micro capital institute™

Managing Commercial Microfinance:
The People and Institutions Behind the Asset Class

Introduction

Microfinance is undoubtedly one of the most diverse sectors of global finance, so it comes as no surprise that there is no single model that covers the institutions that manage commercial microfinance.

Microfinance investors are a mixed breed – they span continents and classes, genders and races, and they are as varied as the investment management institutions they put their money in. Those institutions range from banks and funds to offshore and onshore investment companies and a hodgepodge of other creatively organized and alternatively financed institutions. The microfinance institutions (MFIs) that dole out the loans and other financial products are an assortment of credit unions, cooperatives, NGOs, commercial and private banks, government agencies and a myriad of derivatives of these institutions – every bit as varied as the rural peasants, urban mothers, roadside traders, Arctic fishermen and Slavic seamstresses who borrow their money.

Collectively, however, all of these players have managed to prove that microfinance works. It achieves social agendas such as poverty reduction and economic development, and it can be – when managed properly – profitable. For investors, microfinance is a new and exciting asset class that is already a growing part of the portfolios of some institutional and individual investors the world over.

This paper will try to explain how microfinance works – by painting a picture of the parties involved and the processes by which parts of the sector are managed. By doing so, we also hope to identify some best practices the industry has adopted. Finally, we'll draw some conclusions about the direction commercial microfinance is moving, and what the future holds. Keep in mind, this paper is meant as a primer for investors and others who are looking at microfinance from the outside, and not as a blueprint for microfinance managers.

Background

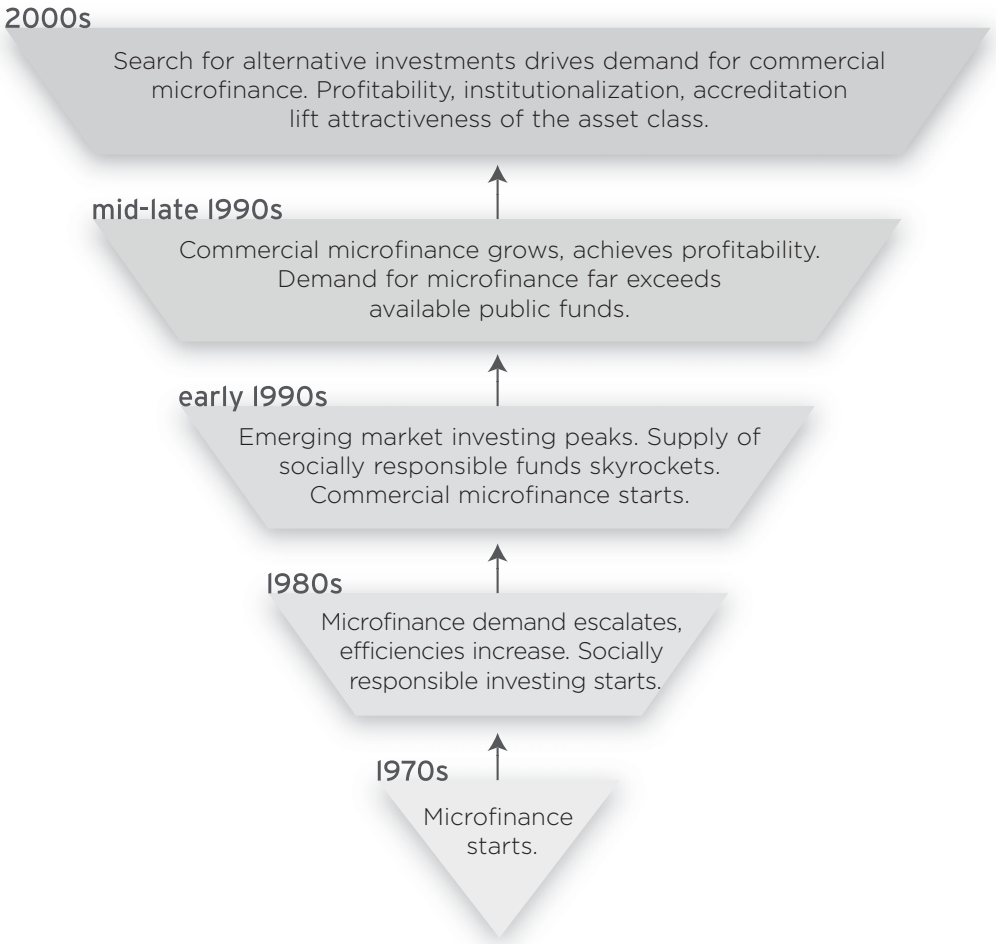
While micro-lending dates back hundreds of years – perhaps thousands – modern microfinance can trace its roots to nearly simultaneous initiatives in Bangladesh and Bolivia in the mid-1970s. The Grameen Bank in Bangladesh has had enormous success over the years in taking its peer-group-based model to rural clients throughout Bangladesh, and has exported that model to several other countries, where it has been repeatedly copied and modified by other MFIs.

