

new horizons: creating value, enabling livelihoods



**opportunities in microfinance
for the UK financial services sector**



acknowledgements

Forum for the Future would like to thank all the individuals who contributed to this project through providing interviews or participating in the workshop in October 2006.

This project has been supported by:



The Defra support came through funding from the Implementation Fund of the World Summit on Sustainable Development

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list of abbreviations

AECI-ICO	– Spanish development finance
ATM	– Automatic Teller Machine
BOMFS	– Blue Orchard Microfinance Securities
BOLD	– Blue Orchard Loans for Development
CGAP	– Consultative Group to Assist the Poor (microfinance resource centre hosted at the World Bank)
CDO	– Collateralised Debt Obligation
DFID	– Department for International Development
EBRD	– European Bank for Reconstruction and Development
FMO	– Netherlands Development Finance Company
IFC	– International Finance Corporation
KfW	– German development finance (part of KfW Bankengruppe)
LIBOR	– London Inter-bank Borrowing Rate
OPIC	– Overseas Private Investment Corporation
MFI	– Microfinance Institution
MIV	– Microfinance Investment Vehicle
NGO	– Non-Governmental Organisation
SRI	– Socially Responsible Investment

June 2007

All dollar figures (\$) used in this report refer to United States Dollars.

1 introduction

Microfinance used to be known as a basic banking model for villages in the developing world. It had no connection with the fast-moving capital markets, private equity funds and giant banking groups that make up the modern financial sector. But the two worlds are now starting to converge. From Citigroup's growing global microfinance business to Morgan Stanley's placement of AA-rated structured instruments in the mainstream markets, from Vodafone's experimentation with mobile banking to venture capital investment by Sequoia Capital – the firm behind Google and Yahoo – a wave of innovation is transforming the microfinance sector.

These are early days, but more and more opportunities are emerging for mainstream players to get involved. The full potential of the sector is estimated at \$300 billion, pointing to a huge reservoir of untapped commercial and human development returns.

This summary paper¹ provides an insight into this emerging trend. It gives examples of innovations in products, processes and market mechanisms that are giving poor communities increased access to financial services. It also explores the potential for a UK financial sector initiative to accelerate the development of the microfinance industry.

Forum for the Future is exploring how profit-seeking capital can increasingly be allocated to activities that provide environmental or social returns in addition to financial return. Microfinance is among the most dynamic areas of progress but is certainly not the only one. Further work will look to apply similar innovative techniques and models to a much broader set of activities.²

1.1 the microfinance model

Around 2.5 billion people do not have access to formal financial services that help to grow incomes, accumulate wealth and manage risk. Microfinance has emerged as a successful bottom-up phenomenon that has demonstrated that the poor are a low credit risk and can be served profitably.

Microfinance broadly refers to the provision of credit and other financial services to low-income clients in small increments, with affordable service charges.

Microcredit – the provision of small loans (usually under \$200) without formal collateral – is the most well known form of microfinance product. But the sector also extends to savings, insurance, payment transfer and remittance services. Microfinance institutions (MFIs) range from small-scale NGOs to major banks. Some of the key differences between microfinance and mainstream finance models are outlined in the table below.

table 1. Main differences between mainstream finance and microfinance

	Product range	Lending model	Organisational status
Mainstream finance	Comprehensive product portfolio based on higher-value transactions. Competitive transaction costs and interest rates.	Mostly built on collateral-based lending. Use of sophisticated credit scoring systems. Individual and enterprise lending.	Formal regulated institutions, with a wide variety of local, national and international entities. Use of strong management information, technology and risk management systems.
Microfinance	Limited products concentrated on credit but increasingly offering other services. Uses low-value, high-volume model. Very high costs because of transaction-intensive business model, leading to high interest rates.	No need for formal collateral. MFIs use group lending to provide social collateral but increasingly lend to individual and micro-enterprise clients. Short loan cycle (6-12 months) with weekly payments.	Diverse range, from small NGOs through to formal bank status. Most use little or no technology, have rudimentary information systems and lack financial sophistication.

