

Introduction

On October 10-11, 2005, leaders of microfinance institutions (MFIs), investment firms, and development agencies met in Switzerland for the Geneva Private Capital Symposium. This event was designed by the Centre for Applied Studies in International Negotiations (CASIN), a Swiss non-profit foundation, to showcase micro and small business finance and to increase investor interest in this sector. In keeping with this objective, many of the featured speakers gave persuasive speeches about the merits of microfinance (MF) investment. This persuasion proved to be unnecessary, given the acumen, experience, and commitment of the symposium's participants.

A major event in microfinance in 2005, the symposium attracted an unprecedented group of experts in microfinance and investment, including the leaders of highly successful MFIs, founders of leading microfinance investment firms, internationally acclaimed journalists, top executives of international banks, world renowned consultants, experts from development agencies, and distinguished public figures.

Collectively, this group possessed unsurpassed knowledge of the microfinance sector. Through the official sessions and private conversations with participants, it was possible to construct a picture of the current and future state of microfinance investment.

The Current State of Microfinance: How Large is the Global Market?

Statistics about microfinance go out of date rapidly, both because the market is changing and because we continue to acquire more complete data. Just a couple of years ago, several papers estimated that there were \$4 billion in microloans outstanding.³ In Geneva, most symposium participants relied on the estimate from the Consultative Group to Assist the Poor⁴ (CGAP) that microfinance is currently a \$15 billion sector.⁵ Dinos Constantinou, Managing Director of Global Microfinance Group SA, a private for-profit microfinance investment group, estimated that micro and small business lending together total about \$30 billion. Others have asserted that there are \$24 billion in microloans outstanding.⁶

One reason for these disparities is that the microfinance sector spans different types of firms, such as non-profit non-governmental organizations (NGOs), regulated MFIs, commercial banks, and local money lenders. Some organizations have been started by local entrepreneurs or foreign philanthropists who are still unaware of, and invisible to, the broader microfinance network. Damian von Stauffenberg, founder and CEO of MicroRate, a leading rating agency for MFIs, stated frankly that we really don't know the full size of the microfinance sector.

Whatever the current size of the microfinance industry, though, there is broad agreement that the vast majority of poor bankable people still do not have adequate access to financial services. Many of the participants now believe that this market has a potential size of \$300 to \$500 billion. This compares with estimates of \$60 or \$100 billion that were common just a year or two ago.

Financing MFIs

The current picture of the financing needs of MFIs is also inconsistent and changing. Just last year, CGAP and the Microfinance Information eXchange (MIX)⁷ reported a survey in which MFIs identified the lack of financing as their greatest impediment to growth.⁸ At the symposium, though, several experts asserted that the top 200 or 250 MFIs now have access to ample financing. Private conversations with microlenders support

this. An elite group of MFIs has emerged.

Many top tier MFIs have reorganized as regulated financial institutions and can accept local deposits. In addition, they have achieved the size, professionalism, and profitability to attract commercial investment. Finally, these leading MFIs now earn healthy returns on equity and can rely increasingly on retained earnings.

It is appropriate that these successful firms are attracting the capital they need, but investors who care about poverty know that top tier MFIs only serve a small fraction of this enormous market. There are innumerable firms in the second tier that have the potential to extend their reaches and to achieve similar success given adequate funds.

Two Bottom Lines: Poverty and Profits

Most MF investors care both about poverty and investment returns. Given current conditions, here are some observations.

Opportunities

to fight poverty: Since top tier MFIs presently have ample financing, socially conscious investors should consider investing in strong second tier firms. In addition to MFIs, there are also numerous opportunities to help the poor by investing in organizations that make small business loans. In fact, Laurence Carter, Director of the Small and Medium Enterprise Department at

the International Finance Corporation (IFC), a World Bank organization that promotes sustainable private investment in developing countries, said that one of our most important challenges is to encourage financing to expand from the micro sector into the small business sector. Others expressed this same conviction privately.

For now, MFI debt continues to be more available than quality MFI equity. In a recent article for CGAP, Gautam Ivatury, a microfinance analyst, and Julie Abrams, a consultant, report that most regulated MFIs have ample equity capital, and that most unregulated MFIs are not structured to issue equity.⁹ Even when equity offerings are available, investors need to be cautious because it is frequently risky and illiquid. Shareholder interests frequently take a back seat to other stakeholders. For example, one microlender at the symposium said that his firm's equity offered a 12% return. By MFI standards this is very respectable.

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Further discussion, though, revealed that the same firm was paying 18% on short-term commercial loans. Its equity investors thus have an illiquid investment with more risk and a lower return than debt holders.