Commercial microfinance, on the other hand, is relatively new. It wasn't until the early 1990s that a confluence of supply and demand factors drove the provision of some micro-lending into a profit-focused model with a double bottom line – a return to investors and a socially responsible agenda. On the demand side, many MFIs had finally reached a level of efficiency where subsidized loans were not only no longer necessary, but in some cases were a disincentive to the efficient management of commercial microfinance and an obstruction to the social goals of economic development and self-sustainability. Meanwhile, the size of the microfinance industry worldwide had hit a point where subsidized funds from government agencies and multilateral institutions like the World Bank were no longer sufficient to cover demand. Global political and economic changes contributed to the growth in demand, as rapid democratization in Eastern Europe and the former Soviet Republics, along with capitalist reforms sweeping many Latin American and African countries, left hundreds of thousands of rural peasants suddenly dependent on no one but themselves. Many of them flooded cities, where they couldn't find work, or became refugees.

Around the same time that demand was escalating, the supply side of microfinance was undergoing its own renaissance. The 1980s saw the rise of a Nouveau Riche class of philanthropists, many of whom had made their money in the computing revolution and

were now looking for outlets for their charitable donations. Perhaps tired of having library wings named after them, they began to look overseas. Meanwhile, there was a surge in the amount of private sector funds looking for alternative investments. Emerging market investing hit its heyday in the early 1990s. Around the same time, socially responsible investors such as Amy Domini and mutual fund groups such as Calvert and Pax raised the level of awareness of socially responsible investing, and began to show investors that it isn't all about charity – that investors can help make the world better while still earning a return on their investment. And if the Nouveau Riche of the PC Generation planted the seeds, the overnight wealthy of the Internet Generation grew the garden, raising awareness of labor and human rights issues beyond their home country borders.

That brings us to the 2000s, when the dot-com bust and the ensuing economic and stock market downturns in the U.S. and other developed countries sent some investors out of the stock market in search of new, alternative places to put their money. Microfinance



is one such alternative, as it offers investors capital preservation, a steady return with low correlation to global capital markets, and a socially responsible agenda. Surveys by the MicroCapital Institute show the commercial side of microfinance – inflows from privately held sources -- has been growing at an annual pace of between 50 and 60 percent over the past four years.

Managing that growth is no easy task. Like any new industry, microfinance has grown unsystematically. The people and institutions that manage microfinance funds are still exploring new types of management structures, processes, investment vehicles and best practices. Practices differ from country to country, institution to institution. Meanwhile,

governments and international regulatory bodies are at odds over what, if anything, to do about microfinance. And capital markets are still experimenting with the first tranches of securitized commercial microfinance offerings.