Several studies have shown how the financial picture can improve for individuals, households and enterprises as microfinance boosts entrepreneurial activity and enables people to spend money on education, nutrition or healthcare. But microfinance is not a magic solution to poverty, nor is it an automatic enabler of higher living standards. An exhaustive survey of impact assessments found that much depended on the type of services offered, client profiles and the regional environment.³

Successful microfinance can help the poor enhance incomes, manage risk and create wealth. But to do so it needs an enabling environment. It is dependent both on industry-specific factors – interest rate caps, financial regulation, foreign investment rules – and on wider social and economic influences, such as the general rule of law, functioning economic systems and viable income generation opportunities.

Microfinance institutions range from small-scale NGOs to major banks.

1.2 commercialisation needed to scale up the sector

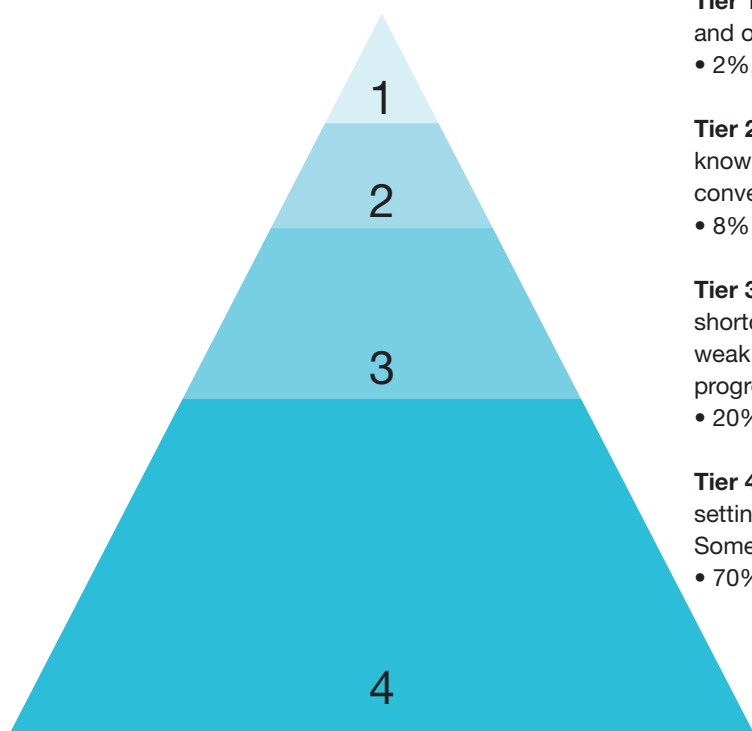
The microfinance sector is attracting increasing global attention – including the award of the 2006 Nobel peace prize to Muhammad Yunus and the Grameen Bank of Bangladesh. But it still lacks capacity and capital to meet the latent demand for financial services. At best the industry is currently meeting only about 10 per cent of a potential demand of \$300 billion, mainly through the provision of credit. Products such as insurance and remittances are particularly under-developed.

The sector is also highly fragmented. The ‘tier-1’ MFIs – an exclusive club of 75-100 organisations - have developed an excellent track record that compares favourably with mainstream financial institutions. They tend to be characterised by high growth rates, a good product portfolio, strong profitability, low default risk, robust Management Information Systems and access to commercial funding sources. A return on equity of above 20 per cent is common, and average default rates are only 3 per cent. Some studies report that many top MFIs outperform local banks in terms of return on equity.⁴

However, the majority of the industry is at the other end of the spectrum – very small scale, with weak balance sheets, inefficient operating systems and a complete reliance on grant funding. Only 11 per cent of MFIs have more than 10,000 clients, while 73 per cent have under 2,500.⁵

The microfinance business model has shown itself to be sound, but it needs to professionalise to realise scale and operating efficiencies. Interest rates are unsustainably high in a mainstream context – ranging from 30 to over 100 per cent annually. This may compare favourably to the rates charged by local money lenders but it is clear that reducing the high costs both of capital and of administering services is essential.

figure 1. The microfinance sector is highly fragmented



Tier 1: Mature and best-known MFIs with strong financial and operational track record. Most are regulated.

