

# Microfinance: an attractive dual return investment opportunity

Raimar Dieckmann, Senior Economist, Deutsche Bank AG

Socially responsible investments (SRIs) are increasingly gaining investors' attention today. Between 1995 and 2007, U.S. investment in SRIs more than quadrupled from U.S.\$639 bln to U.S.\$2.7 tln<sup>1</sup>. European SRIs doubled from €501 bln to €1.0 tln in the 2003-2006 period<sup>2</sup>. These impressive growth rates show the rising importance investors place on the social and environmental effects of their investments. Amongst the plethora of SRIs, investments in the microfinance sub-sector are currently becoming popular with institutional and individual investors.

## From village to global success

Modern microfinance derives from micro-lending initiatives in South Asia and Latin America in the mid-1970s, but it was not until the early 1990s that a small part of the micro-lending business started to transform from being donor-oriented to becoming formally regulated financial institutions and to offer microfinance services. Microfinance is nowadays considered to be a key factor in reducing poverty in both developing and developed countries. The United Nations proclaimed 2005 the "International year of Microcredit," recognizing microcredits for their unique bottom-up approach, which stands in stark contrast to the typical top-down methods of traditional development initiatives. In 2006, Professor Muhammad Yunus and the Grameen Bank were awarded the Nobel Peace Prize for their "efforts to create economic and social development from below." The Nobel committee honored the contribution microcredit has made to the advance of democracy and human rights worldwide.

## Microfinance at a glance

Microfinance is an umbrella term describing the provision of banking services by poverty-focused financial institutions (microfinance institutions – MFIs) to the working poor in developing countries who are not served by mainstream financial services providers. World Bank figures state that approximately 1.4 bln people have to live on less than U.S.\$1.25 a day, while 2.6 bln people – roughly 40% of the global population – have to make a living with less than U.S.\$2

per day<sup>3</sup>. The core service of microfinance is the provision of microcredits, typically ranging from first loans of just below U.S.\$100 to several times this amount in the course of time, depending on the geographic region (Figures 1 and 2). Micro-lending recognizes that the working poor are able to act in an entrepreneurial manner and are thus, in principle, creditworthy. As loan sharks charging interest rates of up to 1000% p.a. are typically the only source of credit for the poor in developing countries, MFIs offer an attractive alternative, since they only charge between 15% and 70% p.a. These interest rates still seem high in comparison to those in developed countries, but up to two-thirds of the interest revenue goes into administrative costs and there is also a higher need for risk provisioning. Loans are mainly handed out to women, especially in Asia, where the share of female debtors is as high as 99% [Deutsche Bank Research (2007)]<sup>4</sup>.

## Microfinance institutions

Globally, it is estimated that a total of over 10,000 MFIs exist, made up of various forms of organizations, such as credit unions, NGOs, cooperatives, government agencies, private and commercial banks, and various permutations of these forms. The funding situations of the MFIs differ widely and can roughly be divided into four tiers by the level of commercialization reached by the respective MFI. The top tier consists of MFIs which have developed more formal structures and which are already attracting the attention of commercial banks and private and institutional investors. They are usually profitable and are run by an experienced management team, and account for 1 to 2% of the MFI market. The second tier is made up of smaller, younger MFIs. They are typically NGOs currently transforming into regulated MFIs. This group accounts for around 8% of MFIs. The third tier includes mainly NGO MFIs which are in the process of approaching profitability while suffering from a lack of funding. These institutions account for around 20% of the MFI universe. Fourth-tier institutions, which account for around 70% of the MFIs, are start-ups or entities whose main focus is not on microfinance [Deutsche Bank Research (2007)].

## Loan volume, funding sources, and funding structures of MFIs

Driven by the increasing access of leading MFIs to commercial funding sources, the volume of total microfinance loans has risen considerably, up from U.S.\$4 bln in 2001 to an estimated U.S.\$25 bln in 2006. Global assets of MFIs were estimated to total U.S.\$35.2 bln in 2006<sup>5</sup>. Start-up MFIs are characterized by a larger dependency on donations in the form of equity grants and technical assistance, while the more advanced MFIs tend to turn to debt financing through domestic or foreign borrowing. The most advanced tier-1 MFIs use domestic deposits and debt financing, with some even accessing capital markets by issuing bonds, going public, or securitizing their loan portfolios. Issuing equity is the costliest source of finance for MFIs, followed by unsecured and subordinated debt, while retail