The Process

Before microfinance was commercialized, the process of micro-lending usually began with a grant or a subsidized loan from a government agency or from a multilateral institution. These funds would be made available to any number of different types of MFIs, which in turn would either lend them directly to individuals or distribute them to smaller, village-level MFIs which would in turn make the loans available to individuals. It's important to note that in almost all such cases, the goal of the original funding source was not to earn a profit but to stimulate economic development and help eradicate poverty.

In commercial microfinance, the process begins on the supply side with an investment into any number of microfinance-oriented funds, investment companies, cooperatives or partnerships. The investment might be a securitized or non-securitized share in a fund, an equity share in a company or partnership, or a share in a cooperative. Microfinance might be the entire focus of the fund, a majority focus, or just a small percentage of the fund's assets. In many cases, commercial microfinance funds will take a combination of public and private funds, including subsidized loans from multilateral institutions or commercial loans that are guaranteed by quasi-government agencies – such as the U.S. Overseas Private Investment Corp. (OPIC).

While a few commercial microfinance institutions deal directly with clients in foreign countries, most invest in carefully selected, profit-driven MFIs, which in turn distribute the loans to individuals and small businesses. The average loan for microfinance as a whole tends to be under $600, while loans from commercial microfinance institutions are on average slightly higher, in the range of $900, although some can go as high as $30,000 or as low as $100.

INVESTORS	INVESTMENT MANAGERS	MFIs
Private Private Individuals Pension Funds Academic Endowments Foundations Commercial Banks Corporations **Public** Government Agencies Multilateral Agencies Development Banks	Microfinance Funds Private Equity Funds Investment Companies Cooperatives Commercial Banks	NGOs Bib-bank Financial Institutions Village Banks Credit Unions Commercial Banks Savings Cooperatives Development Banks

The Investors

Private Investors

Investors in commercial microfinance include a who's who of major philanthropic foundations such as the Ford Foundation and Canada's Agridius Foundation, as well as individuals, corporations, endowment funds, socially responsible mutual funds, many of the world's largest commercial banks, and more. Still, the amount of money invested in microfinance by private sources is miniscule compared with other alternative asset classes or other types of

socially responsible investments such as mutual funds. The MicroCapital Institute estimates that some $3.4 billion in loan volume was processed by the microfinance industry worldwide last year, close to $1 billion of which originated from private sources. That pales in comparison with the estimated $2 trillion in professionally managed funds earmarked for socially responsible investments.

The biggest obstacle for many private investors is the lack of a significant track record, a dearth of available information, and the absence of clear, standardized reporting and accounting guidelines. While that is rapidly changing, most microfinance investment vehicles still have a long way to go before they qualify for funds from such large institutional investors as the California Public Employees Retirement System (CalPERS), or even from more socially responsible institutions like the Harvard endowment fund.

Donor Agencies

Accounting for more than 70 percent of microfinance funding worldwide, donor agencies do more than just provide funding to microfinance institutions. They can also be valuable partners to private investment managers, and in recent years the donor agencies have become the first to admit that donor financing is not always effective, and that privately run microfinance institutions can be more effective in poverty alleviation and economic development. As a result, they have become willing partners with private institutions. Some of the ways they can help include:

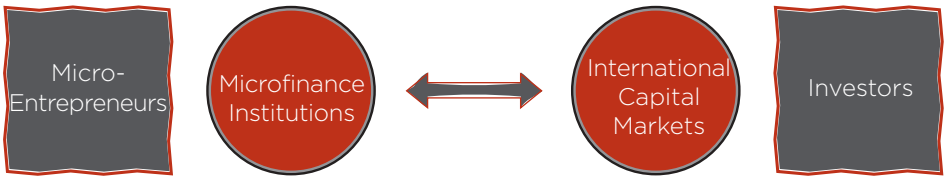
- Providing specialized technical oversight of microfinance projects.
- Taking risks on promising but not yet proven institutions and mechanisms that private investors might not be ready to fund.
- Adjusting country-level programming to support global or multi-country initiatives on training, common reporting standards and the application of technology to financial services.
- Working with local government and regulatory bodies to ensure adherence to local laws and to streamline approvals for new projects[1].