- 2%, at most, of all MFIs, the “top 50 or 100”.

Tier 2: Successful but smaller, younger, or simply less well known MFIs. At or near profitability. Mostly NGOs; consider conversion. Majority will progress up.

- 8% of all MFIs.

Tier 3: Approaching profitability. Understandable shortcomings due to young organization, lack of capital, weak MIS or other needs. Nearly all NGOs. Some will progress up.

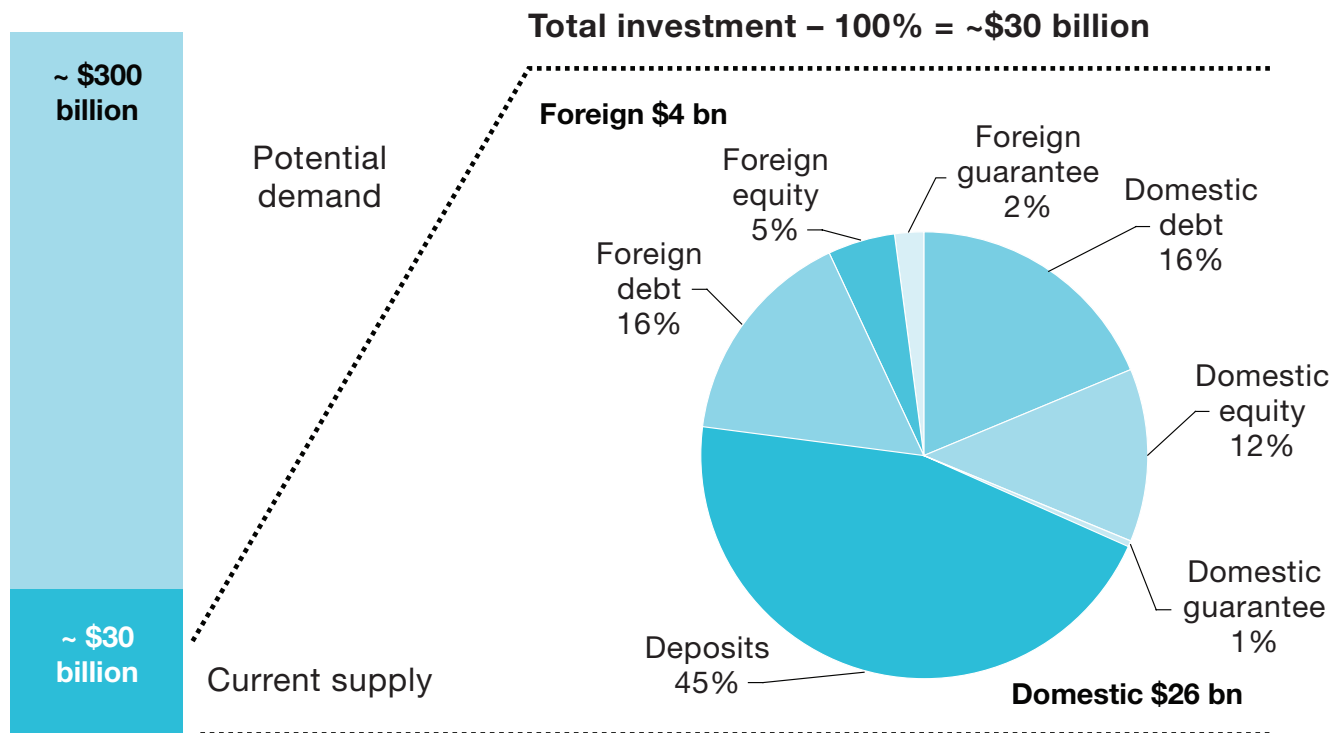
- 20% of all MFIs.

