

**THE CHANGING ROLE OF FOREIGN
DIRECT INVESTMENT
IN MICROFINANCE CAPITAL AND
MEASUREMENT OF FINANCIAL AND
SOCIAL PERFORMANCE:**

***Doing Good Works Meets Commercial
Enterprise***

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Preface: The following paper summarizes key developments in microfinance capital and makes observations and recommendations primarily for managers of microfinance institutions in developing countries. The paper recognizes the increasing flow of new capital, particularly from commercial sources. The paper relies on comments and observations from a number of key capital providers and other figures in the microfinance industry.

Microfinance has always had some unique, unusual or even counter-intuitive qualities. It has proven to be feasible in spite of its critics or pessimists. It has provided very small loans when the conventional wisdom of the bankers has been that larger is better. Microfinance has provided loans without collateral again in spite of the normal practices. Its borrowers have very limited business skills and experience, at least by the standards of western practices.

Will a couple of decades of success spoil microfinance? With its history of ruining the predictions of the experts and authorities, the 'smart money' would not bet on it. However, the smart money may be making its own bets by flocking toward microfinance.

Originally funded primarily by international donors and public agencies, microfinance capital markets are small, even tiny, by most investment standards. As recently as the spring of 2005, investments totaling only about US\$1.7 billion were identified from 59 investment

funds and donors acting as lenders/investors.¹ Almost all of these investors or lenders have primarily social motives in a desire to help the poor to become self-sufficient and/or revitalize the economies of developing countries. While attracted primarily by the social objectives, many have found their investments to be remarkably successful in financial terms.

In fact the strongest microfinance institutions (MFIs) have equaled or surpassed the profitability of their distant cousins in commercial banking. A number of microfinance institutions can boast returns on equity of 15% or more. Sustaining those returns in the face of increasing competition may prove to be significant challenge for the MFIs. Nevertheless, microfinance has earned that most unusual attribute of poverty-fighting tools: profitability.

The profitability of microfinance is driving a new wave of investment into the sector. Three deals alone in the past year would cause the size of the microfinance capital markets to increase substantially. Deutsche Bank announced the formation of its Global Commercial Microfinance Consortium, a \$75 million fund that brings together over 25 institutional investors with an interest in microfinance.² Deutsche Bank arranged the financing and will place the funds with microfinance institutions around the world.

EBay founder Pierre Omidyar and his wife made a US\$100 million donation to their alma mater, Tufts University, the largest gift that the university has ever received. The proceeds have created the Omidyar-Tufts Microfinance Fund which will be invested in various microfinance activities. Tufts hopes the fund will generate a rate of return similar to its existing endowment, which has a target return of 9%. Half of the interest generated

¹ Goodman, Patrick, *Microfinance Investment Funds: Key Features*, Appui au Développement Autonome, February 2005, page 16.

² Deutsche Bank, press release, March 11, 2005.

by the microfinance fund each year will go to the university and the remainder will be reinvested in the fund.³

A similar sized fund has recently been announced by BlueOrchard Finance, a Swiss company that specializes in microfinance investment. The \$100 million raised by BlueOrchard from bond investors is backed by loans to 21 microfinance institutions. The bond was divided into several tranches paying an average of 6.14%, more than the 4.9% paid at the time of its issuance for five year bonds.⁴

Commercial banks were once reluctant to get involved in microfinance. That reluctance has been attributed to the unconventional practices necessary in microfinance, expected low repayment rates, or no interest in having poor customers. Those days are in the past as commercial banks are increasing their involvement in microfinance in at least three different ways:

- (a) Loans and investments in MFIs and in microfinance companies.⁵
- (b) Strategic alliances in which a commercial bank provides technology, bank office functions and perhaps capital for MFIs.⁶ In general, the MFI serves as the primary contact with the client and the commercial bank may provide many or few services. Depending on the relationship, the loan to the borrower may be an asset of the commercial bank in which the MFI acts only as its agent.
- (c) Purchase and direct operation of MFIs.⁷ There are numerous examples of local commercial banks in developing countries which

³ “An eBay Founder’s Bid to Aid the Poor,” *Wall Street Journal*, November 4, 2005, p. W1.

⁴ “Bond Issue Lets Investors Buy into Microfinance,” *Wall Street Journal*, April 27, 2006, <http://online.wsj.com/article/SB114610401811537243.html>.