Donor agencies include multilateral institutions such as the World Bank, the Inter-American Development Bank, the European Bank for Reconstruction and Development, the UN Capital Development Fund and the UN Development Program. They also include a host of national development agencies such as Germany's Kreditanstalt für Wiederaufbau, France's Agence Française de Développement, Britain's Department for International Development, the Swedish International Development Corp., the Japan Bank for International Cooperation and the US Agency for International Development.

The Investment Managers

As we mentioned earlier, the managers of privately raised funds for microfinance are a mixed group. While we have attempted to categorize them, most such institutions follow no set structure and are in the process of evolving. This evolution is being driven mostly by the supply side – managers are being driven to adopt whatever structures and processes are necessary to capture additional funding. Many of them began with funds from friends and family, and have grown mostly through word of mouth and the trust of their investors, which has managed to outweigh the lack of proper disclosure and a long and consistent track record. However, that is all rapidly changing, and 2003 saw the beginnings of formal financial structures aimed at raising larger amounts of money from widespread pools of investors that may have little or no relationship with the principals of the management institutions. Below is an illustration of how one fund, BlueOrchard, depicts its role in the microfinance industry – as a bridge between investors and capital markets on one hand, and lenders and borrowers on the other.

[1] Adapted in part from the Consultative Group to Assist the Poor (CGAP), brief on donor effectiveness: http://www.cgap.org/priorities/donor_effectiveness.html.



Microfinance Funds

The jury is still out as to whether microfinance will eventually evolve toward a mutual fund-type model for the top tier of investment institutions. Already though, some large funds are moving in that direction. To our knowledge, there are no microfinance funds that are publicly traded on capital market exchanges. However, there have been several securitized fund offerings that were sold in private placements in the U.S. and Europe. Blue Orchard Finance, for example, recently announced a private placement solicitation for a new, $63 million microfinance fund which would be guaranteed in part by OPIC and underwritten by J.P. Morgan. Rather than try to categorize the various types of microfinance funds, we have profiled below two of the largest fund managers, Blue Orchard and ACCION. Their starkly different approaches to the market provide a good glimpse into the fast-growing microfinance industry.

ACCION INTERNATIONAL

ACCION is a non-profit organization that takes its own model of peer lending to partner organizations (MFIs) throughout developing countries, mostly in Latin America. The organization is backed by the World Bank, USAID and the Inter-American Development Bank. For private investors, that backing can be both a positive and a negative. It gives ACCION access to a substantial amount of public funding and assistance on the ground, but it also means that the objective of ACCION's programs is not so much to make a profit as it is to "cover their own costs," as ACCION itself says on its website. "ACCION's partner programs provide small, short-term loans at interest rates that reflect the cost of lending. ACCION's loan methodology has been designed to both meet the needs of microentrepreneurs and to ensure that the microfinance organizations we work with are financially sustainable," the organization says. Still, ACCION has managed to raise two funds – a $5 million fund which has already been fully deployed, and a new $20 million fund raised last year, 15 percent of which was raised from private investors. The bulk of the fund came from International Finance Corp., Inter-American Development Bank and other public institutions. Private investors and/or donors in ACCION include Citigroup, the Ford Foundation, Johnson & Johnson and J.P. Morgan. ACCION also has a subsidiary called ACCION USA which makes microloans in low-income neighborhoods within the U.S., mostly to Hispanic Americans.

BLUEORCHARD

BlueOrchard is one of the largest and most established microfinance funds in existence. With headquarters in Geneva, Switzerland, and more than $43 million in assets under management, BlueOrchard is one of the few – and certainly the largest – pure-play commercial microfinance funds in existence. Its first fund is called the Dexia Micro-Credit Fund, although BlueOrchard is currently making the rounds in the United States to raise a new, $63 million fund that would be underwritten by J.P. Morgan and guaranteed in part by the U.S. Overseas Private Investment Corp. (OPIC). The fund consists of securitized senior and subordinated notes and invests exclusively in MFIs throughout the developing world.

