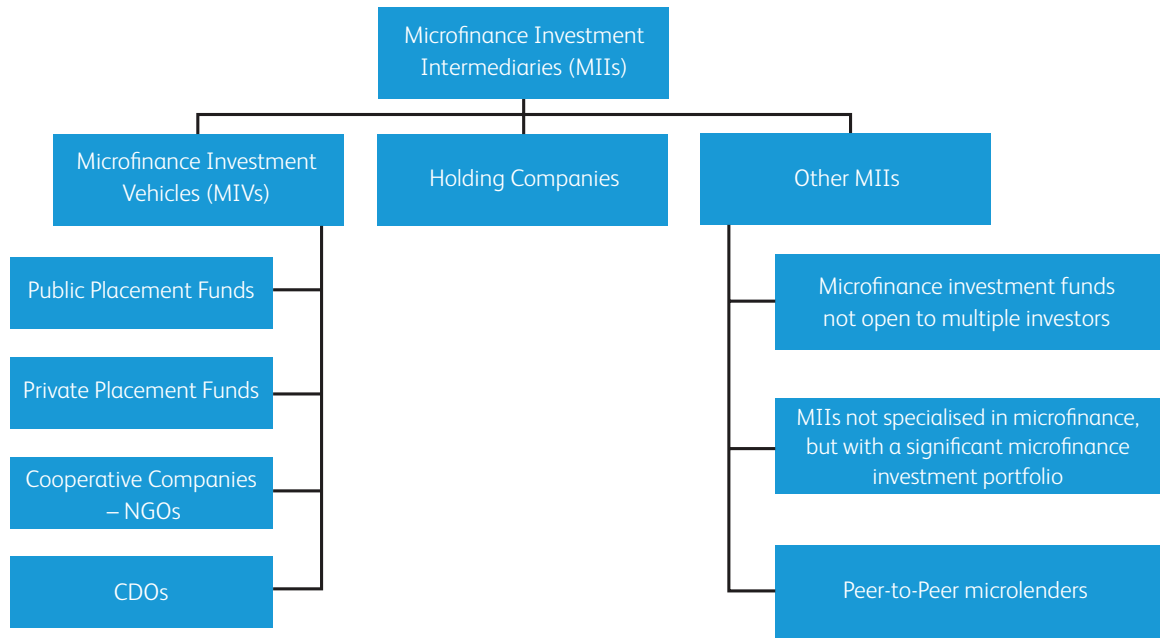
## 2.3 Mainstream commercial funding and intermediary vehicles

In its early days, microfinance was almost entirely funded by social or public investors. In the late 1980s, the only commercial products financing microfinance were heavily guaranteed bank loans to MFIs (see the discussion under section 1.3 above regarding subsidies, guarantee funds and ‘The Latin America Bridge Fund’ case study).

Over the last decade, the development of different types of investment products has increased access to traditional private sector resources and capital markets. The professionalisation of microfinance brought the depth, scale and stability that encouraged institutional investors to develop specialised microfinance investment vehicles (MIVs). Market leaders and innovators have introduced bonds, equity funds, and commercial investment funds that enabled larger flows of investment. Today, guarantees still exist. However, top-tier investment banks and specialised financial institutions have also channelled billions of dollars into this market.

Figure 4 demonstrates that a sophisticated ecosystem of microfinance investment intermediaries now exists – i.e. investment entities that have microfinance as one of their core investment objectives.

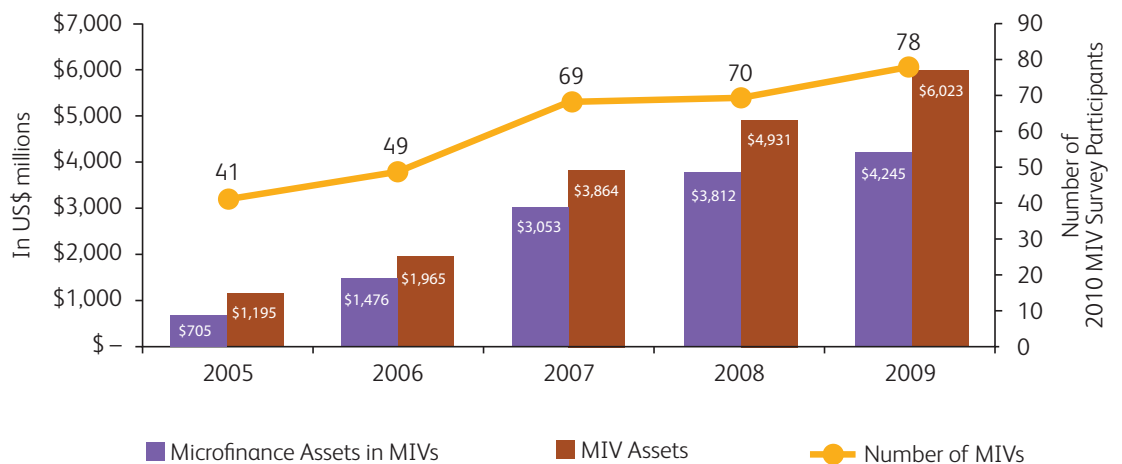
Figure 4: Ecosystem of microfinance investment intermediaries



Source: CGAP, 2010 MIV Survey, section 1.2

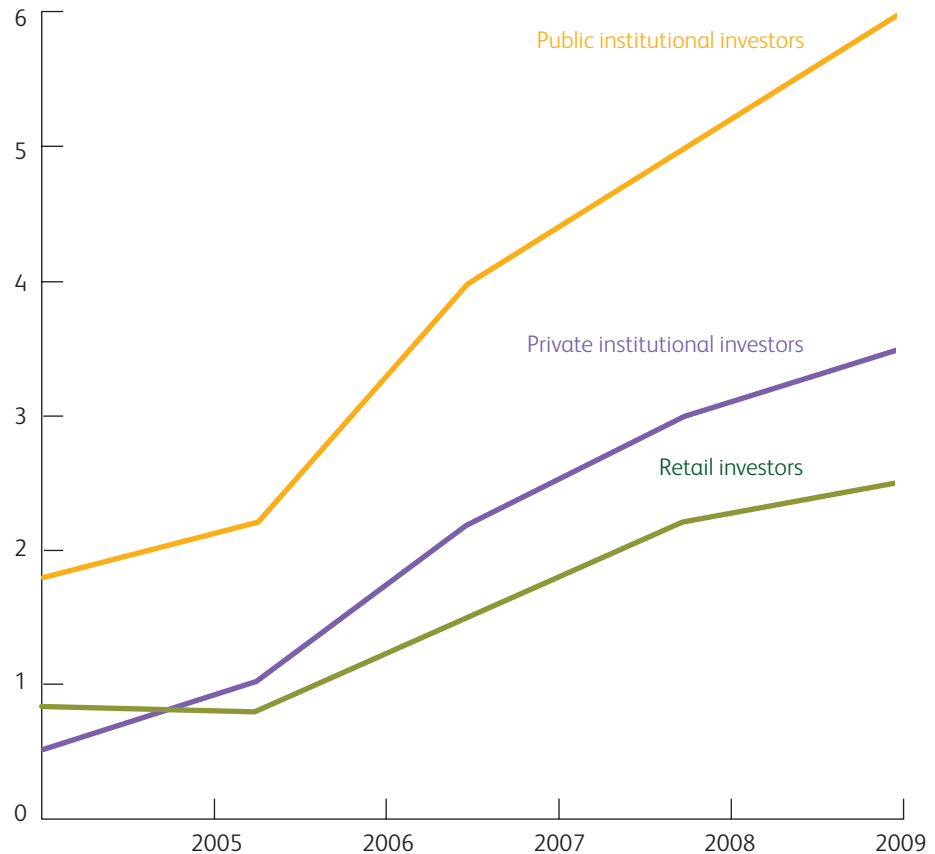
MIVs represent 76% of the market<sup>59</sup> (see Appendix for a list of global MIV funds). The value of total MIV assets topped \$6 billion in 2009 in spite of the global financial crisis, and the scale of cross-border global investment in microfinance also continued to grow at a breath-taking pace (see Figures 5 and 6). This growth was in part due to the perception of microfinance as a ‘responsible’ asset class linked to grassroots borrowers whose businesses were relatively shielded from the impact of the global economic recession.

Figure 5: Growth in MIV assets from 2005-6 (\$bn)



Source: MicroRate, 2010 MIV Survey (2010), 3.

Figure 6: Growth in cross-border investment in microfinance from 2005-09 (\$bn)



Source: Amy Kazmin, "Microfinance: Small loan, big snag", *Financial Times*, 1 December 2010 (based on research from CGAP and MIX)

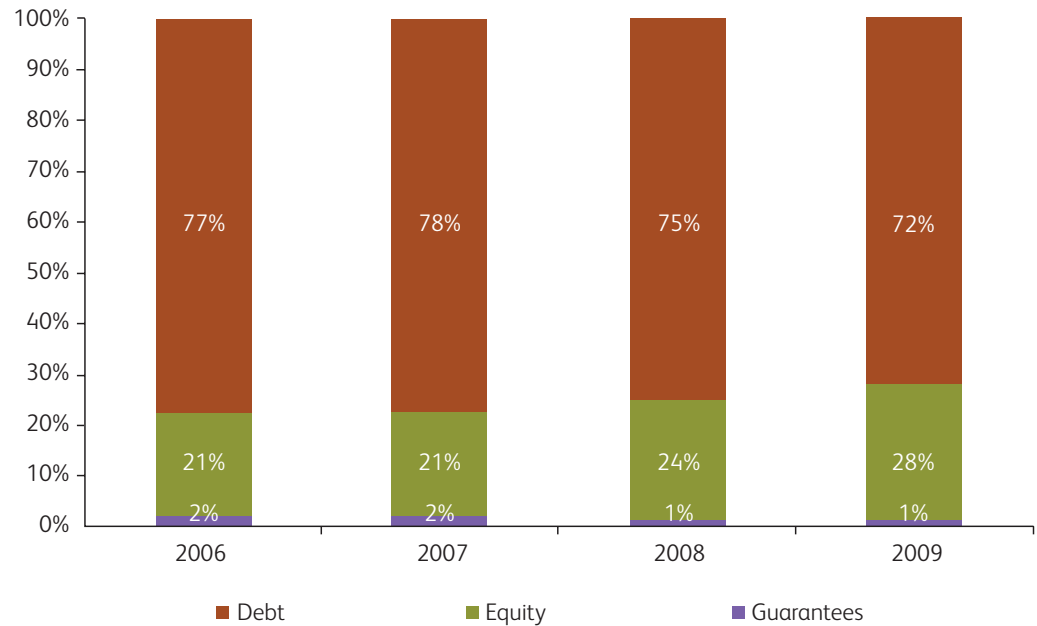
*“there appears to be more capital available to the industry than there is capacity for this capital to be placed”*