⁵ Citigroup, ABN Amro, and HSBC are among the major participating commercial banks. See “Entrepreneur Gets Big Banks to Back Very Small Loans,” *Wall Street Journal*, May 15, 2006, p. 1.

⁶ For instance, ICICI Bank, the largest private bank in India, has relationships of different kinds with a number of MFIs in India.

⁷ ProCredit Holding AG, a German company with 19 banks in developing countries, is perhaps the best example.

are “downscaling” in order to reach microfinance borrowers and savers.

Types of Institutional Investors in Microfinance

The results of this influx of capital, new players, and older players in new roles will have profound consequences on the microfinance industry. Predicting those trends and outcomes is difficult for a variety of reasons including the different countries, regulatory frameworks and infrastructure involved. The demonstrated ability of the microfinance industry to defy expected norms is a further indicator of our inability to predict with any certainty.

Whether lenders or investors, an understanding of the general characteristics of the providers of capital in microfinance sheds some light on their perspectives and roles, which can otherwise be confusing. Conventional asset classes do not have the mixing of social and profit motivations that characterize microfinance. The descriptions below are not rigid and some capital providers may fit into more than one group. Donors who provide grant funds for increasing the size of the portfolio, capacity building or other innovations are not included.

1. Conventional investors. These are the large, usually for-profit investors, such as pension funds, whose participation is widely sought to legitimize the microfinance capital industry. These institutions generally do not invest directly in microfinance institutions but in funds or companies that are organized for the purpose of investing in microfinance. In that sense, such an institution may be characterized as a “fund of funds” or a wholesaler of capital. They might be represented by an investment banking firm, but also may invest directly in those funds.

2. Commercial investment funds. These are funds which, although they may invest primarily or exclusively in microfinance, are primarily driven by profit. They must deliver a market-rate of return, adjusted for risk, to their investors or face the prospect of losing those investors to other available opportunities. A few years ago, commercial investors may not have existed in microfinance as it was seen as a poverty alleviation technique or a social program. However, among the direct investors, commercial investors are the fastest growing segment of the microfinance capital industry.

3. Social investment funds. The characteristics of these funds are more likely to vary. Although they often have a stated commitment to poverty alleviation or other social goals, their behavior is more often governed by the source of their capital. Do their investors seek a market rate of return or do they expect a return of, for example, 2%? Microfinance institutions have become frustrated when they are dealing with an investor who shares their social goals but find that the investor is very demanding with regard to return on investment and security. The genuinely social investment funds often have relatively small portfolios and, in total, are becoming a smaller proportion of the marketplace as more sources with larger portfolios enter into microfinance. That is, it will be harder for MFIs to identify the genuinely social investors and more competition for those genuinely social investment funds should be expected. A subcategory of social investment funds are those which may be dedicated to funding a network of MFIs which are operated by their parent sponsor. Those 'captive' funds rarely invest outside of their network because of their desire to support the members of their network.

4. Donors acting as investors/lenders. These players are the first actors in microfinance and still a significant capital source. Varying

donor interests may cause this group to target particular sectors, strategies or regions. "Donor fatigue," as well as the large number of other investors, may cause donors to diminish in importance as an investment category. Nevertheless, their participation in key areas may help to determine the rate at which the microfinance industry will continue to grow. Their ability to provide below-market or concessionary financing can be critical in certain situations.

In an effort to shed some light on the future of microfinance capital, a number of leading practitioners in each of the above groups in microfinance capital markets were consulted for their observations on the impact and trends in the industry. All of these practitioners are long term participants in microfinance capital and most are managers of investment funds that provide debt or equity to microfinance institutions. The survey was conducted informally with no attempt to be either comprehensive or scientific. The results of this informal survey are summarized in the findings below.

Current Trends in Microfinance Capital Markets

The significantly increased flow of capital to microfinance is well recognized. Most believe that the recent influx of capital is just the "tip of the iceberg." Much further investment is expected if microfinance continues to deliver the kind of returns with the relative security that has been provided to date. The overwhelming majority of the new capital in the industry is debt or subordinated debt, rather than equity.

It is recognized that only the "Top Tier" of microfinance institutions is 'investable' at the present time. While there is no consistent definition of the Top Tier, different sources characterize it as from 150 to not more than 350 MFIs, which is only a small percentage of the universe of MFIs which is said to range from 8,000 to 10,000.