Region	Borrowers (million)	Percentage of total
East Asia and Pacific	15.4	20%
Eastern Europe and Central Asia	1.8	2%
Latin America and the Caribbean	11.2	15%
Middle East and North Africa	1.8	2%
South Asia	38.9	51%
Sub-Saharan Africa	7.7	10%

Based on a sample of 2207 MFIs in 2007, The MIX

Figure 1 - Borrowers per region (based on a sample of 78.9 million)

Region	Eastern Europe and Central Asia	Africa	Latin America and Caribbean	Middle East and North Africa	Asia
Average loan	1597	235	678	263	149

Figure 2 - Average loan size (U.S.\$ 2006)

1 Social Investment Forum, 2008, "Report on socially responsible investment trends in the United States," Washington  
 2 European Investment Forum, 2007, "European SRI study 2006," Paris  
 3 World Bank Development Research Group, 2008, "The developing world is poorer than we thought, but no less successful in the fight against poverty," Policy Research Paper 4703

4 Deutsche Bank Research, 2007, "Microfinance: an emerging investment opportunity," Frankfurt  
 5 Gonzalez, A., 2008, "Selected microfinance indicators," www.themix.org

deposits are reported to be the cheapest funding source. Foreign funding is prone to currency risks. The maturity of each funding instrument has also to be taken into consideration. However, in the long run and from a normative point of view it would be desirable for MFIs to refinance themselves primarily from domestic funding sources, as the ultimate goal of developing financial markets and developing countries is to create an efficient exchange between domestic borrowers and domestic lenders. Foreign investors would then change their role from providing loans to buying an MFI's domestic bonds or shares.

### Transformation of MFIs and other risks in microfinance

Currently, an increasing number of MFIs are transforming themselves into regulated MFIs or even niche banks. While this process allows MFIs to improve their access to funding by taking deposits and to expand their client base, incorporation as a regulated entity also entails risks of inappropriate management and governance systems. In practice, internal control systems of MFIs are often not well equipped for this transformation and enhanced regulatory requirements often pose additional challenges. In rare cases, MFIs even drift away from their original target, which is the low-income customer base. Other MFIs have moved upmarket, serving the growing financial needs of middle-income clients. By doing so, they often enter into direct competition with traditional retail or commercial banks. A recent survey conducted by CSFI and sponsored by CGAP and Citi confirmed these conclusions and ranked poor management and corporate governance structures as the greatest current risks in microfinance.<sup>6</sup>

The strong rise in private-sector investments also entails some risks, as foreign investments are concentrated on the 200 largest MFIs. In addition, they focus on the well developed microfinance markets in Latin America and South Asia, leaving African and other Asian markets underdeveloped. This situation leads to risks for investors as some MFIs expand their client base too rapidly, potentially impairing the quality of their loan portfolios as a result. In addition, strong competition amongst leading MFIs drives down not only interest rates for MFIs but also those charged by MFIs to micro-borrowers. While this is at first glance good news it might also impede MFIs' profitability and, thus, ultimately their ability to repay loans to foreign investors. Consequently, risk-adjusted returns become less attractive in some countries and the increased leverage ratios of MFIs point to limits on further borrowing in certain markets. This situation will ease in the medium term when a broader range of (tier-2) MFIs will become capable of absorbing foreign debt finance.

### Social versus commercial orientation of microfinance

In light of the aforementioned developments, the debate on whether microfinance should be considered a purely philanthropic business concept that primarily relies on donor money and development aid or a commercially viable business concept gained addi-

tional momentum in 2008. For example, Nobel laureate Dr. Yunus warned about the consequences of a further commercialization of microfinance. However, as the current substantial funding gap cannot be overcome without the increasing involvement of private-sector investors a careful balance between social and financial returns seems to be a pragmatic solution to this debate. This could, for example, be achieved through the introduction of a code of conduct for foreign investors. In April 2008, the first steps towards such a code of conduct were made with the 'Pocantico declaration,' which was signed by, among others, CGAP and Deutsche Bank<sup>7</sup>. This declaration stipulates a set of core principles that aim at balancing social and financial return considerations and constitutes a good starting point towards a code of conduct.