Tier 4: Mix of unprofitable MFIs: start-ups, post-conflict settings, weak institutions or microfinance is not focus. Some will progress up.

- 70% of all MFIs.

Source: Jennifer Meehan, Tapping Financial Markets for Microfinance', Grameen Foundation USA, 2004.

figure 2. The microfinance industry is only meeting a fraction of total demand



Source: CGAP, McKinsey estimates. This refers to a very broad estimate of the total microloan portfolio including government-run institutions.

The exact scale of the industry is difficult to assess. Information systems are weak, and data sources conflict. One calculation produced an estimate of \$30 billion including broad government-run programmes. Another analysis from a commercial perspective estimated \$8 billion outstanding in microloan portfolios in 2005, forecast to grow to \$20 billion by 2008.⁶

Despite such wide disparities most sources confirm a strong growth trend, with a rapid increase in borrowers, loan portfolios and the number of MFIs. One study found explosive growth in tier-1 MFIs across all regions. Among a sample of 71 MFIs total assets grew by 191 per cent to \$6.7 billion between 2004 and 2006. Total equity increased by 122 per cent to \$791 million, loan portfolios by 231 per cent to \$4.8 billion and the number of borrowers by 73 per cent to four million.⁷

An increasing number of industry experts argue that microfinance needs to access commercial capital to unleash its full potential. The estimated capital

requirement of \$270 billion to meet potential demand – \$45 billion in equity and \$225 billion debt assuming a 5:1 leverage – will not be met by donor funds or philanthropists alone. Total Official Development Assistance – including all emergency aid, debt relief, bilateral and multilateral funds – was about \$100 billion in 2005.⁸ This capital gap is likely to grow, as particularly high rates of population increase are anticipated among lower-income groups.

It is essential to expand the tier-1 and tier-2 MFI base significantly by building institutional capacity and seeding new commercial MFIs. Without this the industry will not be able to scale up and improve absorptive capacity for debt and equity capital. Continuing the current trend of focusing private and public investment on a handful of tier-1 institutions could have dangerous consequences, leaving the majority of smaller-scale MFIs to stagnate and decline.

microfinance and international banks

A wide range of global and regional banking groups is getting involved in microfinance to test the waters. Only Citigroup and ICICI Bank (an Indian bank expanding globally) seem to be developing comprehensive commercially driven strategies.

Wholesale loans to MFIs by a set of international banks were estimated to amount to between \$450 and \$550 million in 2006 – a \$100 million increase over 2005.

ABN Amro is building a strong microfinance business through its local subsidiaries in Brazil and India, focusing on wholesale loans and services to MFIs but also investing in microfinance venture funds and pursuing strategic partnerships.

Barclays has a small microbanking service in Ghana but a large retail presence in South Africa through its subsidiary ABSA, which has 4.3 million low-income clients.

Citigroup has a dedicated Microfinance Group which works across the global business. It forms commercial relationships with MFIs, develops products, creates financing facilities and facilitates capital market transactions - particularly in local markets. It is pursuing a partnership model with MFIs.

Deutsche Bank manages a number of global microfinance funds that offer tailored funding options for MFIs, including guarantees, long-term local currency funding through co-lending, letters of credit and credit default swaps.

HSBC is piloting projects to provide wholesale services to MFIs, including loans, transaction and remittance services. It aims to embed microfinance within local subsidiaries.

ICICI Bank pioneered the partnership model in India and is aggressively pursuing a multi-pronged microfinance strategy that includes product development, use of new technologies and a comprehensive technical assessment and seed capital programme. ICICI has innovated in launching new products, including life and crop insurance, and is piloting a new internet-enabled rural agent banking model.