The increased flow of capital, when coupled with the relatively few 'investable' MFIs, will have significant price consequences. Those "Top Tier" MFIs can expect to negotiate reasonable prices and terms for the capital that they require. Those MFIs who are not considered to be in the top group but still need capital for growth may find that they need to pay more than they had expected. Because there is no boundary between the two groups, the surplus of capital may cause some previously less well known or more recently successful MFIs to raise financing at reasonable rates if they can demonstrate good performance and prospects. However, the majority of MFIs may not benefit from this initial influx of new capital.

Difficulties in attracting capital can be attributable to a number of factors but perhaps the most common reason is a lack of scale or size. Using the generally accepted figures for the microfinance industry, a majority of the 8,000 or 10,000 MFIs have a portfolio size of less than US\$500,000. Investors, both social and commercial, are concerned about the costs of their transactions. It costs them just as much to invest US\$200,000 in a small MFI as it does to invest US\$1 million in a large MFI. As a result, many have adopted minimum investment amounts (such as US\$500,000) or minimum size of MFIs which they would consider (such assets or portfolio of US\$5 million). While this may seem to arbitrarily eliminate many MFIs from consideration, a very large loan or investment from a single investor is not financially wise for either the MFI or the investor. To avert this problem, smaller MFIs need to consider a merger or consolidation with a nearby or competing MFI. The resulting institution may be more attractive to lenders and investors both because it may be more profitable (due to the distribution of its overhead expenses over a greater volume of business activities) as well as its increased size.

Some observers note that the poorest are not likely to be the recipients of the bulk of the large supply of new money, partly because of

this need to employ large amounts of capital. As one fund manager says, the new money will have a bias toward those MFIs that are large and profitable, and perhaps that profitability is because they serve borrowers and savers who have greater assets, income or skills. The commercial investors will look for those countries and institutions where they can put their money to work efficiently at high rates with recognized levels of risk. According to one observer, the moderately poor will be “pushed” into commercial finance and an increasing number of social niche players (e.g., foundations, social funds) will target hard-to-serve sectors like rural microfinance, countries with fragile governments, or post-conflict environments. Except for those special situations, it may become increasingly difficult for MFIs to find below-market-rate or concessionary capital in spite of the large supply of new money. Another investor notes that some of the largest countries with enormous numbers of poor, such as India, have relatively few investable MFIs.

Social advocates have feared that the new money will cause a wide segmentation in the market for microfinance capital. According to the microfinance investors surveyed, segmentation is likely to occur but it might not be so predictable. Funds will certainly flow to the most profitable and most efficient MFIs. Funds are also very likely to flow to the largest countries and those countries in which the industry is well developed, i.e., with reasonable regulatory frameworks and laws protecting or encouraging foreign investment. Both trends may result in expanded service to the poorest, according to the investment professionals, but that will be a by-product rather than the objective of the flow of new money.

Private investors, both social and commercial, note that investments from donors is competing with private sector investors and driving down the rates that can be charged. This practice is detrimental to the interest of private investors in earning a competitive return for their investors. They feel that they cannot easily move to invest in lower quality MFIs because of the increased risk profile that is entailed. Bilateral or multilateral donors, the

private investors argue, do not need to invest in the “Top Tier” MFIs and in fact could be helping the industry more by investing in second or third tier MFIs.

There is some uncertainty about the new capital providers in the industry. Will they be able to find and conclude transactions with the “Top Tier” MFIs who are already receiving significant investment from their existing investors? The competition to invest in those leading MFIs may drive down the price of capital for the top performers or expand the amount of capital for second and third tier providers. Both would be beneficial for the industry as a whole, although not welcome by those investors, both social and commercial, who have promised hefty returns for the investors in their funds.

Perhaps for the majority of MFIs, the influx of new capital may not have much consequence. For those who are struggling toward sustainability, the new money is not likely to provide additional capacity-building help. For those who serve rural or other more difficult populations, new capital is not particularly likely because the rewards to investors are not greater in spite of a perception of greater risk. MFIs that have successfully developed mechanisms for profitably serving difficult populations may be rewarded. Their success in a difficult environment may have created a barrier to entry for competitors which will allow them to maintain a higher portfolio yield in spite of higher operating expenses. Their reward may be increased investor interest.

