Microfinance in a Nutshell

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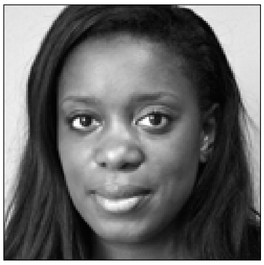
Microfinance plays a significant role in supporting low income people who generally have limited access to financial services. According to MIX ***www.themix.org*** *'microfinance institutions currently operate in over 100 countries, serving more than 92 million clients'.*
In May an event, entitled 'Impact Investing – Doing Well by Doing Good took place in London. There were presentations on global microfinance initiatives, impact investing, inclusive finance and philanthropy. Aa panel debated 'The Two Dimensions of Impact Investing'. CSSP AG Liechtenstein launched their new guide about 'my Impact - Fundamentals of Modern Philanthropy' at the event. The guide has been issued as a print title (2014 edition) and is available online ***www.myimpact.li.*** *To find out more about the EMF Initiative, please visit* ***www.enabling.li***

A Significant Industry

Microfinance can be defined as the provision of access capital in low and deprived economies.



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While the microfinance industry has its historical roots in the 19th century, it wasn't until the 1970s that microfinance institutions such as Accion and Grameen in India started to emerge.

It was the realisation that return on investment for the lender was not only relative to the interest charged but also to the size of the loan that created a gap in the market for social enterprise and charitable investment.

The first ever microfinance fund was launched in 1998, ahead of the United Nations development goals which promoted the use of such funds for financial inclusion. The growth of the industry culminated in 2006, when Muhammad Yunus, the acclaimed father of microfinance, won a Nobel Prize.

Microfinance investment has emerged about a decade ago and has been transformed from unattractive rural financial activity into development programs for investors to be lending directly to a micro entrepreneur in remote area.

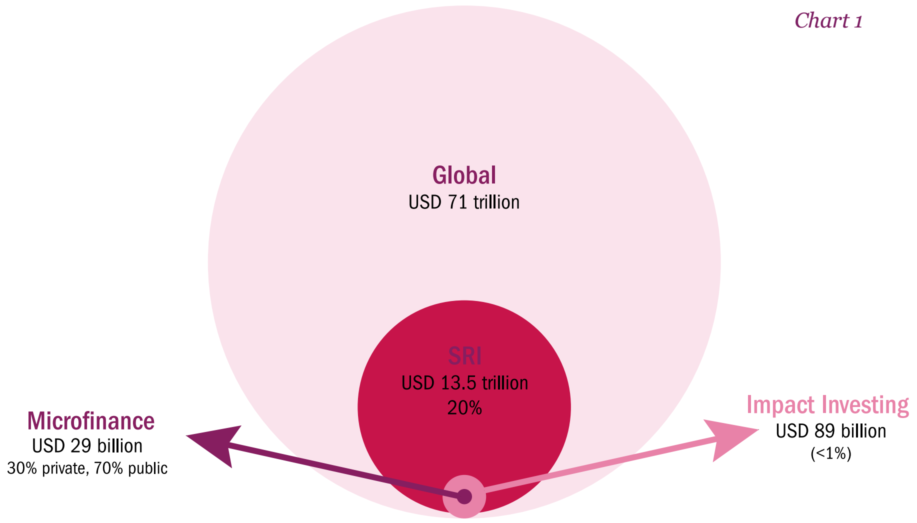
Microfinance has seen an unprecedented growth in developed markets from 2004 to 2008, representing a staggering USD 29billion in assets under management.

Overall the microfinance investments industry has developed into an attractive uncorrelated asset class. See Chart 1 below.

Microfinance is widely recognized as a strong development tool and financial inclusion mean, providing an appropriate macro and micro economic framework to support the underprivileged.

Microfinance, as useful as it may sometimes be in reducing poverty, is of limited use in long-term economic development.

Chart 1



MIV survey 2014

The danger of microfinance is that it promotes the worldview that poverty reduction, rather than economic transformation, is the central purpose of development.

Microfinance as an investment vehicle. The current Asset under management in Microfinance is estimated at USD 9.9 billion. The annual MIV survey produced by Symbiotics (with the collaboration of 80 participant), which include exclusively commercial funds, shows us an increase of 17% growth of the total asset and microfinance portfolio. Both Switzerland and the Netherlands were the top managers in microfinance. See Table 1 and and Chart 2.

Microfinance: its Challenges and Controversies.

In the past few years the microfinance industry has encountered challenges in countries where the industry has become highly institutionalized. Unstable levels of growth left some countries, such as Nicaragua and Morocco, vulnerable to repayment crisis.