The relative commercial attractiveness of microfinance now means there appears to be more capital available to the industry than there is capacity for this capital to be placed (see section 2.4 regarding developing the industry’s absorptive capacity). Thus, MicroRate’s latest MIV survey noted that “Less than half of the funding mobilized in 2009 ended up in microfinance. Most of the rest increased fund liquidity”.<sup>60</sup> In light of this, David Roodman, a senior fellow at the Center for Global Development based in Washington DC, has also warned investors to reign in expectations:

“In the mid-1990s, Alex Silva struggled to raise a few million dollars for the first microfinance investment vehicle, ProFund. Now microfinance investment managers are struggling to absorb millions per day. For the sake of the industry’s health, investors must adapt to the new reality. If they do not institutionalize collective limits, they may finance further unhealthy lending”.<sup>61</sup>

The way in which private capital has flowed into the industry has largely been twofold: through debt products, which account for 72% of total investments in the microfinance industry, and equity investments which are gradually increasing relative to debt (see Figure 7).

Figure 7: Microfinance investment instruments, % Microfinance portfolio



Source: CGAP 2010 MIV Survey

*“The development of collateralised and securitised debt products was significant for paving the way for large amounts of commercially-driven capital”*

#### (a) Debt finance

Building on the 1980s model of soft loan debt finance, more structured debt products developed throughout the early 2000s including: bonds, collateralised debt obligations (CDOs) and collateralised loan obligations (CLOs), as well as securitisation of microfinance portfolios. Despite the significant scale and professionalism achieved by the industry during this decade, these first-generation product innovations were all still guaranteed by a multilateral bank or donor agency.

The development of collateralised and securitised debt products was significant for paving the way for large amounts of commercially-driven capital, characterised by a higher degree of liquidity, to enter the industry. The cases below illustrate the characteristics of the first CDO and securitisation.

#### CASE STUDY

#### Dexia and BlueOrchard create an investment vehicle with market returns

In 1998 Dexia, a Franco-Belgian bank, and BlueOrchard created the first MIV that reached beyond the pool of purely socially motivated investors, through structuring a fund that targeted a commercial rate of return and featured redemption rights. Investors included funds of funds, retail and banking clients, and institutional investors. At November 2007, the fund had \$233 million under management. However, due to its legal structure the fund could only offer short-term maturities, which ultimately limited its appeal to both investors and MFIs.

BlueOrchard went on to develop the first CDOs in the industry, in collaboration with Developing World Markets (a corporate finance advisory). The CDOs overcame the limitations of the earlier fund, and resulted in longer term loans to MFIs, attracted a larger and broader investor audience, and generated higher rates of return. The success of the CDOs was also assisted by the Overseas Private Investment Company (OPIC) providing a guarantee to reduce investors' perceptions of risk.

**Lesson 7: The development of mainstream financial products only occurs when demand and supply are aligned through vehicles that allow for common language and interests.**

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Sources: *Brad Swanson, The Role of International Capital Markets in Microfinance (2008)*; *Elisabeth Rhyne, Microfinance for Bankers and Investors: Understanding the Opportunities and Challenges of the Market at the Bottom of the Pyramid (2009)*.

#### CASE STUDY

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### BRAC securitisation supported by Citigroup and MF Analytics

BRAC is one of the world's largest NGOs, with extensive microfinance operations. In 2007, with the assistance of Citigroup and MF Analytics, BRAC created the first securitisation of microfinance loans – an innovation that many previously regarded as impossible. Despite its reputation and 32-year track record, the issue required collateral of 150% and grant funding from the Dutch bank FMO and the German bank KfW to cover transaction costs.

These measures allowed the issue to receive a 'AAA' rating from a Moody's affiliated local rating agency. BRAC received \$180 million of low cost and long term investment, diversified its sources of funding and expanded its programme to over 1.5 million new clients. This deal was recognised by The International Financing Review as the 2006 Securitisation Deal of the Year.

**Lesson 8: Engaging with high profile, well-known organisations can help NGOs to build credibility and confidence to break into mainstream markets.**

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Sources: *Shams Zaman and S N Kairy, 'Building Domestic Capital Markets: BRAC's AAA Securitization', MicroBanking Bulletin, issue 14 (Spring 2007)*.

#### (b) Equity finance

In the late 1990s, alongside the commercialisation of microfinance and the creation of the first shareholder-owned MFIs, equity investments started to appear. The development trajectory was similar to that of debt products: initial equity investors in MFIs were public sector development banks and not-for-profit organisations, with a shift to private investors evident over the last decade. The Council of Microfinance Equity Funds, the umbrella association for all investment funds focused on microfinance, today has more than 25 members – many of them drawn from the private sector.

*“Engaging with high profile, well-known organisations can help NGOs to build credibility and confidence to break the mainstream market”*

ACCION International, Calmeadow of Canada, Triodos of the Netherlands and Fundes of Switzerland collaborated to raise \$23m for the first equity fund dedicated exclusively to microfinance, ProFund. From 1995 to 2005, ProFund returned 6.6% – a strong result given the fund’s Latin American focus that needed to weather significant devaluation of local currencies.<sup>62</sup> The growth in valuations of equity investments in microfinance illustrates how the industry has become much more attractive and legitimised for commercial investors. According to a JP Morgan and CGAP report on microfinance asset quality, the book values of equity investments in microfinance have increased from 1x to 6x over the last 10 years.<sup>63</sup>

The growth of equity investments has also been stimulated by the success of Initial Public Offerings (IPOs) from MFIs eager to access large amounts of capital at favourable rates. Only the largest and most efficient organisations, located in countries with well-functioning stock markets, have been capable of making this transition. Bank Rakyat in Indonesia, BRAC in Bangladesh, Equity Bank in Kenya, Banco Compartamos in Mexico and SKS in India are the best examples of transactions in which initial investors saw returns that were several times the value of their initial capital.<sup>64</sup>

#### CASE STUDY

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### Sequoia and SKS – Handsome returns on venture capital investments

SKS, one of the fastest growing MFIs in India, was established as a non-profit organisation in 1997 and converted into a for-profit Non-Banking Finance Company in January 2005. Organisations in India such as SKS typically face a cost of capital of 9-12% (cost of borrowing) and operating expenses of 15-18%.

In 2007 and 2008, the organisation raised more than \$100 million from private investors in a transaction led by Sandstone Capital, a Boston-based hedge fund. One of the major investors was Sequoia Capital India, which invested \$11.5 million at an average cost of acquisition of Rs 88 a share.

Since that period, the SKS loan portfolio has grown 300% annually and its profit in 2008 and 2009 grew by 116% and 329%, respectively. Such exponential growth, and the hunger for more liquid sources of capital to fuel further expansion, saw SKS conduct an IPO in late 2010 at a price of Rs 1,036 per share. The IPO was oversubscribed by 13.6 times. Sequoia received a 12x return on its investment (per share acquisition cost).

As noted in section 2.2, the enormous profits generated in this process played a role in a major microfinance industry crisis in Andhra Pradesh, the home state of SKS in India.

*“Sequoia received  
a 12x return on  
its investment”*

Lesson 9: Once organisations have reached scale, demonstrated a track record of growth and proved stable returns, mainstream capital markets will enter. This brings with it an injection of expertise that can greatly contribute to market growth.

Limitations: Mainstream capital markets are by definition profit-oriented. When they engage with organisations that have more than one bottom line, there can be mission conflict or mission drift.

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Sources: 'SKS Microfinance Raises \$75.4m in Equity Capital in Transaction Led by Sandstone Capital', Microcapital Story, 14 November 2008; 'Unitus Equity Fund Investment in SKS Microfinance Valued at \$60m, Partial Exit Expected This Week', Microcapital Story, 30 July 2010; 'SKS Microfinance Public Issue Too Expensive, Say Analysts', Microfinance Africa, 27 July 2010; 'India News: SKS Microfinance Initial Public Offering,' Sequoia Capital India, 16 August 2010; 'Madhav A. Chanchani: Narayana Murthy's Catamaran Invests Rs 28Cr In SKS', VCCircle, 26 March 2010.

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#### CASE STUDY

### Banco Compartamos – IPO controversy comes to microfinance

*“the most profitable IPO in the history of microfinance”*

Banco Compartamos in Mexico was launched in 1990 as an NGO by a Catholic social action group, with the support of grants from various sources such as USAID, IDB and CGAP. In the early 2000s, Compartamos issued several bonds that initially needed public sector guarantors (from institutions such as the IFC). As a track record was established, later tranches of bonds were issued on purely commercial terms and without guarantees.

In 2006, the organisation became a regulated bank and in April 2007, it undertook the most profitable IPO in the history of microfinance, raising \$467m on the Mexican Stock Exchange by selling 30% of its shares: it was 13 times oversubscribed, with 5,900 mainstream international fund managers, commercial and retail investors acting as its primary purchasers. This resulted in a price to earnings ratio of 24.2 and a return on investment for original investors of approximately 100% compounded over eight years.

The commercial success of the Compartamos IPO was attributable to its exceptional growth and robust financial performance. However, this performance was partly due to charging interest rates that in some cases exceeded 100%, with the cost of capital (13.6%), operating expenses (36.4%), taxes (11.32%) and value added taxes (15%) cumulatively representing less than 80% of the loan portfolio, i.e. a profit margin of over 20%.