Needs of the microfinance capital industry

With the discovery of the profit potential in microfinance, the most commonly cited reform desired by investors is the need for less donor investment in the top MFIs. In particular, they do not want donors providing subsidized or concessionary capital to the leading MFIs and thus undercutting

their returns. While their objections are certainly self serving, the investor community points out that donor funds are better used to meet needs that cannot be met by the private sector.

Perhaps chief among these needs is an expansion of the pool of investable MFIs. Investors consistently respond that there are only 150 to 350 MFIs globally which are likely to meet the standards required for outside investment. (It is not clear if these numbers are derived from any research or simply the result of educated estimates.) If there are 10,000 MFIs in the world, as is often stated, then only 1.5% to 3% of the population are investment candidates. The competition to invest or lend to those few will be welcome for the fortunate few but will reduce investment returns for the industry generally.

That competition for the top quality MFI may also lead to some investment failures as investors reduce their underwriting standards in order to make deals or MFIs reduce their own quality of underwriting in order to fully employ the money which they have recently received. Such defaults or failures should be the expected hiccups in the fast growth of an emerging industry. Because microfinance is an unconventional business in developing countries, these hiccups may be viewed as a bad cold or even pneumonia by new investors. That may lead to a sizeable dip in future capital investment in the microfinance industry with some domino effects for both the biggest and smaller MFIs.

Investors mention several roles that the donor community can take to reduce the possibility of these setbacks.

- The most widely mentioned is the ability of the international financial institutions, including multilaterals and other donors, to actively invest in the second and third tier MFIs and thus to help to expand the pool of investable microfinance institutions. The risk inherent in these

institutions may prohibit investment from more conventional investors (or the risk-adjusted cost of capital would be untenable for the MFIs) but donors could continue the role of institutional support and capacity building that they employed when they pioneered the microfinance industry. Some investors comment that donors often talk about strengthening the second tier institutions but few do it and some continue to undercut private investors with their pricing.

- Second, large multilaterals may be well positioned to encourage transparency and regulatory quality through their relationships with sovereign governments in countries where microfinance is growing rapidly. The ambitious CGAP initiative in regulation is recognized for its potential impact. However, there is much opportunity for cross-fertilization of regulatory principles and practices from those who have developed and implemented reasonable standards. Those reasonable standards should encourage the transformation of NGOs while protecting the interests of investors and depositors without excessive and costly burdens on the MFIs and without political interference.
- A third major need cited by MFIs is training for microfinance managers. Too many general managers of microfinance institutions seem to manage by risk avoidance and too few have an entrepreneur's zeal for new markets, new products and new profit opportunities. Donors can provide short or long term training in 'best practices' or 'creative microfinance' that will highlight the successes and pitfalls facing the entrepreneurial microfinance manager. The industry has sufficient experience and talent from which it can disseminate these valuable lessons.
- A fourth major need that donors can help to fill is related to the need for equity investment. Most of the new capital flowing into microfinance is debt. In fact, there are relatively few commercial

equity providers in microfinance. The ability of the some MFIs, particularly the second and third tier MFIs, to incur debt may be limited by the amount of equity on their balance sheets. Donors were instrumental in providing grant funds that functioned as equity capital in the earliest days of microfinance. Another initiative to strengthen the balance sheets of promising MFIs may be a necessary next step in the growth of the industry.

- For donors who are concerned about the possible erosion of the social mission of microfinance, an equity initiative may have additional benefits. The vast majority of the new capital is oriented toward commercial rates of return. Donors can use their equity investments to gain a “seat at the table” in order to help the governing bodies of MFIs to chart their growth toward profitability and commercial return without losing the vision of service to the poor that was the inspiration for their founding. The pursuit of the dual objectives of social mission and financial return require enlightened governance practices and committed equity-holders.

There are a number of additional reforms that are very much needed, according to industry participants. However, most industry observers feel that a private sector solution to these issues is preferable, although a public role may help to lower costs. To accelerate the development of additional support and infrastructure, Acción International has recently formed Gateway Microfinance Infrastructure Fund, described as an equity fund that will not invest in microfinance institutions but rather in microfinance infrastructure such as “banking technology, software companies, credit bureaus, payment systems, remittances, micro-insurance and ratings agencies.”⁸ There are various needs that industry observers feel could benefit from more private sector leadership and investment.

⁸ http://www.accion.org/media_press_releases_detail.asp_Q_NEWS_E_265, July 11, 2006.