Looking at Nicaragua, one can note a sharp decline on the return on equity beginning in 2008, and a PAR (portfolio at risk) that exceeded 10%. These two indicators highlight a severe deterioration in the quality of loans. As always, context is crucial to understanding the origins of the issue. Nicaragua suffered from a delinquency crisis that affected 22 major Macro Financing Institutions (MFIs) in the northern region of its country. The fundamental reason for this was that the northern region was the epicentre of the *no pago* movement (no payment); a strong political movement encouraging borrowers to not repay any debt accumulated which emerged in 2008. Similar to Nicaragua, the quality of debt in Morocco in 2008 raised alarm bells with a PAR over 30 days >10 %.

However, the main issue in Morocco was that the merger and acquisition of the largest MFI at the time became public, that particular MFI grew by 150% in 2006 with an obsolete technology, producing misleading reports and leading to a delinquency crisis soon after.

The industry came under scrutiny when things started to get more difficult. Especially in connection to the credit crisis the world has suffered from. Furthermore, the microfinance industry has been highly criticized for the high rate charged by some MFIs to their end clients, since the microfinance is intended to help the poor. Indeed, in some instances usurious lending practices tarnished the reputation of the industry.

In addition, some criticized the fact that lending to entrepreneurs with a promising future may not have achieved the desired effect. Indeed, in some instances, some first time borrowers found themselves unable to grow as part or all their profits were consumed by debt servicing costs. Thus, in some cases, a small business relying on an unsecured loan needed to grow at a faster rate than a large business on top of the normal pressures of competing in an open marketplace.

Lessons have been learned from these recent challenges, allowing the industry to understand how to address these issues. For example, in many countries we have seen the emergence of credit bureaus that support MFIs to prevent delinquency problems by providing help on managing the credit risk for lenders. Also, a good exchange of information with regulators and a mapping of the market should allow MFIs to better understand the risks and opportunities of their market. Moreover, better access to technology should help both sides of the loan to lend and repay.

These recent developments are expected to strengthen the microfinance industry in many countries. Nevertheless, the recent delinquency

Table 1. Asset Managers' Domicile

	TOTAL ASSETS (USDm)	MICROFINANCE PORTFOLIO (USDm)	NUMBER OF PARTICIPATING ASSET MANAGERS
	9,276	7,080	44
SWITZERLAND	28.4%	32.9%	13.6%
THE NETHERLANDS	28.0%	25.4%	13.6%
GERMANY	16.8%	14.4%	6.8%
UNITED STATES	8.9%	9.7%	25.0%