### Large funding gap

Although MFIs' customer base is experiencing rapid growth (23% in 2006), estimates are that only 80 to 100 million, out of over 500 million potential micro-borrowers, currently have access to micro-loans. Untapped demand is unevenly distributed around the globe, as the penetration rate in Bangladesh has already reached 35%, while it is as little as 2 to 3% in India, Brazil, and Nigeria<sup>8</sup>. To fully satisfy demand, experts estimate that a total funding mix of debt, subordinated debt, equity, deposits, and guarantees for MFIs of approximately U.S.\$250 bln to U.S.\$300 bln is theoretically needed [Deutsche Bank Research (2007)].

### Strong increase in foreign investments

There are two main types of foreign investors that provide the lion's share of foreign funding to MFIs. The first type consists of international financial institutions (IFIs) such as the KfW, the EBRD, or the IFC, which invested an estimated U.S.\$3.0 bln in 2007, as compared to U.S.\$2.5 bln in 2006. The largest market shares are held by the KfW (29%), followed by the EBRD (13%), and IFC (12%). The second type includes private-sector investors made up of NGOs, individual donors, foundations, high net worth individuals, pension funds, and other institutional investors. This group had invested an estimated U.S.\$2.7 bln by the end of 2007, compared to U.S.\$2.0 bln in 2006. Recent investments include the U.S. pension fund TIAA-CREF's allocation of up to U.S.\$100 mln, or that of eBay founder Pierre Omidyar, who invested U.S.\$100 mln in the Omidyar-Tufts Microfinance Fund [Reille and Forster (2008)]<sup>9</sup>.

	2004	2006	2007
<b>Private sector investments</b>			
MIV portfolio	0.637	2.0	3.7
<b>Investments of IFIs</b>			
IFI portfolio	1.1	2.2	3

Source: CGAP, 2007 figures are estimates

Figure 3 - Investments in microfinance (U.S.\$ bln)

6 CSFI, 2008, "Microfinance banana skins 2008: risk in a booming industry," www.cfsi.org.uk

7 Available for download at www. http://www.deutsche-bank.de/de/downloads/company/the\_pocantico\_declaration\_final\_0515b.pdf

8 Gonzalez, A., 2007, "How many Borrowers and Microfinance Institutions (MFIs) exist?" www.themix.org

9 Reille, X., and S. Forster, 2008, "Foreign capital investment in microfinance," www.cgap.org

## Microfinance investment products and strategies

During the last few years, the market for microfinance investment products has grown rapidly. It is estimated that around 92 different investment vehicles and funds existed in 2007, half of which were created in the previous three years. Investment products include a large range of legal forms such as registered mutual funds, specialized investment funds, various forms of structured products, or even holding structures. They all make use of a variety of debt, mezzanine finance, equity, and guarantees. Hence, the umbrella term of microfinance investment vehicles (MIVs) seems to be more appropriate to describe various funding structures. One thing that all MIVs have in common is that they strongly rely on the provision of debt finance to MFIs. Debt finance is still the core service of all investment products with an estimated volume of around 80%.

The ten largest MIVs account for 67% of the market. The first rank is taken by the holding company ProCredit, followed by the member-based fund organization Oikocredit, and the public-private partnership EFSE. The largest registered mutual investment funds are the Dexia Microcredit Fund and the responsAbility Global Microfinance Fund, while the largest CDOs have been issued by BlueOrchard and Deutsche Bank. While registered mutual funds offer investors only one risk-return profile, which is close to money market returns, structured investment products are made up of tranches offering different investors different risk-return profiles. CGAP estimates that fixed-income funds achieve average performances that are close to money market returns, in euro terms around 3.2% [Reille and Forster (2008)]. With market conditions as of July 2007, an investment-grade-rated senior tranche might yield a coupon of around 6% p.a., while the mezzanine tranche comes with a coupon of 9.5% p.a. [Deutsche Bank Research (2007)]. When comparing these two types of products investors need to bear in mind that funds can often be redeemed on a monthly basis while structured products usually have a fixed maturity. IFIs honoring their social mandate will go for the junior first-loss tranches, while