- It is recognized that the poor are best served by microfinance in regions that benefit from competition among various microfinance institutions because the costs of loans are reduced in order to attract and retain qualified borrowers. Bolivia may be the best example of such regions but there are others as well. Lower portfolio yields force the MFIs to focus on control of their operating costs and portfolio quality in order to remain profitable. However, borrowers can easily become overextended by borrowing from multiple MFIs. The solution is credit bureaus that serve MFIs with information about the extent of borrowing and repayment practices of their customers. With the technology readily available, credit bureaus simply need the entrepreneurs to establish them.
- The problem of financial exchange risk is more difficult. Until the recent growth in local sources of capital, microfinance institutions have often had to borrow in hard currency and lend in local currency, which creates significant risks in the event of the depreciation or devaluation of their local currencies. Although sharp devaluations are less likely with more currencies allowed to float, foreign exchange risks remain potentially very serious with costs that not easily absorbed by relatively small financial institutions like MFIs. An unexpected devaluation, such as have occurred in Mexico, Malaysia and Argentina in recent years, could easily lead to the failure of otherwise sound institutions. Forward contracts and swaps are two derivative products available in developed markets and some lesser developed markets. Other solutions are also available but can be costly or cumbersome, especially for smaller MFIs. Triodos and Oikocredit, two of the leading social investors, have implemented different techniques to mitigate foreign exchange risk in their investments in microfinance institutions.⁹ As microfinance capital markets grow, more effort is necessary to

⁹ For an excellent summary of foreign exchange risk and current methods of mitigating it, see Cavazos, Rocio, "Foreign Exchange Risk Management in Microfinance," Women's World Banking, Occasional Paper, July 2004.

develop products to diversify risk and price foreign exchange risk at acceptable levels.

- Inevitably in an emerging industry, there will be ebbs and flows in the amount of capital available to sustain that growth. Although capital moves more rapidly to areas in short supply than ever before, it moves considerably slower to developing markets. Because of the critical importance of some industries, public and private vehicles are established to ensure the adequate supply of capital. A good example is the US housing industry which benefits from the Federal National Mortgage Association (FNMA), a private company that buys mortgages that are backed by the US government, in order to ensure an adequate supply of capital for the banks and mortgage companies that make mortgage loans to home buyers. Microfinance industry observers suggest that similar arrangements to establish secondary markets for microfinance securities could help to provide a steady and predictable source of capital for microfinance.
- Investors and other industry practitioners see a number of other needs that should be met through the private sector. These include investment bankers who specialize in microfinance, a larger cadre of microfinance professionals, more independent third party analysis of business models, customer data, geographic differences, regulatory regimes, actual vs. expected return, and spreads in the cost of capital. These efforts to increase transparency will help to separate the success of publicly financed models from the returns generated by the business of microfinance. The resulting clarity will spur investor confidence and increase the availability of capital for the industry.

Capital-Raising for MFIs: A Continuing Challenge

Managers of microfinance institutions may be enthusiastic or even overjoyed at the prospect of the large inflows of capital toward microfinance. However, unless they are among the top 1.5% to 3% of MFIs, they may find that the process is still challenging and arduous. While they will find more investors with more money than ever before, they are also likely to find fewer with an understanding of the special needs of microfinance, a willingness to finance capacity building, or a tolerance for less than strong financial performance. Like early-stage entrepreneurs anywhere, the keys to capital-raising in microfinance are preparation, performance and perseverance.

The importance of preparation is often underestimated by those who believe that capital-raising is merely a matter of making contact with the right individuals or institutions. Preparation involves knowing the market for the products and the strengths and weaknesses of the competitors. Competition in microfinance is increasing and it is causing declining portfolio yields and increased pressure to control operating expenses. The result is good news for microfinance borrowers who get lower-priced loans but often bad news for MFIs whose profitability may be squeezed and who, as a result, may be less attractive to investors.

These are risks, both for the microfinance company and the investor. Prudent investors in microfinance, like any industry, recognize risks and either avoid them or price the risk into their transactions. Investors also want to reduce the costs of their transactions. Just like an MFI, their net income (and their investors' return on investment) is influenced as much by the costs of their operations as by the price of capital charged to the MFIs in their portfolio.