Opportunities to earn high returns: Some speakers at the symposium spoke glowingly of astronomical returns with negligible risk. Others were skeptical, with good reason. Competition between private and public investors and the costs of several layers of financial intermediation drive down the returns that investors in high income nations can expect to achieve, especially from second and third tier MFIs.¹⁰ Microfinance is not immune to the cycles and meltdowns that characterize other investments. Many proponents of microfinance emphasize the high repayment rates on microloans, but Michael Hölz, Global Head for Sustainable Development for Deutsche Bank, and Didier Cossin, UBS Professor of Banking and Finance at the Institute for Management Development, reminded us that MFIs face numerous risks other than repayment risk. Sooner or later, every sector of the economy faces declines and it's unlikely that microlending will prove the exception. A participant from Triodos Bank encouraged investors to take the long view. Arthur Vayloyan, Head of Private Banking at Credit Suisse, wisely warned us that investments in microlending should be conservatively managed, to avoid losses that could cause investors to eschew microlending in the future.

This does not mean that good investment opportunities are not available in microfinance. Gerhard Pries, President of MEDA Investments and cofounder of MicroVest, North America's first private equity investment fund for microfinance, said that MicroVest finds more attractive investments than it can fund; albeit that this comes from a firm seeking investment dollars.

Several speakers believed there is a herd mentality among investors: that favorite MFIs and regions have access to more financing than they need, while equally creditworthy MFIs are overlooked. In particular, Sanjay Sinha, Managing Director of Micro-Credit Ratings International Limited, a credit rating firm for Asian microlenders, believes that investors have favored Latin America and overlooked opportunities in Asia. Chikako Kuno, Director for the Group for Small Business at the European Bank for Reconstruction and Development, an organization established to promote private sector investment in formerly communist nations, suggested that investors are herding to the Balkans and disregarding equally attractive MFIs elsewhere. This suggests that there are still attractive opportunities for those who are willing to look.

Public vs. Private Investment

Development agencies and other public entities dominate foreign investment in microfinance. According to Ivatury and Abrams, direct foreign investment in microfinance totals about \$1.16 billion.¹¹ Development agencies, such as the World Bank's IFC and the German development bank KfW, account for 56% of this total; private funds account for the remaining \$511 million. But the actual private investment in microfinance is even smaller than \$511 million, because development agencies are also major investors in the private funds. Relative to the MF market as a whole, commercial private investment in microfinance is minuscule.

Role of government entities: Many symposium participants were less than enthusiastic about the dominant role of public investment in microfinance. Vijay Mahajan, the founder and CEO of BASIX, the first MFI in India to attract commercial equity investment internationally, complained that the World Bank distorts the marketplace by offering a billion dollars of free credit to small households. Damian von Stauffenberg, CEO of MicroRate, asserted that development banks crowd out investors.

Still, many of the participants saw a role for public investment and government incentives. Representatives from the IFC said that they were working to create private investment rather than compete with it. Stefan Gavell, Executive Vice President and Head of Regulatory and Industry Affairs at State Street, suggested that there could be tax incentives, such as those offered to municipal bonds, to increase the attractiveness of the risk adjusted return. Elizabeth Wallace, Director of Global Development Services, a consultancy that advises governments and financial institutions about effective development strategies, believes that governments can be catalysts that encourage recalcitrant banks to enter the profitable microfinance market.

Attracting private investment: Symposium participants disagreed about why private commercial investment plays such a small a role in microlending. Some blamed financial institutions for ignoring the promising MF sector. One speaker pointed out that only two or three pension funds were represented at the symposium, while over 100 had been invited. However, the recalcitrance of financial institutions doesn't adequately explain the dearth of private investment in microfinance.

The alternative view is that there simply are not enough financial products that are attractive to private investors. Experts espousing this view included Peter Johnson, a Founding Partner at Developing World

Markets, an investment banking boutique that raises money for microfinance; Gerhard Pries, cofounder of MicroVest; Marc de Sousa Shields, a Partner with Enterprising Solutions Global Consulting, an international development consulting firm; and Arthur Vayloyan, Head of Private Banking at Credit Suisse. It is certainly true that the U.S. market needs more suitable financial instruments for microfinance. There have been few offerings of sufficient size to attract institutional investors, and we do not have securities that can be purchased easily by ordinary, unaccredited investors. U.S. investors need liquid securities that are registered by the Securities and Exchange Commission and available through mainstream channels. This presents an opportunity to entrepreneurial financial institutions.

Will Changes that Expand Microfinance Leave Investors Behind?

We are all enthusiastic about innovations that improve financial services to the poor, but prudent investors also care about the impact that these changes will have

what effect they are likely to have on existing MFIs. For example, an equity investor in MFIs will want to know whether VISA will emerge as a competitor or a partner to MFIs.