Mexican banks usually charge interest rates up to 90% due to inefficiencies, high costs, and limited competition. Compartamos, however, has been able to produce greater efficiencies and a strong credit rating as a result of its for-profit orientation. Critics charge that Compartamos does not pass on these savings to borrowers, instead steering interest income into boosting its own bottom line. As a result, return on equity was 38% and return on assets was 17% for 2007. By contrast, average return on equity for Mexican commercial banks is 15%, and the average return on assets is 6%.

This situation has provoked allegations of mission drift and even exploitation. The bank's proponents, on the other hand, point to the benefits of attracting abundant investor capital including greater competition, public accountability from an exchange listing, and a wider range of financial products being offered to the poor.

**Lesson 10: Strong financial performance will capture market attention and resources, but transparency about business models, a clear mission and codes of ethics from the outset will help justify profit margins and maintain public confidence and trust.**

**Limitations: It is not yet clear how for-profit motives can exist harmoniously with organisations primarily engaged with making an impact on social issues, particularly when these organisations have initially received grants or subsidies from governments or NGOs.**

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Source: Richard Rosenberg, 'CGAP Reflections on the Compartamos Initial Public Offering: A Case study on microfinance interest rates and profits', Focus Note, No 42 (June 2007).

### (c) The 'mission drift' debate

The rapid adoption and transformative impact of the commercialisation process, and in particular the proliferation of equity investments in MFIs and IPOs, are developments that have polarised the industry. Many regard MFI commercialisation (see section 1.4 above), and the related movement to link microfinance to globalised capital flows, as the underlying cause of 'mission drift' which is purportedly reflected in the following industry shifts:

- Shift from targeting 'poorest of poor' to the moderately poor
- Shift from rural to urban
- Shift from starting businesses to growing businesses
- Shift from peer lending to individual collateralised lending
- Shift away from auxiliary services and non-financial outreach (including value-added services such as training and debt advice to borrowers)
- Shift from the poor as the primary beneficiary to the investor.<sup>65</sup>

The argument is that a focus on generating financial profit and positioning MFIs to access commercial funding have weakened the industry's preference for servicing 'hard to reach' (marginalised) clients, and that such mission drift has weakened the social impact of the industry. Some, including Muhammad Yunus, believe that microfinance is heading in the wrong direction. Yunus says he is not against making a profit. But he denounces firms that seek windfalls and pervert the original intent of microfinance: helping the poor. From Yunus's perspective, it is essential that the industry move away from seeking maximum profits and get back to focusing on the poor. "If not, you are not helping poor people's lives," he says. "You are not patient. You are not restrained. You don't have empathy for the people. You are just using them to make money. That's what blinds you when you are in the profit-making world. We need to see the people, not profit."<sup>66</sup> For Yunus, the rule of thumb for a loan should be the cost of funds plus 10 percent.

*"We need to see the people, not profit"*



*“certain parts  
of the industry  
have lost sight  
of its purpose”*

Jennifer Meehan, the Asia Regional CEO of the Grameen Foundation, explained that “Certain parts of the industry have lost sight of its purpose. Microfinance is a means to an end: the end being reduction of poverty.” Some large micro-lenders in India have focused “on growth of the institution rather than transformation of the client”.<sup>67</sup>

However, others argue that the ‘shifts’ identified above are based on misguided stereotypes about the history and purpose of microfinance. According to this view, access to mainstream capital markets is the best and most natural way to scale and expand. “If we treat profits as having been ‘stolen’ from the poor,” wrote one advocate, “we deprive microfinance of its most essential steering mechanism. Without profits, funds will be used inefficiently and MFIs will have little incentive to offer products that their clients really want.”<sup>68</sup>

Another practitioner highlighted the tension inherent for investors in marrying commercial funding sources with a social purpose by arguing that “Investors must have more realistic expectations... The company does not exist to serve their interests. The company exists to serve clients, and they make money because they do that well”.<sup>69</sup> The argument here is that the responsible and sustainable operation of profitable microfinance is in complete alignment with long-term financial returns.

As the social investment market reaches scale and continues to receive interest from more commercial investors, the mission drift debate is one that the sector must be ready to engage in. The success of the sector will depend in part on the improved accountability of funds. Although some social investment funds may be more ‘socially motivated’ than others, all should meet standards for ethical behaviour. These ethical standards will need to be openly discussed and decided upon as the social investment market matures.

Another key aspect of a mature, well-functioning market is information transparency – this means that investees use consistent language and tools for describing and demonstrating their social impact; and investment funds clearly communicate their business models and investment thresholds (cost of capital, ceilings on financial returns, etc). Investors can then make well-informed choices about the appropriate vehicle for achieving their social investment aims.

## 2.4 Sector builders’ contribution to absorptive capacity

As the microfinance industry matured, growing attention from commercial and institutional investors meant there was an increasing need to find ways to relieve the pressure of large amounts of capital seeking relatively scarce investment opportunities, and to improve the absorptive capacity of local-level MFIs that lacked the sophistication to operate in the globalised finance industry. This training and consulting role is often hard to separate from the activities of other players, including investors, intermediaries and more successful MFIs that, like Grameen and ACCION, also took on a broader sector-building role.

Nevertheless, new actors did emerge to help bridge the gap between supply and demand. Organisations such as Developing World Markets<sup>70</sup> and Unitus started providing consulting services, technical assistance and matchmaking services to MFIs that were at a tipping point in scaling up and reaching out to commercial investors. This technical assistance greatly contributed to the professionalisation and commercialisation of microfinance.

## Unitus Capital: Responding to a market need for intermediation and absorptive capacity

Unitus Capital (UC) carved out a unique role in the microfinance ecosystem by playing a role as a catalytic force through their four point Unitus Acceleration Model: selecting strong MFIs and leaders, connecting them to critical investment, consulting on growth constraints and issues, and acting as a hub to connect MFIs to information as well as each other.<sup>71</sup>

In 2004, Unitus established a capital markets group to act as an advisor in arranging finance for MFIs. After four years of operating within the non-profit structure, Unitus Capital was spun out as a for-profit financial advisory firm. “It was a philosophical approach: the sector is about sustainability, so it didn’t seem right to keep the team within the non-profit arm and potentially have it cross-subsidised by donor funding”,<sup>72</sup> explained Kylie Charlton, Managing Director at UC.

“We saw more money coming into microfinance, and more funds being set up, which were having difficulty placing money; further, these funds were set up without a local presence on the ground”.<sup>73</sup> UC advises MFIs on preparing for investment, and on negotiating mutually favourable terms. When UC started its work, “we saw MFIs that may have gone through the process of transformation from non-profit to for-profit, but were having trouble accessing the capital that had been available. We saw lots of pools of money not being able to connect”.<sup>74</sup>

Due to its deep expertise and emerging markets presence, UC is an effective intermediary between the demand and supply sides of microfinance capital, particularly capital from large investment banks, commercial banks, institutional investors and MIVs.

In recent years, UC has found that its microfinance intermediary skill set is transferable to other social purpose organisations and sectors.

**Lesson 11: Intermediaries with deep expertise can help accelerate industry development through efficiently matching demand- and supply-side capital, particularly those intermediaries that also operate locally to develop investment readiness in clients.**

**Limitations: In order to remain viable, for-profit intermediaries will need to focus on higher value transactions associated with larger organisations that have already achieved sufficient scale. As such, these players require a certain level of industry maturity to be feasible. Unfortunately, this can lead to ‘cherry-picking’ the most profitable clients, unless the intermediary has an explicit goal to appropriately balance its service offering across large and small organisations at various stages of profitability and maturity.**

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Source: Unitus website, <http://www.unitus.com/>; Unitus Capital website, <http://www.unituscapital.com/>; interview with Kylie Charlton, Managing Director, Unitus Capital, 23 November 2010.

*“We saw lots of pools of money not being able to connect”*

# Recommendations

## viii) Promote a transparent market, and be prepared to subsidise initiatives that enhance transparency

The social investment market remains opaque. Organisations that help improve transparent and independent evaluation of market players (such as ratings agencies, research firms, indexes, technology platforms) are fundamental to help build confidence and credibility in the sector. However, such organisations are likely to require subsidy support in their initial phases to establish themselves.

## ix) Share best practices and measurement methodologies, and be honest about failures.

Interviews revealed an expectation that any 'kid glove' treatment of social capital markets is coming to an end, and in some ways this has been hastened by the attention on microfinance and its decidedly mixed results in demonstrating impact. Social purpose entities will need to have a very clear claim to social impact. This will mean collective investment in industry vehicles that generate universally agreed measurements and proxies for impact. Of course, care must be taken that standardisation does not lead to 'one-size-fits-all' methodologies. Efforts such as SROI, GIIRS and the new IRIS<sup>75</sup> are a good start, but are still far from being universally adopted or accepted.

## x) Adopt industry regulation that facilitates the development of viable social investment funds and other market infrastructure.

The first step will be to review financial services regulations as they apply to impact investing. Current regulations create significant cost burdens for any investment fund seeking to specialise in social investment. In particular, appropriate legal structures tailored to financial initiatives that have charitable purpose, processes for conversion from non-profit to commercial structures, consumer protection standards and industry codes of conduct should be prioritised. To avoid distortion of the market, certain mechanisms could be phased out over time or be subject to a sunset period. Specifically, the requirements for compliance registration, authorisation and obtaining licences could be modified to recognise that many potential social investment players may come from backgrounds other than financial services – and will be performing few of the activities typically associated with a financial professional.

## xi) Provide subsidies and guarantees to capitalise pioneering funds and reduce risk for first-time investors.

The market will not necessarily fill the funding gap merely because a model has been 'proven' by subsidies or philanthropic support and appears sustainable. Don't over promise the potential short-term self-sustainability of the sector, or underestimate the long, and possibly permanent, role for some subsidies and guarantees. Although subsidies are often viewed as distorting a well-functioning market, they proved essential in pushing forward the microfinance industry which was initially perceived as too risky for commercial investors. The development of impact investing in the UK and worldwide will similarly depend on this support until greater awareness, better track records, and more effective intermediation leads to a differentiated marketplace where risk-adjusted returns are both possible and meaningful.