The business plan provides an efficient vehicle for investors to both analyze risks and to reduce their transaction costs. It is also an efficient tool for MFIs to reach potential investors. A well-prepared business plan allows both the MFI and the investor to determine if there is mutual interest in proceeding down the investment path. Too few MFIs have up-to-date business plans. Some business plans look more like marketing literature which may cause the investor to lose interest. The well-prepared business plan includes both the business opportunity and the critical risks and assumptions about the venture. In this way, the business plan becomes an initial observation of the quality of the management team – the decisive factor in the eyes of almost all investors.¹⁰

Financial Performance

The microfinance industry has made great strides in recent years in the transparency of its performance metrics. The development and use of common standards, most notably by microfinance rating agencies, has contributed greatly to the validation of the industry's performance and the resulting increase in investment. Most recently, the SEEP Network has developed and published a Framework for Reporting, Analysis and Monitoring (FRAME)¹¹ after consultation with a number of interested parties and the comparison of various measures and definitions. The FRAME methodology is a significant advance toward a set of industry-wide standards for the microfinance institutions. It is a very useful tool both for MFI managers who need to identify and solve problems quickly as well as for investors who seek to compare the financial performance of an MFI with its peers.

Nevertheless, the industry needs to adopt further standards and practices in order to increase transparency and investor confidence. A

¹⁰ While the precise format may vary, sample guidelines for the preparation of business plans for microfinance institutions are available in both English and Spanish at <http://www.MEDA.org/WhatWeDo/Microfinance/Resources/Tools.html>.

¹¹ See <http://www.seepnetwork.org/section/frame/>. The FRAME tool is available in several languages.

number of investors express skepticism when they read boasts of “98% repayment rates.” With the maturation of the microfinance industry will come more trade associations and trade publications that will promote best practices in the industry as well as the adoption of industry standards. Additional professionals will be employed in credit bureaus, investment banking, microfinance consultancies and research services. Business schools at universities will focus additional attention on microfinance. These functions will increase knowledge of existing standards as well as develop performance benchmarks for the industry. As knowledge of these practices and standards become further disseminated, investors will gain more confidence.

Social Performance

Social performance measures are not nearly so well developed. That may seem ironic for an industry which was founded because of the social benefits that it can achieve. Yet the lack of well-developed social standards may be the product of that heritage. It may simply be presumed that a microfinance institution in Bolivia, Bangladesh, Bosnia or Botswana is providing significant social and economic benefits to the poor.

The influx of commercial capital provides an opportunity for MFIs that seek to attract the attention of social investors. Investors always seek to invest in companies that have a sustainable competitive advantage. That advantage is usually some proprietary technique, barrier to entry by competitors, or high gross margins. The interest of social investors may provide the opportunity for MFIs to distinguish themselves by their articulation of their abilities to alleviate poverty as demonstrated in concrete performance measures.

An MFI that is seeking to demonstrate its ability to improve social conditions through microfinance should consider at least three factors in developing its social performance indicators.

- (i) The consistency of the performance measure with the mission of the organization. Some social indicators will measure jobs created, housing quality or children in school. While each of these may be valid and appropriate, it may take several such measures to demonstrate that an organization is alleviating poverty.
- (ii) The ability to measure performance in discrete units. The beauty of financial measures is our familiarity with currencies as the common measure. In contrast, housing quality and household health status, for examples, are difficult to define and subject to interpretation.
- (iii) The cost or staff time required to collect, analyze and distribute the data. In general, the data should be able to be collected by loan officers in the course of their normal duties and recorded much like the posting of payment information.

The more useful measures will be expressed as rates, much like portfolio quality is expressed as a percentage of the portfolio and return on average assets is expressed over a twelve month period. The most commonly used social measures today measure outreach (total loans outstanding) and female participation (number of percentage of female borrowers). While these are important characteristics, their measurement could be more meaningful.

As an example, consider job creation which may be the most common measure of the benefits of economic development. Like other social measures, job creation has definitional considerations. Because a job is considered to be created only once, the notion of jobs created has given rise

to a second measure – jobs retained. In both cases, the definition of a job has further evolved to “full time equivalents” in order to include part time work. It may be reasonable to assume that two part time jobs equals one “full time equivalent” and two seasonal jobs equals one “full time equivalent.” Such assumptions should be explicitly stated.