Although BlueOrchard has been known to provide financial and management assistance to some of the MFIs it invests in, it is much more focused on the fund management and

fundraising aspects of the business, carefully selecting MFIs and then allowing them to manage the loan portfolios.

Since its launch in 1998, the fund has had a five-year net cumulative return of 26.21 percent as of Sept. 2003, and has a $10,000 minimum investment. Some 55 percent of investors are individual private clients, with another 42 percent institutions and 3 percent socially responsible mutual funds. "Obviously they are attracted to the social impact of microfinance," BlueOrchard founding partner Jean-Philippe de Schrevel says of the fund's investors. "But you have to look at the fiduciary side as well."

Investment Management Companies, Partnerships and Cooperatives

Dozens of investment companies, partnerships and cooperatives have been incorporated around the world for the purpose of raising and managing funds for microfinance. The way they are structured and managed varies according to their ownership, their purpose and the local rules by which they are governed. Some are simply the financial arms of enterprising NGOs, while others are the microfinance units of commercial banks or cooperatives formed by groups of companies, banks and individuals. Again, we have chosen to profile two widely different institutions to give readers an idea of the breadth of different offerings – Alterfin and Prisma.

ALTERFIN

Alterfin was founded in 1995 as an investment cooperative by a coalition of Flemish NGOs along with two banks, Mercator Bank and Triodos Bank, both of which remain major shareholders. Other institutional shareholders include FORTIS, The Body Shop, SOS Faim and Oxfam Solidarity.

Alterfin has a dual objective: microfinance and fair trade. It spreads its money across some 30 institutions (21 MFIs and the remainder fair trade organizations) in 17 countries throughout Africa, Asia and mostly Latin America. Jan De Grande, a director at Alterfin, says between 85 and 90 percent of the funds are invested in Latin America. "Our investors would like us to put more in Africa. But Africa is less prepared to attract investment capital. They want gift money and not microfinance capital," De Grande says. Aside from that, most investors simply "want to know that we are doing just what we promote."

That agenda might not appeal to everyone, and indeed is more euro-centric because of its secondary emphasis on fair trade – it invests in organizations that distribute products at above market price that have been unfairly squeezed by world trade, such as bananas.

For those that do subscribe to Alterfin's agenda, the fund has a long and established track record and pays out annual dividends ranging from 1 to 2 percent. Alterfin has some 670 shareholders, 40 of which are institutional. The fund typically lends out money to MFIs in amounts ranging from $30,000 to $300,000 USD, at rates between 6% and 10%. All investors have equal voting rights and are entrusted with major decisions such as picking board members and approving auditors and annual reports. Keep in mind, there are no guaranteed returns on your investment. An investment in Alterfin is a share in the company, and the principal could be eroded if the fund loses money.

PRISMA

Prisma is unique in that it is one of the few U.S.-based microfinance funds that makes its own loans directly to microfinance clients, rather than through MFIs. It is established as an investment company, with offices in Boston and Managua, and has a lending network throughout Nicaragua and Honduras.

Kendall Mau, chief operating officer at Prisma, has made a point of structuring the fund to meet internationally recognized CAMEL standards (Capital, Assets, Management, Earnings, Liquidity) in an attempt to draw institutional investors and help allay their concerns about the profitability of loaning money to poor people.

"You can't just offer investors two to three percent. Nobody is going to buy it," he says, adding that Prisma's goal is a real return of 6 to 10 percent each year, which it is able to achieve through the efficiency of its on-the-ground network. Still, Prisma's small size (less

than $2 million in assets under management) and its concentration on two Central American countries means its not for everyone.