**xii) Encourage mainstream finance to engage where appropriate, particularly with institutions that have demonstrated some track record and are attempting to scale operations.**

Microfinance industry development stagnated in several instances where 'home grown' solutions could not connect with commercial sources of capital. Established commercial organisations can provide those routes, be they ratings agencies, investment banks, law firms, equity and debt investment vehicles, or other players

**xiii) Promote cross-sector collaboration with mainstream, commercial entities in developing innovative financial mechanisms and products.**

Once MFIs grew to a sufficient level of sophistication, they were able to engage on an equal footing with mainstream commercial entities in developing securitisation and other debt products, and leverage equity investments. More established charities and social purpose organisations can lead sector innovation around collaborative models of finance, and promote tangible examples of success.

**xiv) Guard against mission drift when pursuing commercial returns.**

Organisations must be sure that sources of capital are appropriately matched to their social impact goals. As more commercial sources of capital are sought, it becomes increasingly difficult to ring-fence a social mission, particularly if that mission implies limits to profitability. Building an effective organisational culture dedicated to a social mission through strong leadership and management, hiring practices, governance structures, and transparency, can all help mitigate the risk of mission drift. But organisations should be prepared to articulate to potential investors an unambiguous choice between speed of growth, or depth of impact.

**xv) Simultaneously develop investees' absorptive capacity for capital.**

Investees rarely come investment-ready. The experience of microfinance sector-builders and intermediaries in building and professionalising investees is instructive for the broader impact investing industry. In 2011, it appears that there is no longer a bottleneck of capital supply for microfinance, but a paucity of truly professional MFIs with the absorptive capacity to effectively deploy that capital. Investment readiness remains a significant challenge with no easy answers.

## 3 Movement-building and cultural factors

### 3.1 Cultural attitudes towards international development

During the decades of its growth, the microfinance industry was remarkably well-aligned with prevailing socio-cultural norms surrounding the interrelationship between the individual, society, and markets. Some contend that the perceived failure of traditional international aid approaches, and the powerful rebirth of a neoliberal belief in free markets in the 1980s, increased the global appeal of microfinance for development practitioners, advocates and governments.<sup>76</sup> Against such a backdrop, the features of the microfinance model that were particularly attractive include:

*“the powerful rebirth of a neoliberal belief in free markets in the 1980s”*

- Promise of, and potential for, self-sustainability (despite little evidence of this during the first decade of microfinance);
- A free market-based approach to development;
- Multidimensionality of impact. Among other social benefits, microfinance was promoted as a direct poverty eradication programme, and a tool for empowering women and enhancing social inclusion;
- Objectively measurable impact, with astonishing repayment rates;<sup>77</sup>
- Replicability;
- A demonstrable and extensive market need. Microfinance products were extremely popular with end users who had been previously ignored by traditional banking systems.

While some of these concepts have become controversial over time (notably, repayment rates, measures of social impact and a focus on financial sustainability), they are instructive for thinking critically about how today’s social finance movement can potentially relate to current socio-economic and cultural trends.

### 3.2 Advocacy, coalitions and partnerships within the sector

Advocacy and partnership within the sector were instrumental; the microfinance movement created a relatively supportive and collaborative ecosystem in which all organisations shared their experiences and knowledge freely. One example of this is the Small Enterprise Education and Promotion Network (SEEP), which for 25 years has provided a forum to connect microfinance practitioners, share best practices and promote discussion on standards and reporting.<sup>78</sup>

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## CGAP – Creation of an industry knowledge hub

CGAP (Consultative Group to Assist the Poor) was started in 1995 as a collaborative effort from 33 top bilateral and international donor agencies, as well as key foundation supporters. Housed at the World Bank, CGAP acts as an anchor point for industry information and research, consensus-building on standards and advocacy, and training for multiple stakeholders, among other services. The protagonists were unified behind the common goals of improving access to financial services and poverty alleviation. This is a level of collaborative action as yet unseen in the broader social investment market.

In conducting interviews for this handbook, virtually all interviewees referred to CGAP as the authoritative repository of information and expertise in the sector.

**Lesson 12: Unifying around a single industry body as an impartial broker for the sector can create a powerful platform for shared action.**

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Source: CGAP website, [www.cgap.org](http://www.cgap.org).

*“a powerful platform for shared action”*

### 3.3 Social movements and mainstream publicity

Another significant inflexion point in building a united movement behind microfinance was the 1997 Microcredit Summit.

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## Microcredit Summit Campaign

Attended by over 3,000 participants from across the industry, the 1997 Microcredit Summit was one of the first real indicators of a unified movement. The Summit was consciously built for just that purpose by Sam Daley-Harris and his organisation RESULTS. This conference acted as a rallying call, galvanising the industry behind a goal of reaching 100 million people by the year 2005. Some version of the Summit has occurred almost annually ever since.

In time, the Summit and its organisers have faced significant criticism over the years for taking too much credit for sector-building, not evolving with the times, maintaining too narrow a view and even stimulating conflict. While its influence may be waning, it is hard to deny that the Summit played a catalysing role in setting ‘revolutionary goals’ that many deemed almost impossible to meet and track, uniting the bulk of the industry behind them, and creating a place for all players to meet, debate, and be heard in a way that media, governments, funders and others able to support could understand.

Lesson 13: While there is rarely unanimous agreement in a sector, significant gains can be made when a unified, industry front is presented.

Limitations: In a rapidly growing field with disparate views, maintaining a single unified voice is difficult for an extended period of time. The 1997 Microcredit Summit, and the momentum that followed it, define a seminal moment.

Maintaining this in a permanent way may not be feasible.

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Sources: *The Microcredit Summit Campaign website*, <http://www.microcreditsummit.org/>; Susan Davis and Vinod Khosla, *Taking Stock of the Microcredit Summit Campaign (2006)*.

Arguably, major publicity coups that stemmed from the momentum built by the Summit included the UN designating 2005 as the UN Year of Microcredit, and a Nobel Peace Prize for Grameen Bank and its founder Muhammad Yunus in 2006. With this award, Yunus seemed to burst onto the international scene, grabbing media attention and the imagination of the broader public. Sam Daley-Harris from the Microcredit Summit Campaign played a significant role in raising Yunus' profile and that of Grameen Bank, systematically making introductions to congressmen, setting up press conferences and gaining exposure for Yunus' work on the 60 Minutes current affairs show well before the Nobel Peace Prize. Such deliberate, focused effort on the part of specific individuals put microfinance 'on the map' for the American public, policy-makers and investors.

### 3.4 Conclusions on the movement-building and cultural factors

*“the hard work and sheer tenacity of a few early leaders to generate a wave of popular attention”*

Individually, these events and organisations seem relatively unimportant. However, they collectively formed a purposeful movement that combined a strong history with good timing, and shone the light on the hard work and sheer tenacity of a few early leaders to generate a wave of popular attention. One of our interviewees emphasised that “we cannot underestimate the interlinked evolution of this popularised mainstream support and the first tentative steps taken by major intermediaries and investors around this time”.<sup>79</sup>

Social movements are constantly interacting with developments in the global economic order in a dynamic, rapid interplay. One example is the rise of the 'ethical consumer.' While not entirely new, this movement recasts consumers, newly empowered through social networks and online tools, as drivers of commercial and marketing trends, rather than passive participants. The ethical consumer movement has intersected with the microfinance industry to 'empower' individuals to express their values through the investment of small amounts in micro-entrepreneurs through Kiva, MYC4, MicroPlace, Shared Interest and others.<sup>80</sup> This transforms an 'ordinary' retail consumer into a direct investor in micro-businesses which would otherwise be disconnected from that individual's immediate circle of influence. This is one cultural trend with which the UK social investment market should attempt to leverage.

## Recommendations

**xvi) Exploit market hunger for new ideas.**

Emphasise the potential capacity for the social investment market to pose a more sustainable model of capitalist investment in contrast to the unsustainable models that underpin current economic turmoil.<sup>81</sup> Indeed, the global financial crisis may have created a unique window of opportunity for impact investing. As traditional investments have floundered, many impact investments (especially in microfinance) appear to be doing better by comparison, even with their relatively modest returns. Also engage with debates about the fairness and ethics of financial infrastructure through providing successful examples of social investment.

**xvii) Create a unified voice for the sector that can engage with the media and other elements of civil society.**

There was a unity of purpose displayed by the microfinance industry that allowed it to speak with one voice and attract the attention of media, government and funders. This is exemplified by the creation of CGAP and other sector-wide organisations, and the conscious move to create coordinated action at the Microcredit Summit.

**xviii) Build on momentum to create both regional and global movements.**

The Microcredit Summit represented a concerted effort to create shared momentum. Events like the annual SoCap Conference in the United States, Skoll World Forum and the Good Deals conference in the UK, the annual EVPA conference and other gatherings show potential to form an international coalition for the broader social finance movement.

**xix) Promote mainstream recognition.**

The UN Year of Microcredit and Nobel Peace Prize, together with its compelling story of successful poverty alleviation, caught the attention of the general public for microfinance. The social investment market needs to capitalise on opportunities to generate mainstream, popular support.

**xx) Leverage social networking technologies and online movements.**

The social investment market is particularly well positioned to utilise movements such as crowd-funding, mobile technologies and social networks to establish alternative funding sources. Market players should be encouraged to collaborate in creating online platforms for sharing data and due diligence on social investments, for facilitating co-investments, and enabling refinancing of existing investments.

**xxi) Don't oversell the capacity and mandate of the social finance sector.**

Our interviewees emphasised the major risk of a backlash created by unrealistic expectations and extremely fast expansion.<sup>82</sup> Major claims of finding a poverty 'solution', incredibly low default rates, the benefits to women, and the unfaltering trustworthiness of poor borrowers all may have served to romanticise the potential of microfinance. Practitioners should keep in mind the risk of backlash when building broader social capital markets, and maintain a fair view of social finance as one civil society mechanism among others. The immediate need to maintain the buzz around the sector should be balanced by the longer term need to set realistic expectations.