To apply job creation to microfinance, an appropriate indicator may be the Jobs Created Rate which could be defined as

$$\text{Jobs Created Rate} = \frac{\text{Net Increase in Jobs in Microenterprises with Active Loans Over 12 Months}}{\text{Average Portfolio Size over the Period/US\$100,000}}$$

The only new data required in order to formulate the Jobs Created Rate is the number of jobs (i.e., full time equivalent jobs) as of the beginning of the twelve month period and at the end. Those numbers would be relatively easy for the loan officers to collect. Any jobs “lost” during the period would offset those that are “created.” The Jobs Created Rate may be very interesting to both donors and social investors. However, because microfinance often provides working capital financing rather than expansion capital, the Jobs Created Rate may understate the economic impact of the work of an MFI.

A more appropriate measure may be an overall measure of employment impact. An Employment Intensity Indicator might be defined as follows:

$$\text{Employment Intensity} = \frac{\text{Average Jobs in Microenterprises with Active Loans over 12 Months}}{\text{Average Portfolio Size over the Period/US\$100,000}}$$

The data necessary for to measure Employment Intensity would also be relatively easily to collect in the course of normal operations.

The Employment Intensity Indicator of microfinance portfolios would yield some very interesting numbers. The Employment Intensity Indicator is expected to be higher in Africa than, for instance, Eastern Europe because the loan sizes in Africa are much smaller and therefore a portfolio of the same size reaches many more microenterprises in Africa and therefore should sustain more employment. The Employment Intensity Index would also favor MFIs that lent primarily to businesses rather than those that had a high proportion of housing or consumer loans.

Both the Jobs Created Rate and the Employment Intensity Indicator could be calculated over the MFIs fiscal year, a period of the trailing twelve months regardless of the fiscal year, or extrapolated to twelve months from data collected over a shorter period. In the interests of clarity and comparison, the precise period would need to be stated. Naturally, the data would have to be able to be readily verified. However, if the data is properly collected, the resulting figures would provide useful information for the management of the MFI to judge its progress from one period to the next and for policy makers and investors as they judge the effectiveness of microfinance operated in particular regions or institutions.

Similar measures could be developed to measure other social factors such as housing quality (perhaps by using indoor plumbing as a proxy for housing quality) or health status (by using the absence of certain diseases as a proxy for a healthy household).

As the industry matures, these or other social indicators will be developed to demonstrate the ability of microfinance institutions to serve their constituencies. The twin and sometimes competing objectives of financial returns and social results will provide significant managerial challenges for the governing boards and top management of microfinance institutions.

Special Considerations of Equity Capital

Much of this discussion of microfinance capital has not distinguished between debt and equity capital. In fact, the discussion has primarily focused on the attributes of debt capital because the vast majority of the new money flowing into microfinance is debt. It is simply much easier to lend capital to microfinance institutions than to invest in their equity.

However, equity is far too important to the lifeblood of a business enterprise to ignore. If equity levels are not increased, at some point the flow of debt capital will slow or stop. Regulated microfinance institutions are generally not permitted to increase their debt-to-equity ratio (or a similar measure) beyond specified limits. The high leverage at these limits is perceived as a threat to the solvency of the institution. Even unregulated institutions are affected because providers of debt capital are well aware of the pitfalls of excess leverage.

Strong and profitable MFIs can increase their equity simply through the retained earnings generated from their net income from prior years. However, if they are in a market with strong demand, increased equity through growth in retained earnings is not likely to be sufficient to allow them to meet that demand.

Some regulatory authorities permit debt capital that is subordinated to other liabilities on the balance sheet to be considered equity for the purpose of the calculation of leverage. However, there are usually limits to the extent to which subordinated debt is considered equity.

The difficulties in acquiring equity capital by MFIs are numerous. In addition to the common obstacles to attracting capital to early stage companies, the sovereign government may have prohibitions or restrictions on foreign capital. A typical rule might limit foreign ownership to a small

percentage of a business, particularly a firm engaged in finance. Situations in which foreigners may invest but may not take their money out of a country are clearly problematic. If someone cannot get their money back, they are not likely to put it in. Fortunately, in most jurisdictions, these restrictions are diminishing as governments recognize the importance of foreign capital to their economies.

In addition, there are three very significant obstacles to attracting equity capital. Each of these deserves more attention than can be provided here.