The effects of banking and MFI investment:

Some banks have established very successful partnerships with MFIs. Suvalaxmi Chakraborty, Head of Rural, Micro-Banking and Agribusiness for ICICI, India's largest bank, and Gary Hattem, Managing Director of Deutsche Bank, gave some excellent examples. It's inevitable that more banks will enter microfinance because of profit opportunities and pressures from government and stakeholders.

Most discussions of banking and microfinance focus on the benefits to the poor and to the banks. From an investor's perspective, it would be useful to learn more about how the entry of banks into this sector will affect investments in existing MFIs. If a bank competes against an existing MFI, it could wipe out the value of the MFI's equity. On the other hand, if a bank partners with an MFI or even acquires it, equity holders could be richly rewarded. Although the regu-

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on their investments in particular MFIs. The Geneva symposium would have benefited from a more thorough discussion of this. Here are two examples:

Technology was not a major topic at the symposium, but some of the participants offered snippets of information. For example, Vijay Mahajan, CEO of the Indian microfinance institution BASIX, said that the increased use of microcomputers would help micro-lenders to provide affordable financial services to the poor. Stanley Fischer, Governor of the Bank of Israel, observed that technology would make it possible for MFIs to keep better records on savers, borrowers, and rates of return. Technology, then, could help MFIs to become more operationally efficient and gather the detailed information that many Western lenders demand.

In response to questions, Tom Easton, New York Bureau Chief for The Economist newspaper, and Elizabeth Littlefield, a Director of the World Bank and CEO of CGAP, spoke about VISA's interest in microfinance and the growing use of biometric ID cards in India, Malawi, Uganda, and elsewhere. Opportunity International, a not-for-profit "wholesale microfinance network" with over 500,000 affiliated micro-borrowers, is one of the biggest issuers of ID cards. Investors would be wise to follow these trends and to consider

lar sessions of the symposium had little to say about this issue, some of us discussed it privately. The consensus seems to be that banks have strong incentives to establish partnerships with existing MFIs rather than entering microfinance independently. MFIs that would make suitable partners will probably benefit from this trend.

Conclusion

In summary, there are still ample opportunities to help the poor by investing in micro and small business finance. Socially conscious investors should consider holding debt and selective equity investments, especially in second tier MFIs and small businesses. There is room in the U.S. market for more institutional offerings and SEC registered products for small investors. And if you have financial experience and a heart to serve, do not overlook opportunities to share your expertise with organizations that serve the poor.

¹ See <http://www.casin.ch/web/index.html>.

² The Symposium Programme reads, “The Symposium will showcase today’s leading investment vehicles and business models in micro & small business finance and will appeal to the financial community, from institutional to “field” investors, to explore this new asset class.”

³ This estimate apparently originated from The Business Case for Investment in Microfinance, by Drew Tulchin, Social Enterprise Associates, September 2003.

⁴ CGAP is “a consortium of 31 development agencies that support microfinance.” See www.cgap.org.

⁵ Ivatury, Gautam and Xavier Reille, Foreign Investment in Microfinance: Debt and Equity from Quasi-Commercial Investors. CGAP Focus Note no. 25. Washington, DC: CGAP, 2004, p. 2.

⁶ Articles in the popular press attribute this \$24 billion estimate to the Microcredit Summit. We have not been able to find the ultimate source of this estimate.

⁷ MIX is a not-for-profit private organization that promotes the exchange of information about microfinance. See www.themix.org.

⁸ CGAP and MIX: “Study on MFI Demand for Funding, Report of Survey Results”. Washington, D.C.: CGAP, 2004

⁹ Ivatury, Gautam and Julie Abrams, The Market for Foreign Investment in Microfinance: Opportunities and Challenges. CGAP Focus Note no. 30. Washington, DC: CGAP, 2005.

¹⁰ Vijay Mahajan, The Demand for Micro and Small Business Finance, pg. 19, October 3, 2005.

¹¹ Ivatury, Gautam and Julie Abrams, The Market for Foreign Investment in Microfinance: Opportunities and Challenges. CGPA Focus Note no. 30. Washington, DC: CGAP, 2005.

About MicroCapital

MicroCapital is a news and research initiative on international microfinance investment housed in Prisma MicroFinance, a for-profit microfinance institution (MFI). Since microfinance is currently dominated by governments and charities, objective information with a business orientation is scarce and buried under academic jargon. We seek to provide candid information on microfinance as an emerging investment class. Feedback is welcomed. Special thanks to Timothy S. Mech and Grove City College for this publication.

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