# Concluding thoughts

## How applicable is microfinance to social investment?

Policy-makers, advocates and other market-builders should be cognisant of key points of similarity and difference between microfinance and other social investment mechanisms, in order to appropriately contextualise and draw upon the microfinance experience in growing the social investment market.

- i) **Target market and metrics:** Although the uses to which microfinance can and has been applied are diverse, the microfinance industry has, in general, a very well defined, and relatively homogenous, 'end user' in the borrowers that patronise MFIs. In contrast, the ultimate beneficiaries or purchasers of goods and services in the broader social investment market are harder to define – charities and social enterprises are more diverse in their capital needs, uses and levels of sophistication. Among other complications, this makes the measurement and messaging of social impact comparatively more complex: the intended impacts are hugely varied, as well as the tools needed to measure them.
- ii) **Commerciality of investees:** Microfinance loans often are directly invested into micro-businesses that theoretically generate a stream of income to fund repayments. Microfinance targets a market that can pay for the service provided, lends itself to a mass production model (high volume, low cost), has relatively standardised outputs, and has a strong development angle which attracts international and bilateral aid donors.<sup>83</sup> As such, microfinance and other forms of income-generating social businesses may be particularly suited to engage with commercial forms of investment. In contrast, other investees in the social investment market – namely, charities and social enterprises – target a market of beneficiaries that often cannot afford to pay for the services provided, or may have restrictions (frequently unnecessary) associated with grant-based funding that may militate against achieving the profit margins that are needed to attract commercial capital.
- iii) **Industry maturity:** Whereas the social investment market is relatively new, microfinance has a track record conservatively pegged at 30 years. In many ways, its success comes down to a strong track record and many opportunities to both make and learn from mistakes, evolve models, and build relationships. Once developed, microfinance models were relatively easy to replicate across similar geographies and sectors. The social investment market can speed up this development trajectory, but will still require patience and long-term commitment.
- iv) **Relationships with parallel sectors:** Microfinance has a strong international development claim, capturing extensive interest and investment from the well-funded international aid industry. The social investment market has a broader mandate, and (at least to date) relatively looser connections to international institutions and multilateral agencies.

- v) **Philosophical tension:** Microfinance harbours a strong tension between those who feel it must maintain a firm social justice grounding, even if subsidies are required, and those who feel the key is to build a robust, permanent extension of the financial system in order to serve the poor, even if prohibitive costs mean not being able to serve the poorest, or hardest to reach. Although currently less pronounced, social investment market proponents also have competing views on the true commercial viability of the market, and concerns of mission drift. This tension can be seen in the polarisation of ‘finance-first’ and ‘impact-first’ investors.<sup>84</sup>

## Applying lessons to the social investment market

This handbook opened with the stated intention to learn from the evolution of microfinance. We now revisit those existing gaps in the social investment market that we outlined earlier.

### Four pillars

i) **Confident and informed demand from the voluntary and community sector**

In many ways, this pillar pertains to the absorptive capacity of the sector, and the increasingly sophisticated nature of the demand for finance.

Both these issues were reflected in the early growth of microfinance. Microfinance was dominated by a non-profit model for two decades, with non-profit MFIs lacking the rigour of commercial financial institutions. Intensive efforts by donor communities and international financial institutions provided training and technical support; and later, this capacity-building role was continued by intermediaries such as Unitus Capital, market rating agencies such as MicroRate and membership networks such as SEEP. Furthermore, the process of commercialisation itself drove demand for more varied sources of capital.

ii) **Efficient matching of supply and demand**

Microfinance faced similar nascent market challenges of inefficiency. Early microfinance networks and informal connections assisted with this process, but transaction costs were extremely high due to small deal flows and high search costs for viable investments. Furthermore, early deals were perceived as extremely risky. This appears to have been overcome by a combination of:

- visionary action from key early players;
- large flows of donor funds to absorb risk for early intermediary funds;
- strong improvements in absorptive capacity due to the professionalisation pressures of commercialisation and extensive support poured into the enabling environment;
- reduced risk premium on microfinance over time as default rates have proven low, and repayments consistent.

Many would argue that a large surge of microfinance investment is now struggling to find appropriate institutions to invest in, with most money still flowing to the same top-tier MFIs and MIVs. There is now too much money chasing too few microfinance investment opportunities.<sup>85</sup> The industry remains ready for further innovation to continue the creation of ever more efficient channels for matching demand and supply

### iii) Variety of investment mechanisms

For all this to equate to an efficient market, each investment vehicle should ideally be based on a clear understanding as to expectations of social and financial return, and the acceptable trade-off between the two. The emergence of a variety of debt and equity tools, as well as microfinance investment intermediaries and MIVs, was subsidised by socially-minded funders to entice more commercial capital into the sector. These developments enhanced clarity between investors, other funders and MFIs.

However, recent events in India (see Case study: Andhra Pradesh – Microfinance becomes politically explosive, section 2.2) show that this discussion is far from settled for the microfinance industry. Investors in microfinance remain diverse, and a fundamental challenge for the industry continues to be assisting investors to identify microfinance opportunities that best match their investment priorities and risk profile, relative to other investors.

At this point, there is no single model or group of models that has matured to prove the reliability and sustainability of social investments (or a class of social investments) – although CAF Venturesome, Triodos Bank, the Esmée Fairbairn Finance Fund, Allia (formerly Citylife), Social Finance Ltd and others are making headway. Proving that models of investment actually work will help investors and intermediaries to clarify the relationship between risk, return and pricing for this asset class.

Where international finance institutions and aid organisations absorbed the first tranche of risk for microfinance funds like BlueOrchard, a similar role can be played by strategic philanthropists in order to attract private capital to the UK social investment market. For example, the establishment of the Big Society Bank, the first wholesale social investment bank in the sector, will be an important innovation for unlocking significant amounts of private capital for civil society. Furthermore, these types of milestones are required to build credibility in an emerging asset class and demonstrate that the risk associated with social investment can be both mitigated and managed.

Leaving aside concerns about mission drift, the commercial success of the development finance institution CDC, its spin-off private equity funds Actis and Aureos Capital, and the positive impact of CDC investment in new fund managers, exemplify the contribution that government-backed institutions can make in reducing the risk perceptions associated with equity investing in emerging markets.<sup>86</sup> Guarantees with relatively low risk can leverage significant amounts of private capital. It is important, however, to reflect on the microfinance debates about the potential for this type of capital to crowd out private capital, or over-inflate a market.

#### iv) Resilient supply of finance

Private institutional investors made up 49% of microfinance funds in 2009, with retail and high net worth investors contributing another 30%, leaving public funders with 21%.<sup>87</sup> Perceptions of broad success in accessing private capital have not assuaged raging debates about appropriate sources and volumes of capital provision in microfinance. Particular tensions involve: the continued need for grant capital to fund more socially-oriented programmes; the potential for excessive public funding (including that from international institutions like the IFC and large aid agencies) to stunt the growth of local deposit-based institutions; and the potential for public funding to crowd out appropriate flows of private capital to more financially sustainable models.

### Other infrastructure issues

- **Need for a unified voice, perhaps in the form of industry bodies or associations, to lobby for regulation and build public recognition**

This handbook has highlighted the role of the Microcredit Summit and CGAP in facilitating industry advocacy, collaboration and thought leadership. The GIIN may assume a similar role for the global impact investing community. However, there is space in the industry for existing or new associations to perform this function at regional and national levels (e.g. the European Venture Philanthropy Association, Association of Charitable Foundations, NESTA etc). The key point is that while legitimate debate and discussion over the sector's development is beneficial, a united front that galvanises funding, lobbies for regulatory change, and builds a public brand for the sector is equally necessary.

- **Standardisation of products, benchmarking, language and metrics**

In the microfinance context, the entry of commercial capital drove parallel movements to standardise products (through MIVs) and create uniform systems of measurement reporting (through tools such as Mifos and MIX reporting). Standardisation remains an ongoing process in microfinance. Some of the same tools will undoubtedly continue to prove useful for the social investment market more broadly, which must now begin to balance the benefits of continued innovation versus the stability and clarity that come from standardising terms and product offerings.

- **Clearer social metrics in order to ensure that the financial vs social return 'trade-off' is more transparent**

Services such as MicroRate, which uses a method for 'social impact' ratings, assist in this regard. Attempts to standardise poverty reduction measures using evidence-based assessments are ongoing, and global applicability and consensus remains a challenge for the industry. This is becoming increasingly important as larger MFIs prove to be very profitable and more and more questions are asked about how this impacts the inherent social mission of these organisations. Social investors and investees in the UK face similar questions, but this debate may heat up considerably as more profitable models of social impact investment are proven, particularly those involving vulnerable populations. Maintaining very clear processes and goals in relation to the definition and measuring of social impact are important first steps to protecting the sector's legitimacy.

- **Support organisations, ratings agencies, knowledge centres and others**

As a relatively developed segment of the social capital marketplace, microfinance enjoys many organisations that support its transactional marketplace – MicroRate, the Microfinance Investment Exchange, Unitus Capital, CGAP and several others have been reviewed in this handbook. Similar players are now emerging in the social investment market such as GIIN, GIIRS, IRIS, NPC and others in the UK<sup>88</sup> and elsewhere. They can look to model themselves on those microfinance pioneers.

# List of 13 lessons from the world of microfinance

The following 13 lessons can be drawn from the microfinance case studies explored in this handbook:

## Grameen Bank's first two decades – The role of subsidies and soft capital

- **Lesson 1:** To prove a concept and reach scale, new social investment models need significant subsidised financial support that traditional commercial sources are unlikely to provide.

## The Latin America Bridge Fund – The facilitative role of guarantee funds

- **Lesson 2:** Guarantee funds can be successfully used to attract commercial funding into the sector before eventual withdrawal as repayment reliability is proven.