- I. Corporate form. Most microfinance institutions are non-governmental organizations (NGOs), i.e., structured as non-profit organizations with no owners of the institution but a governing board that manages its activities. Equity investment, however, is actual ownership in which the holders of the equity participate in the management of the institution and share in its profits and losses. Equity investors buy stock in the business which is a share in the ownership of the company and is sold by the company to raise funds. Their ownership is property which can be sold to someone else. The terms of the purchase of the stock is usually described in a prospectus or shareholders' agreement.

Because an NGO has no owners, it has no share of the ownership to sell and therefore generally cannot raise capital in this way. However, because an NGO can repay its debt obligations, it can borrow money without similar problems. MFIs that are NGOs but which want to raise equity capital generally must "transform" to finance companies, non-bank financial institutions, regulated microfinance banks, or commercial banks, depending on the applicable laws in their country. After such a transformation, the MFI would be a separate institution in which the NGO would be its largest and typically its only shareholder.

The large number of MFIs that are NGOs makes this a very significant problem.

II. Governance. Corporate governance is a term which applies to how an institution is managed, whether it is a private company or an NGO, and includes the composition of its board of directors, their functions, and the relationship with and functions of senior management of the company. Because equity investors are owners of the company, they have a right to participate in governance, even if they have only a small minority of the ownership. There are at least three serious concerns or perceived threats that discourage the sale of equity by MFIs for reasons of governance:

- a. The concern by the existing board of directors (presumably the founders of the MFI) that the new equity holders will somehow take over the institution or exert excessive influence in spite of their minority ownership position.
- b. Concerns by potential equity investors that MFIs are not governed in a transparent and open manner in pursuit of the best interests of the organization but rather are subject to conflicts of interest, favoritism, or simply a lack of competence in the management of the business
- c. Concerns by both parties that the interests of the founders, presumably in serving the social and economic needs of their clients, are not compatible with the interests of the investors, which are presumed to be maximizing the return on their investment.

While all of these issues may be sincerely and strongly felt, none are insurmountable. In fact, most stem from a lack of knowledge about the other. The existing governing body and management team has already demonstrated significant success or the investors would not

have shown interest. Most investors are relative novices in the world of microfinance but have excellent business experience and financial contacts that can help to strengthen a growing MFI. The top tier microfinance institutions have already demonstrated that quality MFIs can achieve a social mission while earning substantial profits. The move toward 'enlightened governance' that accommodates both the social objectives and the need for financial return is likely to accelerate in the future but for now these remain significant issues.

III. Exit. The lack of suitable exit opportunities in microfinance is probably the single most difficult issue and is therefore the greatest barrier to equity investment in microfinance. In fact, there are relatively few commercial providers of equity capital.¹² The concept of exit is simple; an exit is the ability of the investor to receive their investment plus an expected return after a period of time. Most debt instruments are paid with a regular (usually monthly) payment of principal and interest. One of the virtues of equity is that it is patient capital which does not require regular payments. However, that fact, coupled with the higher risk of equity which requires a higher return, is also its difficulty. Among the methods typically available to achieve an exit is (a) a sale of the equity interest to an existing investor or to a third party, (b) a sale of the equity interest to management, or (c) the sale of the entire MFI to another company.¹³ In the world of microfinance capital today, there are simply too few equity transactions to provide a prudent investor with confidence that its investment in an MFI can be sold in the future. While equity transactions do occur, they are often with investors who have a long term strategic interest in microfinance (e.g., donor interests) or with onerous conditions imposed on the MFI in order to conclude the transaction. This situation will improve over

¹² Goodman, Patrick, *Microfinance Investment Funds: Key Features*, Appui au Développement Autonome, February 2005, page 23.

¹³ When the purchase of the investor's equity is required as a condition of the investment, the investor is said to have a "put."

time as more opportunity in microfinance will attract more and varied investors. However, the present situation is typical of an embryonic industry which requires both MFI and investor to take investments risks that are not typical of more mature industries.

Emerging Industry

These are exciting days to be involved in microfinance, but they are not easy. The managers of most microfinance institutions will continue to find difficulty as they try to meet the strong demand for their services by raising more capital. They will need to have a strong business model, a growing market and the ability to clearly communicate those successes in terms that are understood by both commercial and social investors. Commercial investors who are new to the industry will need to understand that while microfinance is not a social experiment it is not banking either.

Like any emerging industry, the rewards will come to those with the discipline and perseverance to recognize its risks and to invest in its successes.