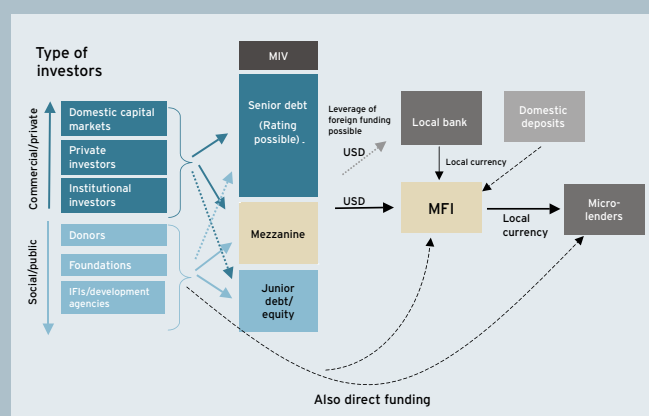


Figure 4 - Stylized deal structure of structured debt instruments  
Source: DB Research

more risk-averse or financial-returns-oriented private investors will buy into senior tranches. Recently, equity investments have also risen substantially, but their total investment volume is still small. Up until now, MFIs have rarely gained direct access to capital markets by issuing shares or debt instruments. However, Mexican MFI Banco Compartamos was oversubscribed 13 times when it went public in 2006 and it is reported that some MFIs, such as ProCredit, India's SKS, and Independencia of Mexico, are currently evaluating the possibility of IPOs.

## Impacts from current financial market turmoil

The financial crisis that started a year ago is also impacting structured microfinance investment products. Some investors have become reluctant to invest in the riskier parts of structured products and others demand a higher risk premium. This situation has led to a slight increase in interest rates charged to MFIs by MIVs. In contrast to structured investment products, mutual funds have benefited from some investors' reluctance to invest in structured investment vehicles and, hence, reported a strong rise in fresh money between the second half of 2007 and the first half of 2008. Currently, some market participants are in the process of preparing the launch of new structured investment products.

## Risk-return profile and potential for portfolio optimization

MFI investments are characterized by a dual return profile, i.e., social and financial returns. In a sample of around 704 MFIs, the leading 176 MFIs exhibited an RoE of 17.2%, outperforming even conventional banks in some countries. In addition, these returns are largely stable over the economic cycle and default rates of MFI loan portfolios in the sample were lower than those of commercial banks in the respective countries, with MFIs suffering an average loan write-off ratio of only 1.1% in 2006<sup>10</sup>. Some preliminary findings<sup>11</sup> indicate that microfinance investments exhibit very low correlations with the returns from mainstream capital markets, especially in comparison to the returns produced by conventional banks. MFIs follow a substantially different business model than conventional (retail) banks. Their clients are by definition less integrated into the formal economy and micro-borrowers primarily rely on domestic products and services, leaving them widely unaffected by currency fluctuations influencing the prices of imports. Microcredits also have a shorter maturity and installments are usually paid weekly or bi-weekly, allowing for careful monitoring and adjustment of lending practices by MFIs. However, investors need to bear in mind that this low correlation might rise over time as regulated MFIs become more integrated into the mainstream financial sector [Deutsche Bank Research (2007)].

With regard to risk, MFI investments are medium- to long-term emerging market plays that bear risks inherent to the nature of the microfinance sector as well as country risks associated with devel-

10 The MIX, 2007, "2006 MFI Benchmarks", MicroBankingBulletin Issue No. 15

11 Walter, I. and N. Krauss, 2008, "Can microfinance reduce portfolio volatility?", available at SSRN: <http://ssrn.com/abstract=943786>

oping markets. Risks affecting microfinance investments emerge from lower standards of financial reporting, greater political instability, exchange rate controls, currency devaluations, liquidity crunches, and restrictions on capital transfers or foreign investments. MIVs have various risk characteristics as they are illiquid instruments, sometimes without recurrent dividends or yields. Usually, they are also not listed on a regulated market or stock exchange and therefore do not have a market price tag.

### Retail investors with untapped potential

At present, most retail investors are based in Switzerland, Germany, and the Netherlands. However due to stringent legal requirements in many countries such as Germany, most registered mutual funds can only be offered on a private placement basis and, hence, are often not available to the mass of retail clients. For example, despite a recent change in the German retail investment fund law that introduced microfinance as a new fund class, no such fund has been launched so far as the legal requirements for eligible assets are too restrictive. However, the success of various social investment managers like responsAbility (AuM of U.S.\$298 mln in H1 2008), Dexia (Microcredit Fund with AuM of U.S.\$400 mln in September 2008) or Oikocredit (AuM of €255 mln in H1 2008) clearly point to the potential of retail investments. Even social investment platforms like Kiva already have a total loan volume of U.S.\$49 mln. To sum up, if retail investors were granted access to fully regulated financial products in countries like Germany, retail investment volumes would be several times this amount.