## The conversion of Prodem to BancoSol – Microfinance begins to commercialise

- **Lesson 3:** Adopting a commercialised business model was a precursor to being able to access capital from commercial sources.
- **Limitations:** As discussed in section 2.3 of this handbook, industry leaders are far from unanimous in their support for commercialised microfinance due to the slippery slope towards prioritising financial outcomes over social ones.

## MicroRate – Enhancing industry transparency (i)

- **Lesson 4:** Information and reporting should reflect the language of commercial market practices as far as possible to garner the trust of mainstream investors. As the investor base broadens, information providers will be increasingly relied upon to interpret data for those less familiar with the asset class.

## Microfinance Information Exchange (MIX) – Enhancing industry transparency (ii)

- **Lesson 5:** Availability of comparable data facilitates the entrance of new investors as it assists with risk management and creates sector-wide expectations on both the demand- and supply-side of capital as to what information can and should be reported.
- **Limitations:** For information to be useful, capital markets must believe in its accuracy and quality. This remains challenging for a sector with high levels of informal activity.

## Andhra Pradesh – Microfinance becomes politically explosive

- **Lesson 6:** In order to reduce the risk of misguided political interference, funds should be as transparent as possible about their business model and practices.

### Dexia and BlueOrchard create an investment vehicle with market returns

- **Lesson 7:** The development of mainstream financial products occurs only when demand and supply are aligned through vehicles that allow for common language and interests.

### BRAC securitisation supported by Citigroup and MF Analytics

- **Lesson 8:** Engaging with high profile, well-known organisations can help NGOs to build credibility and confidence to break into mainstream markets.

### Sequoia and SKS – Handsome returns on venture capital investments

- **Lesson 9:** Once organisations have reached scale, demonstrated a track record of growth and proved stable returns, mainstream capital markets will enter. This brings with it an injection of expertise that can greatly contribute to market growth.
- **Limitations:** Mainstream capital markets are by definition profit-oriented. When they engage with organisations that have more than one bottom line, there can be mission conflict or mission drift.

### Banco Compartamos – IPO controversy comes to microfinance

- **Lesson 10:** Strong financial performance will capture market attention and resources, but transparency about business models, a clear mission and codes of ethics from the outset will help justify profit margins and maintain public confidence and trust.
- **Limitations:** It is not yet clear how for-profit motives can exist harmoniously with organisations primarily engaged with making an impact on social issues, particularly when these organisations have initially received grants or subsidies from governments or NGOs.

### Unitus Capital – Responding to a market need for intermediation and absorptive capacity

- **Lesson 11:** Intermediaries with deep expertise can help accelerate industry development through efficiently matching demand- and supply-side capital, particularly those intermediaries that also operate locally to develop investment readiness in clients..
- **Limitations:** In order to remain viable, for-profit intermediaries will need to focus on higher value transactions associated with larger organisations that have already achieved sufficient scale. As such, these players require a certain level of industry maturity to be feasible. Unfortunately, this can lead to 'cherry-picking' the most profitable clients, unless the intermediary has an explicit goal to appropriately balance its service offering across large and small organisations at various stages of profitability and maturity.

### CGAP - Creation of an industry knowledge hub

- **Lesson 12:** Unifying around a single industry body as an impartial broker for the sector can create a powerful platform for shared action.

### Microcredit Summit Campaign

- **Lesson 13:** While there is rarely unanimous agreement in a sector, significant gains can be made when a unified, industry front is presented.
- **Limitations:** In a rapidly growing field with disparate views, maintaining a single unified voice is difficult for an extended period of time. The 1997 Microcredit Summit, and the momentum that followed it, define a seminal moment. Maintaining this in a permanent way may not be feasible.



# List of 21 recommendations for advancing social investment

We make the following 21 recommendations to advance the UK social investment market:

- i) Embrace and support sector pioneers.
- ii) Co-ordinate sources of early grant capital in order to prove experimental models.
- iii) Demonstrate demand.
- iv) Demonstrate impact.
- v) Create beacons of success by doing deals that prove the impact investing concept.
- vi) Be clear about your business model in order to drive replicability.
- vii) Recognise a range of organisational models that underlie the spectrum of investment returns.
- viii) Promote a transparent market, and be prepared to subsidise initiatives that enhance transparency.
- ix) Share best practices and measurement methodologies, and be honest about failures.
- x) Adopt industry regulation that facilitates the development of viable social investment funds and other market infrastructure.
- xi) Provide subsidies and guarantees to capitalise pioneering funds and reduce risk for first-time investors.
- xii) Encourage mainstream finance to engage where appropriate, particularly with institutions that have demonstrated some track record and are attempting to scale operations.
- xiii) Promote cross-sector collaboration with mainstream, commercial entities in developing innovative financial mechanisms and products.
- xiv) Guard against mission drift when pursuing commercial returns.
- xv) Simultaneously develop investees' absorptive capacity for capital.
- xvi) Exploit market hunger for new ideas.
- xvii) Create a unified voice for the sector that can engage with the media and other elements of civil society.
- xviii) Build on momentum to create both regional and global movements.
- xix) Promote mainstream recognition.
- xx) Leverage social networking technologies and online movements.
- xxi) Don't oversell the capacity and mandate of the social finance sector.

# Appendix

Global MIV list as of 31 December 2009

Source: MicroRate 2010 MIV Survey – Appendix II

## 2010 MicroRate MIV Survey participants

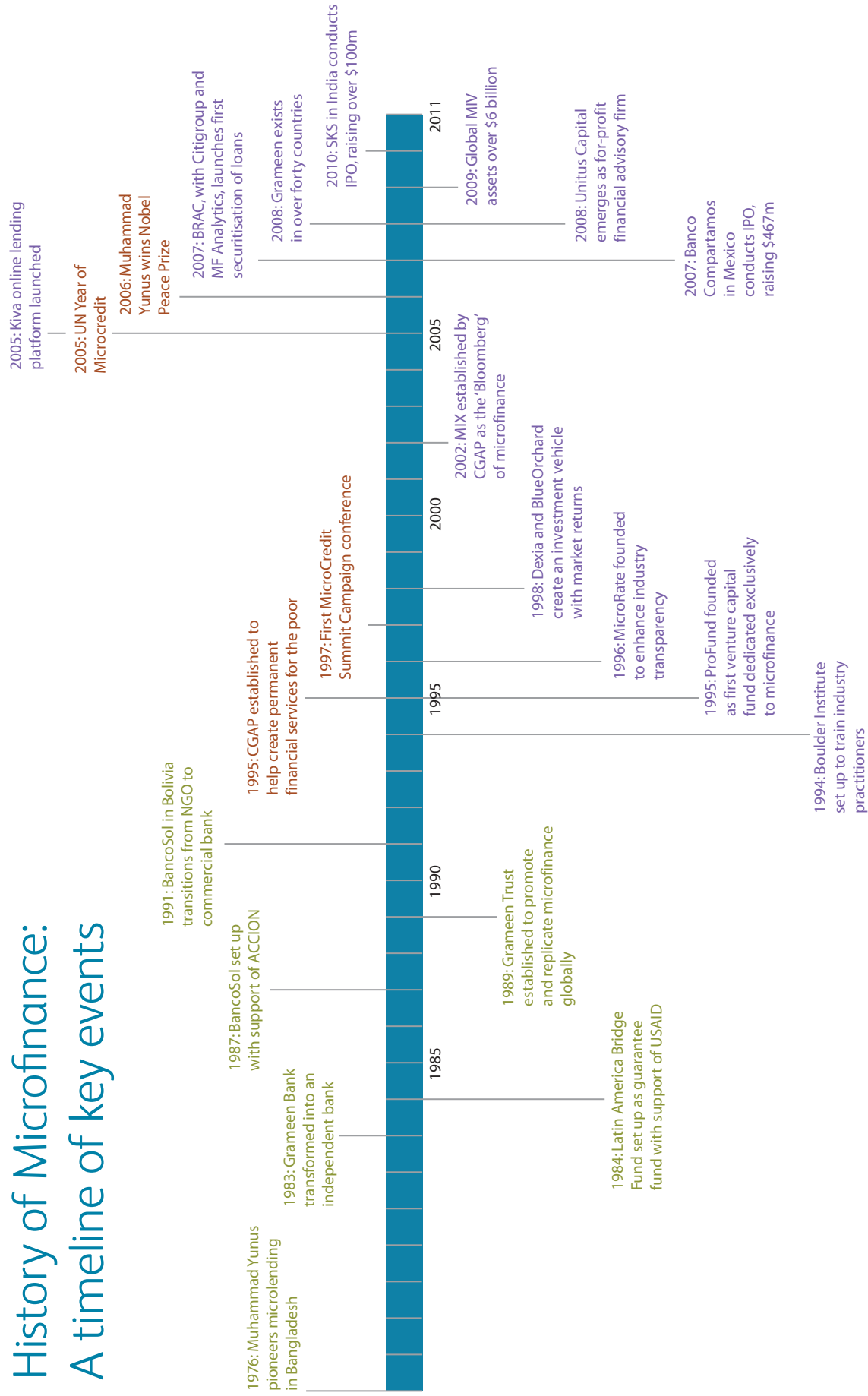
1. Aavishkaar Goodwill India Microfinance Development Company
2. Access Bank Bond I
3. ACCION Gateway Fund LLC
4. ACCION International Global Bridge Fund
5. ACCION International Latin American Bridge Fund
6. ACCION Investments in Microfinance SPC
7. Advans SA Sicar (formerly, La Fayette Investissement)
8. Africap Microfinance Investment Company Ltd.
9. ALTERFIN
10. Antares Equity Participation Fund
11. ASN Novib Fund
12. BBVA Codespa Microfinance Fund
13. Bellwether Microfinance Fund Private Limited
14. Blue Orchard Loans for Development 2006-1
15. Blue Orchard Loans for Development SA (BOLD II)
16. Blue Orchard Microfinance Securities 1
17. Blue Orchard Private Equity Fund (BOPEF)
18. Calvert Foundation
19. Catalyst Microfinance Investors
20. Consorzio Etimos SC
21. DWM Microfinance Equity Fund
22. DWM - XXEB
23. Developing World Markets DWM Microfinance Fund I
24. Development International Desjardins FONIDI
25. Dexia Microcredit Fund
26. Dignity Fund (Fund closes in 2010)
27. Dual Return Fund (SICAV)
28. Dutch Microfinance Fund
29. Elevar Equity Fund II
30. Envest Microfinance Cooperative
31. European Fund for Southeast Europe
32. FINCA Microfinance Fund B.V.
33. Global Commercial Microfinance Consortium
34. Global Microfinance Equity Fund
35. Global Partnerships Microfinance Fund 2005
36. Global Partnerships Microfinance Fund 2006
37. Global Partnerships Microfinance Fund 2008
38. Gray Ghost Microfinance Fund LLC
39. Hivos Triodos Fund Foundation
40. Investisseur et Partenaire Pour le Developpement