The MFIs

Microfinance Institutions are the actual lending organizations that distribute micro-loans to individuals and small businesses. Some MFIs, however, act as "consolidators" or intermediaries between smaller MFIs and funding sources. While there are some regional MFIs that span continents, most are limited to within the borders of a single country, and many are focused on a specific area within a country.

MFIs can be broken down into three categories: formal institutions are those that are subject to specific banking regulation and supervision; semiformal institutions are those that are registered institutions insofar as they are subject to general and commercial laws but are not governed by bank regulation and supervision; and informal providers are those that are organized beyond the realms of law. Formal institutions include public and private development banks, savings and postal savings banks, commercial banks and some non-bank financial intermediaries. Semiformal institutions include credit unions, multipurpose cooperatives, NGOs and some peer lending organizations and self-help groups. Informal providers include most self-help groups, rotating savings and credit associations, moneylenders, etc.

For the purposes of commercial microfinance, we are concerned mostly with semiformal institutions and, on occasion, some formal institutions, as these have the most likelihood of being profit-driven enterprises and being capable of attracting commercial funding.

While there are an estimated 10,000 MFIs worldwide, BlueOrchard estimates that only about 300 of those are both profit-driven and efficient enough to warrant interest from private investors. Many are either financial NGOs or are financial institutions with roots in NGOs. Others are non-bank financial institutions that are governed under regulations set up in many countries specifically to help MFIs circumvent the capital requirements that apply to banks.

While financial NGOs are the most common institutional type for MFIs, there are certain drawbacks to NGOs that commercial lending sources have to deal with. Among them:

- A lack of business acumen in the way they are organized and operated.
- Overly ambitious aspirations with regard to their social relevance.
- A limited scale of operations.
- The frequent use of donated capital or soft loans from foreign development organizations.
- The influence of people who are not part of the target lending group and thus are not subject to peer pressure if the institution's money is eventually lost.

However, NGOs also have several advantages, including a track record of working with the target lending groups, experience in dealing with foreign funding sources, and a desire to perform well so as to secure additional funds.

From the point of view of the commercial lender, good MFIs are evenly divided between their social and financial agendas, and exhibit the following characteristics:

- A systematic and profit-driven approach to the business.
- Financial products that address the target lending group but also meet international standards.
- Attention to capital adequacy, liquidity, portfolio diversification and asset quality.
- A niche borrowing group that is underserved by the traditional financial sector.
- Peer group lending that encourages repayment for more than just financial incentives.
- Compliance with local laws and a strong relationship with regulatory bodies.
- A strong organizational and administrative structure.

Conclusion

Commercial microfinance is a "work in progress." The institutions that administer and manage microfinance funds are constantly evolving to address the needs both of the credit clients they serve and of private investors. Increasingly, oversight authorities are being established and standardized guidelines are being developed that are improving disclosure and reducing the potential for corruption and mismanagement – which in recent years have plagued other sectors of global finance, including the investment banking and mutual fund industries.

Already, most of the MFIs that do receive commercial microfinance funding are required to pass through formal, third-party audits and to meet certain reporting and accounting guidelines. And recently, the MicroCapital Institute implemented a service to provide ratings on the microfinance funds and investment companies themselves, which should help to boost disclosure and adherence to international standards.

As more private investors seek to be involved with microfinance, new investment offerings are being made available every day. Competition will continue to drive the efficiencies, costs and performance of all parties involved with microfinance, from the investment managers to the MFIs.

This research report is for informational purposes only and does not necessarily represent the views of the MicroCapital Institute or its directors. Nothing in this report should be construed as an investment recommendation or a solicitation to buy securities.

about The MicroCapital Institute

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With offices in Boston, San Francisco and London, MicroCapital Institute comprises a team of research and finance professionals headed by Nancy Yonge. Dr. Yonge has more than 25 years experience in international investment and finance.

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