### Medium-term outlook on microfinance investments

Scaling up microfinance in terms of increasing the involvement of private-sector investors is a key medium-term priority. Despite the current financial market turmoil, the market for microfinance investments is largely unaffected except for increases in the minimum return demanded by investors in structured products. Private-sector involvement is expected to increase to around U.S.\$20 bln by 2015 and to exceed IFI funding volume in the long-run, mainly driven by institutional and retail investor demand, regulatory changes, and the enhanced capability of MFIs to absorb commercial funding.

The following medium-term trends are expected to benefit the microfinance sector [Deutsche Bank Research (2007)]: an increas-

	Return on equity of most advanced MFIs (%)	Write-off ratio of MFIs loan portfolios (%)
Asia	18.9	0.70
ECA	16.6	0.50
LAC	20.7	1.80
MENA	8.1	0.50
Africa	8.6	1.90

Source: 2006 MFI benchmarks by The MIX

Figure 5 - Risks and returns of MFI investments

	2004	2007	2015
International financial institutions	1.1	3.0	5.0
Private sector investments	0.6	2.7	20.0

Source: DB Research

Figure 6 - Forecast of private investments in microfinance

ing number of private-sector investors will become attracted to microfinance investments thanks to their dual nature and/or their attractive risk-return profile (this trend is expected to be reinforced by a general rise in SRIs); changes in the regulatory framework will bring more retail investors to the market and make microfinance investments increasingly a mainstream investment product, as evidenced by the recent changes made to the German investment fund law; joint investment activities of public and private investors will foster private sector investments, with public investments acting as a multiplier for private sector investments and 'crowding in' additional non-public investors; structured debt instruments will attract further risk-averse commercial investors who can reduce their risk by purchasing senior notes of a structured debt product; private institutional investors such as pension funds, insurance companies, or trusts will discover microfinance as an attractive supplement for their portfolios; and when the microfinance industry reaches maturity, a critical mass of MFIs can be expected to become capable of absorbing commercial funding and channeling it effectively to micro-borrowers.

### Poverty alleviation requires a broader long-term investment approach

Microfinance is a key tool when it comes to alleviating poverty. However, in the long run, social investors shall consider taking a broader approach to their investments, since microfinance is in itself not sufficient to reduce poverty and improve living conditions in developing and emerging countries. Rather, a more systematic approach to socially responsible investments will be needed that also includes areas such as health systems, education, energy supply, infrastructure, climate change, and SME finance in developing countries. The market for microfinance investments might serve as the guiding light for these endeavors as many joint transactions were carried out very successfully in this area in the past and the cooperation between private-sector investors and IFIs was in many cases very successful. The attainment of the U.N.'s Millennium Development Goals might also be fostered by this approach and while investors would benefit from a range of new (social) investment opportunities, IFIs could at the same time lever development aid.

## Conclusion

The microfinance sector is currently undergoing a significant transformation from a traditional, donor-driven NGO-dominated framework towards a greater degree of capital market involvement while at the same time sticking to its original mission of poverty alleviation and social development. Private-sector investors are needed to narrow and close the immense funding gap. Microfinance offers investors an attractive dual-nature investment opportunity and appealing risk-return ratios, stable financial returns, and potentially low correlations to mainstream capital markets. However, investors also need to consider various risks that result from the transformation of many MFIs, the concentration of large capital inflows to tier-1 MFIs leading to limited investment opportunities, increased risk compensation in the market for structured products, and a debate on whether microfinance shall be considered a social or commercial business concept. In normative terms, it is a good idea to aim for the full development of local financial systems, as they would

enable MFIs to refinance themselves from retail deposits, bank loans, and domestic capital markets. Fortunately, retail deposits are gradually gaining in importance.

For the time being, microfinance will constitute an emerging investment opportunity that institutional and individual investors have only just started to explore. But it is reasonable to expect that by 2015 private-sector investors will have raised their investments in microfinance significantly to around U.S.\$20 bln. This forecast is based on the following assumptions, with which I will conclude this article. First, microfinance will gradually become an established niche investment product that will increasingly attract retail investors and benefit from a general strong rise in SRIs. Second, it will appeal to a wider range of retail investors in the long run and to additional institutional investors as it might even be conducive to efficient portfolio diversification. Third, a critical mass of MFIs will become capable over time of absorbing foreign funding.