40. Investisseur et Partenaire Pour le Developpement
41. Impulse Microfinance Investment Fund NV
42. Incofin CVSO
43. India Financial Inclusion Fund
44. LocFund
45. LokMicro
46. Luxembourg Microfinance Development Fund
47. MicroAccess Trust 2007
48. MicroCredit Enterprises
49. Microfinance Loan Obligation Compartment LC
50. Microfinance Loan Obligations SA Compartment Opportunity Eastern Europe 2005-1
51. Microfinance-Invest. Nr 1
52. MicroVentures Investments SCA, SICAR
53. MicroVentures spa
54. Microvest I, LP
55. MicroVest II
56. Minlam Microfinance Offshore Master Fund, LP
57. MLC Frontiers LLC
58. MV Microfin Pvt Ltd (MicroVentures India)
59. Nowergian Microfinance Initiative Frontier Fund
60. Nowergian Microfinance Initiative - NMI Global Fund
61. Oikocredit Ecumenical Development Co-op Society
62. PGGM
63. responsAbility Global Microfinance Fund
64. responsAbility SICAV (Lux) Microfinanz Fonds
65. responsAbility SICAV (Lux) Microfinance Leaders
66. Rural Impulse Fund S.A.
67. Saint Honore Microfinance
68. Sarona Risk Capital Fund and Sarona Risk Capital Fund 1 LP (formerly, MEDA)
69. ShoreCap International
70. Solidarite Internationale pour de Developpement et l'Investissement
71. SNS Institutional Microfinance Fund I
72. SNS Institutional Microfinance Fund II
73. Societe Cooperative Fonds International de Garantie (FIG)
74. Triodos -Doen Foundation
75. Triodos Fair Share Fund
76. Triodos Microfinance Fund
77. Unitus Equity Fund LP
78. Working Capital for Community Needs, Inc

#### **2010 MicroRate MIV Survey non-participants**

1. Aavishkar
2. Balkan Financial Sector Equity Fund
3. CredSud spA
4. Cyrano Management
5. Finethic Microfinance Fund
6. Kolibri Kapital ASA
7. LokCapital
8. Wallberg

# History of Microfinance: A timeline of key events



Key: Proof of Concept, Donor Support & Model Innovation, Market-building Activities, Movement-building Activities & Cultural Factors

# Endnotes

<sup>1</sup>Tania Mason, 'Social returns are ok, says Commission's new investment guidance', *CivilSociety*, 13 December 2010. The Big Society Bank will be funded through funds held in dormant UK bank and building society accounts, as well as through other private sector investment: see Mark King, 'Dormant accounts to fund "big society" bank', *The Guardian*, 19 July 2010.

<sup>2</sup>Throughout this handbook, we use the term 'social investment market' to refer specifically to the range of impact investing in the UK (from capital/balance sheet-funding grants, debt, equity, quasi-equity and underwriting). The terms 'social capital market' and 'social finance market' are more generic and include the global microfinance industry as a subset. 'Impact investing' is rapidly gaining currency as the phrase of choice to describe all investment activity which has an expectation of both a specified social outcome and an explicit financial return.

<sup>3</sup>CGAP, 'What is Microfinance?', <http://www.cgap.org/p/site/c/template.rc/1.26.1302/> at 20 December 2010.

<sup>4</sup>Sam Daley-Harris, *State of the Microcredit Summit Campaign Report 2009* (2009), 3.

<sup>5</sup>CGAP, *2010 MIV Survey Report* (2010), section 1.4.

<sup>6</sup>Kiva, 'Facts & History', <http://www.kiva.org/about/facts> at 20 December 2010.

<sup>7</sup>'Impact Investing' is defined by the GIIN as "investments that aim to solve social or environmental challenges while generating financial profit... that range from producing a return of principal capital to offering market-rate or even market-beating financial returns.... Impact investors actively seek to place capital in businesses and funds that can harness the positive power of enterprise": GIIN, 'What is Impact Investing?', <http://www.thegiin.org/cgi-bin/iowa/investing/index.html> at 20 December 2010.

<sup>8</sup>See Social Investment Taskforce, *Social Investment Ten Years On: Final Report of the Social Investment Taskforce* (April 2010), 9.

<sup>9</sup>JP Morgan, *Impact Investments: An emerging asset class* (29 November 2010), 16.

<sup>10</sup>CAF Venturesome, *Access to capital: A briefing paper* (September 2009), 3.

<sup>11</sup>Ibid, 4.

<sup>12</sup>Ibid, 7.

<sup>13</sup>Monitor Institute, *Investing for Social & Environmental Impact: A Design for Catalyzing an Emerging Industry* (2009), 15.

<sup>14</sup>CAF Venturesome, *Financing the Big Society: Why social investment matters – A CAF Venturesome working paper* (September 2010), 10.

<sup>15</sup>For more information on Social Impact Bonds, see *Social Finance, Social Impact Bonds: Rethinking finance for social outcomes* (August 2009).

<sup>16</sup>In relation to social impact measurement, the Roberts Enterprise for Development Fund and SROI Network have been thought leaders in putting forward a 'social return on investment' methodology that identifies a financial value for the stakeholder-identified impacts of a project which do not otherwise have market values. SROI methodology takes into account qualitative, quantitative and financial information in creating a 'ratio' that provides a complementary indicator to inform investor decision-making. An alternative is the Social Accounting and Audit approach, with somewhat different priorities and calculations. See REDF, 'From the Community', <http://www.redf.org/from-the-community/topic/sroi> at 20 December 2010; REDF, *The relationship between Social Return On Investment (SROI) and Social Accounting and Audit (SAA)* (February 2010); and SROI Network, 'The Guide to SROI', <http://www.thesroinetwork.org/content/view/100/101/> at 20 December 2010.

<sup>17</sup>In the UK context, a range of players in the social finance marketplace have emerged. A representative sample includes: New Philanthropy Capital (consultancy and think tank targeting funders and charities), Volans (consultancy focused on social innovation strategy), Chelwood Capital (corporate finance and strategic advisory firm for social mission-based ventures), Hogan Lovells (pro bono legal services for social enterprises), Social Stock Exchange Ltd (developing a Financial Services Authority-regulated global stock exchange), Social Finance Ltd (a quasi-social investment bank) and CAF Venturesome (social investment fund that also engages in sector-wide knowledge-sharing and advocacy).

<sup>18</sup>Our primary research suggested that adapting away from the group lending approach to individual loans was also a key inflexion point in scaling microfinance, which simultaneously saw

a shift in emphasis onto analysing borrowers' repayment capacity. This seems to have been one factor in the industry moving from Asia to Latin America: Interview with Sebastian von Stauffenberg, CEO of MicroRate, 24 November 2010. Naturally, the model of microfinance that takes root and proliferates will vary according to geographical region and local conditions.

<sup>19</sup>See David Hulme, *The Story of the Grameen Bank: From Subsidised Microcredit to Market-based Microfinance – BWPI Working Paper 60* (November 2008) for further information on the importance of Professor Yunus in the development of microfinance and how his charisma and passion pushed forward the experimentation and mainstreaming of this model.

<sup>20</sup>See BRAC: <http://www.brac.net/content/microfinance>; BancoSol: <http://www.bancosol.com.bo/>; ASA: <http://asa.org.bd/index.html>; and Rakjat: <http://www.bri.co.id/> all at 20 December 2010.

<sup>21</sup>The term 'absorptive capacity' refers to the investment readiness of the sector as a whole and of the organisations within it, or an individual organisation's ability to effectively 'absorb' investment. This can also be referred to as capacity building, but the context here is very specific to being able to meet the standards and expectations of investors, and make effective use of new sources of funding.

<sup>22</sup>Beatriz Armendáriz and Jonathan Morduch, *The Economics of Microfinance* (2nd ed, 2010).

<sup>23</sup>Interview with Henry Gonzalez, Vice President, Morgan Stanley, 18 November 2010; interview with David Roodman, Senior Fellow, Centre for Global Development, 23 November 2010; and interview with Sebastian von Stauffenberg.

<sup>24</sup>For a full description of the evolution of different models used to finance microfinance programmes refer to Elisabeth Rhyne, *Microfinance for Bankers and Investors: Understanding the Opportunities and Challenges of the Market at The Bottom of the Pyramid* (2009), chapter 9, 77-93.

<sup>25</sup>Interview with Kylie Charlton, Managing Director, Unitus Capital, 23 November 2010.

<sup>26</sup>Elisabeth Rhyne, *Microfinance for Bankers and Investors*, above n 24.

<sup>27</sup>The commercialisation of microfinance refers to the process by which NGOs providing microfinance services started to change their legal status to be commercial entities focused on achieving not only social impact but also self-sustainability and positive returns on their investments. This process began with the idea that MFIs with access to commercial sources

of capital could scale up exponentially and become self-sustainable.

<sup>28</sup>Interview with Sebastian von Stauffenberg.

<sup>29</sup>Amy Kazmin, 'Microfinance: Small loan, big snag', *Financial Times*, 1 December 2010.