MIV survey 2014

Here is the industry performance

Chart 2

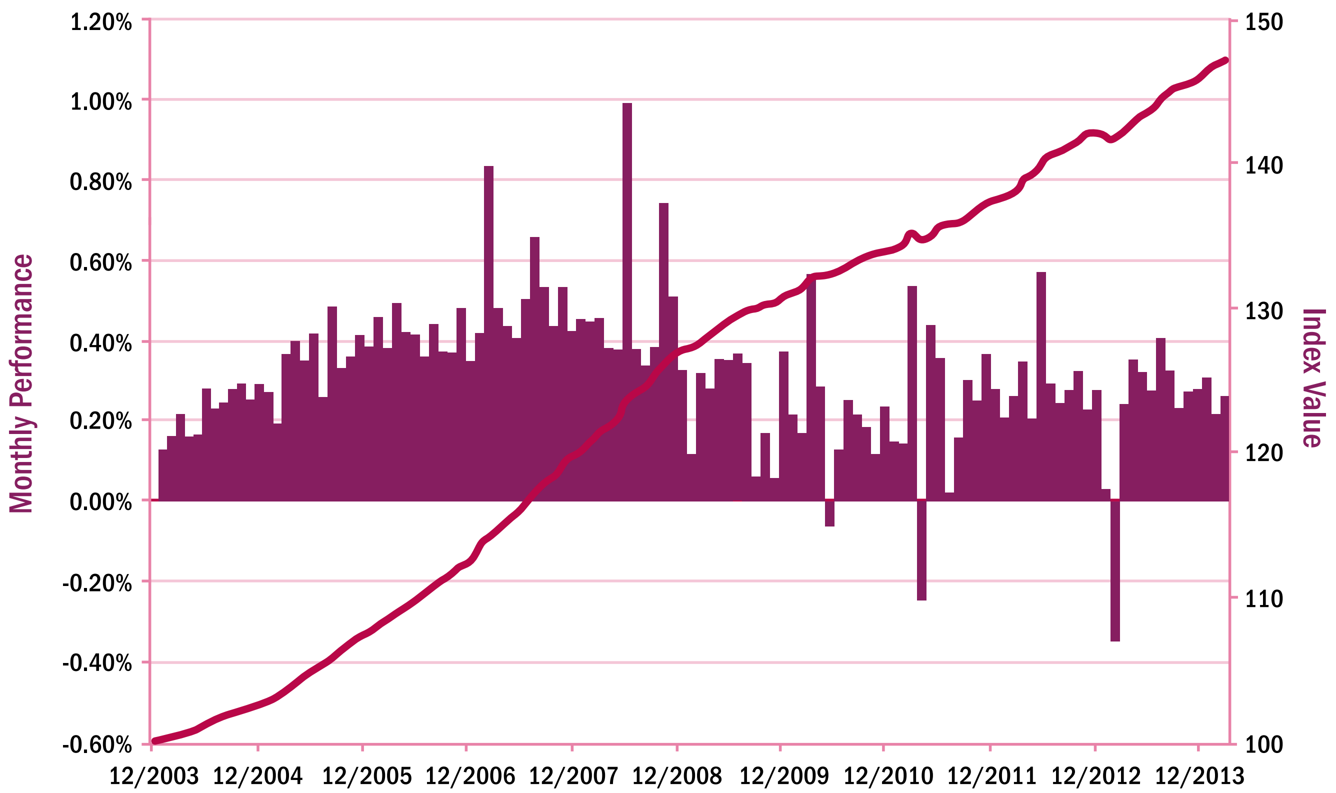


Table 2. Impact investing sector allocations

SECTOR	AuM	% OF AuM
MICROFINANCE	6,400,000,000	72.1
SME FINANCE	1,300,000,000	14.6
AGRICULTURE	585,000,000	6.6
HOUSING	100,000,000	1.1
EDUCATION	17,000,000	0.2
ENVIRONMENT	216,000,000	2.4
CROSS-SECTOR	263,000,000	3.0
TOTAL	8,881,000,000	100

www.cgap.org

crisis is a reminder that microfinance remains a risk management business. The microfinance industry can justifiably emphasize its strong historical financial and social performance. Yet new risks and challenges are being discovered as microfinance develops. MFI managers, investors, and regulators should look for and be open to discussions of these new risks and work to find the most appropriate mitigation measures.

Microfinance and Innovation

Over three billion people in today's world lack access to basic financial services, and extending banking to these individuals has the potential to transform economies and improve livelihoods.

One of the most promising means of reaching this goal involves expanding mobile banking services. Indeed, mobile phones have now become tools for saving money, transferring funds and accessing credit, to mention just a few of the numerous innovating products provided by the mobile banking industry. In the last few years other innovating product linked to microfinance have emerged (which includes microcredit, microinsurance, and a whole host of other innovations).

Microfinance and Impact Investment

The notion of impact investing became integrated in the financial market rhetoric in 2007, and is now widely used by companies investing in developed and emerging markets, especially in Sub Saharan Africa.

A study by JP Morgan, Social Finance and the Global Impact Investing Network highlighted that about 70 percent of the total money is invested in emerging markets, and that investors are most planning to increase their allocations in sub-Saharan Africa.

Impact investing describes an investment approach which aims to make a financial return alongside a positive social impact. Both financial and social objectives are equally targeted and pursued, making impact investing different from philanthropic investing where financial return is not a concern, and from socially responsible investment where negative impacts are avoided but positive impacts are not necessarily required. Impact investments are made with the intention of generating measurable social and environmental impact, along with a financial return. The impact investment term is used to not only do good but measure the positive impact on every investment made without compromising the financial return on the investment.

Impact investors do not distinguish themselves from traditional investors by their funding vehicles, products, or the markets or sectors in which they concentrate, but rather through the motivations behind their investment. Therefore, broadly speaking, impact investors fall into two categories:

- 'Impact first' investors who aim to maximize social and environmental impact and are prepared to accept below-market-rate returns
- 'Finance first' investors who seek investment vehicles that offer market rate or above returns while secondarily generating social or environmental impact

A key feature of impact investment is that 'impact' is measured and reported. From the table above, one can see that Impact investing represents over 89 billion of investments in USD worldwide. A recent study showed that last year about $10.6 billion in impact investments were made and investors intend to commit this year a further $12.7 billion or 19 percent more.

Compared to the entities financed by MIVs, impact investment goes to a much more diverse group of possible investees.

Many specialized investment firms have emerged with the sole focus on impact investment, and many more mainstream institutions have started to offer impact investing products. Indeed, market surveys indicate that a growing number of clients are asking their private banks and family offices to offer impact themed investments.