<sup>30</sup>David Roodman, 'Chapter 8: Development as Industry Building' (unreleased book), available at Centre for Global Development, 'Microfinance Open Book Blog', [http://blogs.cgdev.org/open\\_book/category/about-the-bookoutline/8-development-as-industry-building](http://blogs.cgdev.org/open_book/category/about-the-bookoutline/8-development-as-industry-building) at 20 December 2010.

<sup>31</sup>Jonathan Morduch, 'The Microfinance Schism', *World Development*, Elsevier (2000), vol 28(4), 617-629.

<sup>32</sup>Interview with Kylie Charlton.

<sup>33</sup>See further discussion of 'impact first' and 'finance first' investors in Monitor Institute, *Investing for Social and Environmental Impact*, above n 13; and CAF Venturesome, *Building a resilient civil society: The role of social investment* (July 2010), 4-5.

<sup>34</sup>According to CGAP and Brigitte Helms, the key factors that contributed to improved market conditions in the microfinance sector were: i) Financial Infrastructure (payments and clearing systems); ii) Transparency and information (management information systems, internal controls, performance measurement ratings, benchmarking, auditing, performance and reporting standards, supervision & monitoring); iii) Technical support services (specialised training, information, onsite consultancies); and iv) Business associations and networks (policy advocacy, information dissemination, capacity building, performance monitoring, financial intermediation). See Brigitte Helms, CGAP, *Access for All: Building Inclusive Financial Systems* (2006).

<sup>35</sup>JP Morgan, Impact Investments report, above n 9, 8.

<sup>36</sup>CGAP, 'How Do I Find Accepted Terminology for Microfinance?', <http://www.cgap.org/p/site/c/template.rc/1.26.2527/> at December 20, 2010.

<sup>37</sup>Interview with Sebastian von Stauffenberg.

<sup>38</sup>Interview with Marten Leijon, Executive Director, Microfinance Information Exchange, 3 December 2010; see also Boulder Institute of Microfinance, 'Boulder Microfinance Training Programme', <http://microfinance.itcilo.org/en/boulder-mft-programme/the-boulder-mft-programme> at 20 December 2010.

<sup>39</sup>See <http://www.themix.org/microbanking-bulletin/microbanking-bulletin>.

<sup>40</sup>Interview with Henry Gonzalez.

- <sup>41</sup>MicroRate, 'About', <http://microrate.com/about-us> at 20 December 2010.
- <sup>42</sup>Interview with Sebastian von Stauffenberg.
- <sup>43</sup>Ibid.
- <sup>44</sup>See <http://sptf.info/>.
- <sup>45</sup>This represents the outcomes of impact investor meetings convened by the Rockefeller Foundation: see JP Morgan, Impact Investments report, above n 9, 16-17.
- <sup>46</sup>Interview with Marten Leijon.
- <sup>47</sup>Eric Duflos (CGAP) and Kathryn Imboden (Women's World Banking), 'The Role Of Governments In Microfinance', *CGAP: Donor Brief*, No 19 (June 2004).
- <sup>48</sup>CGAP, 'What Is the Government's Role in Microfinance?', <http://www.cgap.org/p/site/c/template.rc/1.26.1312/> at 20 December 2010.
- <sup>49</sup>Another example of a more flexible approach to regulation for social investment funds has been previously advocated by CAF Venturesome in relation to exempting funds raised and held for purely charitable purposes from the UK collective investment scheme regime: see CAF Venturesome, *Financing the Big Society*, above n 14, 14.
- <sup>50</sup>A 'first loss' tranche refers to a segment of an investment fund that stands ready to absorb any losses up to a pre-agreed maximum.
- <sup>51</sup>Mark Flaming, CGAP, 'Guaranteed Loans to Microfinance Institutions: How do they add Value?', *Focus Note*, No 40 (January 2007), 8.
- <sup>52</sup>'Second floor' institutions refer to governmental bodies that supply a source of funding to organisations, in this case MFIs, which then provide a particular service to the public, without engaging itself in the direct provision of the service.
- <sup>53</sup>Interview with Sebastian von Stauffenberg.
- <sup>54</sup>For a detailed analysis on microfinance interest rates, and their evolution and reasoning, see Richard Rosenberg, Adrian Gonzalez and Sushma Narain, CGAP, *The New Moneylenders: Are The Poor Being Exploited By The High Microcredit Interest Rates? – Occasional Paper* (February 2009).
- <sup>55</sup>See Alex Counts, CEO of the Grameen Foundation: blog post (7 January 2011), <http://grameenfoundation.wordpress.com/>
- <sup>56</sup>See Amy Kazmin, 'Microfinance: Small loan, big snag', above n 29; see also CGAP, 'Andhra Pradesh 2010: Global Implications of the Crisis in Indian Microfinance', *Focus Note*, No 67 (November 2010).
- <sup>57</sup>Elisabeth Rhyne, cited in Amy Kazmin, 'Microfinance: Small loan, big snag', above n 29.
- <sup>58</sup>For more information, see The Smart Campaign, 'Campaign Mission and Goals', <http://www.smartcampaign.org/about-the-campaign/campaign-mission-a-goals> at 20 December 2010.
- <sup>59</sup>CGAP, *2010 MIV Survey*, section 2.1.
- <sup>60</sup>MicroRate, *2010 MIV Survey* (2010), 3.
- <sup>61</sup>David Roodman, 'Chapter 9: Implications', above n 30.
- <sup>62</sup>A survey of microfinance: Bankable banks – Are the poor a good investment', *The Economist*, 3 November 2005.
- <sup>63</sup>JP Morgan and CGAP, *All Eyes On Microfinance Asset Quality: Microfinance Global Valuation Survey 2010* (2 March 2010).
- <sup>64</sup>Ira Lieberman et al, Council of Microfinance Equity Funds, *Microfinance and Capital Markets: The Initial Listing/Public Offering of Four Leading Institutions* (2008).
- <sup>65</sup>Aaron Ausland, 'How Microfinance Lost its Soul', The Huffington Post, 13 December 2010, [http://www.huffingtonpost.com/aaron-ausland/how-microfinance-lost-its\\_b\\_793331.html](http://www.huffingtonpost.com/aaron-ausland/how-microfinance-lost-its_b_793331.html) at 20 December 2010
- <sup>66</sup>Bloomberg Markets Magazine, 28 December 2010.
- <sup>67</sup>Jennifer Mehan, cited in Amy Kazmin, 'Microfinance: Small loan, big snag', above n 29.
- <sup>68</sup>Damien von Stauffenberg, Response to Aaron Ausland's "How Microfinance Lost its Soul", 22 December 2010 (unpublished, provided to authors on 7 January 2011).
- <sup>69</sup>Rajiv Lall, Co-founder, Lok Capital, cited in Amy Kazmin, 'Microfinance: Small loan, big snag', above n 29.
- <sup>70</sup>DWM is a US based firm founded in 1994 which defines itself as an "asset manager and investment bank dedicated to making socially positive investments in order to promote sustainable economic and social development on a global scale": see <http://www.dwmarkets.com/>.
- <sup>71</sup>In 2010 Unitus announced an abrupt mission shift in mission, abandoning its singular focus on microfinance to focus on "a broader array of social ventures", with little other context or explanation: see Unitus, 'Unitus redirects efforts', <http://www.unitus.com/news-and-information/press-releases/unitus-redirects-efforts> at 20 December 2010.
- <sup>72</sup>Interview with Kylie Charlton.
- <sup>73</sup>Ibid.
- <sup>74</sup>Ibid.
- <sup>75</sup>Developing SROI methodology and usage is an agenda currently being pursued by the UK-based SROI Network (among other initiatives):

SROI Network, 'The SROI Network', <http://www.thesroinetwork.org/content/view/full/47/102/> at 20 December 2010. See also <http://www.giirs.org/> and <http://iris.thegiin.org/> at 20 December 2010.

<sup>76</sup>See Milford Bateman and Ha-Joon Chang, *The Microfinance Illusion* (2009) for an interesting but controversial critique of microfinance with good insights on the state of the development agenda in the 1980s.

<sup>77</sup>Though repayment rates are not widely regarded as an effective measure of the impact of a programme, they did provide a tangible means to show that this work was sustainable on some level.

<sup>78</sup>SEEP Network, <http://seepnetwork.org> at 20 December 2010.

<sup>79</sup>Interview with Henry Gonzalez.

<sup>80</sup>See <http://www.kiva.org>, <http://www.myc4.com>, <http://www.microplace.com>, <http://www.shared-interest.com/> and <http://www.sharedimpact.org> at 20 December 2010.

<sup>81</sup>See the discussion pertaining to systemic and structural causes of the global financial crisis in Michael Mainelli and Bob Giffords, Centre for the Study of Financial Innovation, *The Road to Long Finance: A Systems View of the Credit Crunch* (July 2009).

<sup>82</sup>Interviews with David Roodman and Sebastian von Stauffenberg.

<sup>83</sup>Interviews with Henry Gonzalez and David Roodman.

<sup>84</sup>See Monitor Institute, *Investing for Social and Environmental Impact*, above n 13.

<sup>85</sup>Interview with David Roodman.

<sup>86</sup>Originally established as the Commonwealth Development Corporation, CDC continues to be solely owned by the UK's Department for International Development – however, CDC is financially self-sustaining and has not called on public investment for 14 years: CDC, 'About Us: Corporate Structure', <http://www.cdgroup.com/corporate-structure.aspx> at 20 December 2010. Further, in relation to CDC's positive impact on developing local fund managers in emerging markets, a private equity industry body recently noted that 'DFIs such as CDC are among the few institutions that are both willing and able to absorb slightly less favourable commercial terms (e.g., lower hurdle rates or higher management fees) for what is fundamentally a more expensive business model': Emerging Markets Private Equity Association, 'Submission from the Emerging Markets Private Equity Association to the British House of Commons, International Development Committee, regarding the future of CDC' (22 November 2010), [7].

<sup>87</sup>CGAP, *2010 MIV Survey Report*, section 2.5.

<sup>88</sup>For a list of UK social investment entities, see Social Investment Taskforce, *Social Investment Ten Years On*, above n 8, p7, table 1.









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