Impact investments are funded by development finance institutions, private foundations and specialized asset managers. According to CGAP, one third of the impact investing comes from institutional investors and private individuals, donors and public investors as an opportunity to leverage private investments into solving development goals. These investors are the main actors supporting high risk investment and early stage businesses.

What are some of the challenges related to impact measurement?

The impact measurement is one of the most challenging aspect of impact investment. Impact investments should use common metrics and methodologies in order to compare and benchmark every fund and project. There are now 2 international tools that help the community to be aligned. These are IRIS and GIIRS.

Describing the TA Facilities Offers With Funds

Technical assistance (TA) for funds is a powerful tool to help the MFIs develop themselves and the products they offer to their end clients. As well as helping the MFIs on their business development, the TA aspect of an Impact Investing fund is often used to fund various consultancy projects. These projects translate in the form of upgrading IT systems, converting excel spreadsheets into adequate accounting tools. Furthermore, TA can provide training from management to lower level clerks, improving the corporate governance. In most cases the TA is facilitated by grant raising, which runs alongside the Fund for which we can increase the impact.

Microfinance and beyond

Tiny firms, micro-enterprises, usually employing a handful of people, frequently get more attention, as donors seek to help the very poor. The recent Nobel Peace Prize awarded to Muhammad Yunus of the Grameen Bank visibly demonstrates the emphasis given to this approach.

But the type of support inherent to microfinance lending is generally ill-adapted to serving their slightly larger, and arguably more dynamic cousins, the SMEs.

In high-income countries, small and medium enterprises (SMEs) are responsible for over 50% of GDP and over 60% of employment, but in low-income countries they are less than half of that: 17% of GDP and 30% of employment. This SME gap is called the 'missing middle'.

The 'Missing Middle' is a phrase that has been used relatively loosely in economic development discussions. But what does the term 'Missing Middle' really mean? For some, the term has meant 'a lack of SMEs in the developing world.' For others, the term has meant 'the lack of investable capital targeted at funding SMEs.'

Illustration of the 'missing middle'

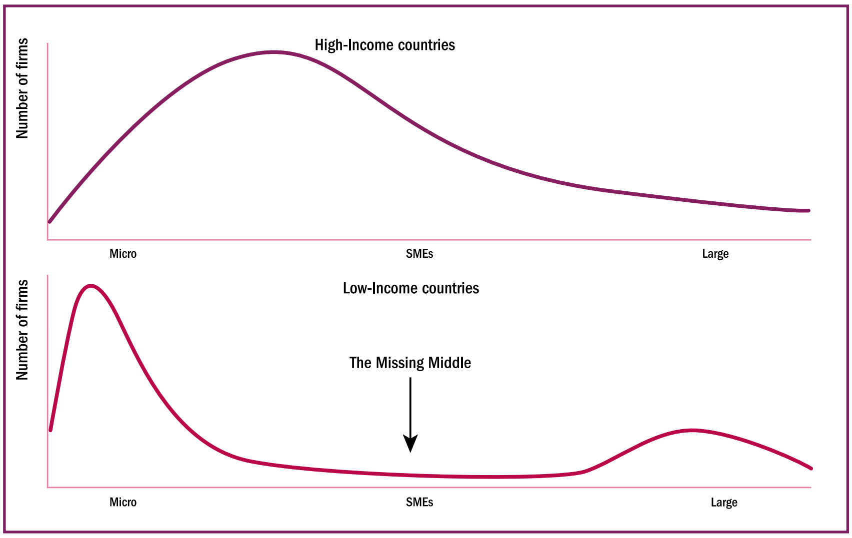


Chart 3

The World Bank defines Small Enterprises as those that need loan sizes of $10,000 to $100,000 and Medium Enterprises that need $100,000 to $1 million to grow. Small and medium-sized enterprises (SMEs), typically employ 10 to 250 workers, form the backbone of modern economies and can be crucial engines of development through their role as seedbeds of innovation. In many small and less-developed countries, it should be noted, firms employing 250 or 500 people could well be among the larger firms in the country. In much of the developing world, though, SMEs are under-represented. A critical missing ingredient often being capital.

New options are emerging for meeting SMEs' financial needs, including commercial banks moving 'down-market,' micro-credit institutions moving 'up,' and creative application of venture capital investing ideas.

Private investors-sometimes with collaboration from and in partnership with the public sector have a key role too. For example, in the case of firms facing high-risk, high-return scenarios, home-grown 'angel investors' can step in.

Donor support for traditional microfinance models has helped provide basic financial services to millions of poor people. But in order to help build dynamic competitive economies in developing countries, the time has come to pay greater attention to the potential of small and medium-sized commercial firms to promote economic growth.