Standard Chartered offers wholesale loans to MFIs in Africa and Asia. The current portfolio is around \$50 million but it is establishing a \$500 million facility to disburse funds over five years in Africa and Asia. It also has equity stakes in a couple of Asian MFIs.

Source: ING 'A billion to gain: Update' 2006, ICICI, Citigroup

Some global banks' microfinance strategies are no longer philanthropy but core business development and opportunity.

There is some concern that the donor and philanthropic community is crowding out private sector investment by allocating soft funds to strong tier-1 MFIs that can access commercial sources of capital.⁹ Donor and philanthropic support needs to be directed primarily to weaker and less commercially appealing organisations. In this way it can be used to leverage private sector funding and can be invested in public goods and an enabling infrastructure for the microfinance industry.

The main public agencies active in international funding are the development-finance institutions – both multilaterals such as the International Finance Corporation (IFC) and those from individual countries such as KfW (Germany) and OPIC (United States). These institutions held a combined microfinance portfolio of \$2.3 billion in 2006. Just five accounted for 75 per cent - KfW (Germany), AECI-ICO (Spain), IFC (multilateral), OPIC (United States) and EBRD (multilateral).¹⁰ DFID, the UK government agency, promotes microfinance within a broader financial sector strategy. It is moving away from directly funding MFIs to providing support for financial infrastructure and capacity building.¹¹

In the medium term, the major portion of the capital requirement is likely to be provided by domestic sources – including savings, commercial bank loans, retained MFI earnings and domestic debt and equity investors. But this is currently happening only in a few isolated cases, with strong MFIs that are legally able to take deposits, and in active local capital markets. Domestic funding, particularly in low income nations, is unlikely to grow fast enough to meet demand without capital from international investors.

1.3 the role of international commercial players

The commercial involvement of international institutions can act as a catalyst to professionalise and scale up the microfinance industry while providing value for mainstream participants. MFIs stand to gain access to a much larger pool of more flexible risk capital, often at lower interest rates than those available through commercial loans from domestic banks. Potential benefits also include opportunities to leverage domestic funding, access to equity investment, market discipline, formalisation, an expanded product portfolio and technical assistance.

The advantages for international commercial financial institutions vary according to business objectives and strategic intent. For large global banking and insurance groups seeking growth opportunities in emerging markets in the mid to long term, early involvement in microfinance will provide market intelligence and access to a potentially massive future customer base.

Commercial involvement in microfinance is increasing. From initial forays prompted by philanthropy or corporate social responsibility concerns, some institutions are implementing increasingly sophisticated strategies to approach microfinance as a business opportunity. Commercial players are looking at ways to provide capital and deliver financial services through employing new techniques, technologies and business models. For those examining microfinance through a commercial lens, this report sets out innovations that are transforming the industry landscape in three main areas – investment, product development and technical assistance.

2 capital markets and investment

A diverse range of investment vehicles has emerged to channel private and public capital into microfinance institutions. The variety of organisational structures – traditional funds, structured instruments such as collateralised debt obligations (CDOs), finance companies – reflects the lack of an industry consensus as yet on performance standards and structures.¹²

Microfinance investment vehicles (MIVs) are growing fast – at 233 per cent between 2004 and 2006 – to about \$2 billion. But there are several challenges to overcome if they are to become viable commercial investment propositions. Although this is

starting to change, the dominant investment model currently involves short-term foreign currency debt to a narrow set of elite microfinance institutions, where foreign exchange risks are borne by the MFI and not hedged effectively. There are no standard performance metrics, transparency is poor and most MIVs of this kind do not offer market-rate returns. This forces them to rely on donors and social investors. There is a real need for funding solutions that can provide longer-term debt and equity funding in local currency to a broad range of MFIs beyond the top tier. Some new initiatives such as Minlam and Locfund are trying to focus on local currency lending.

figure 3. Growth in the microfinance investment vehicle universe

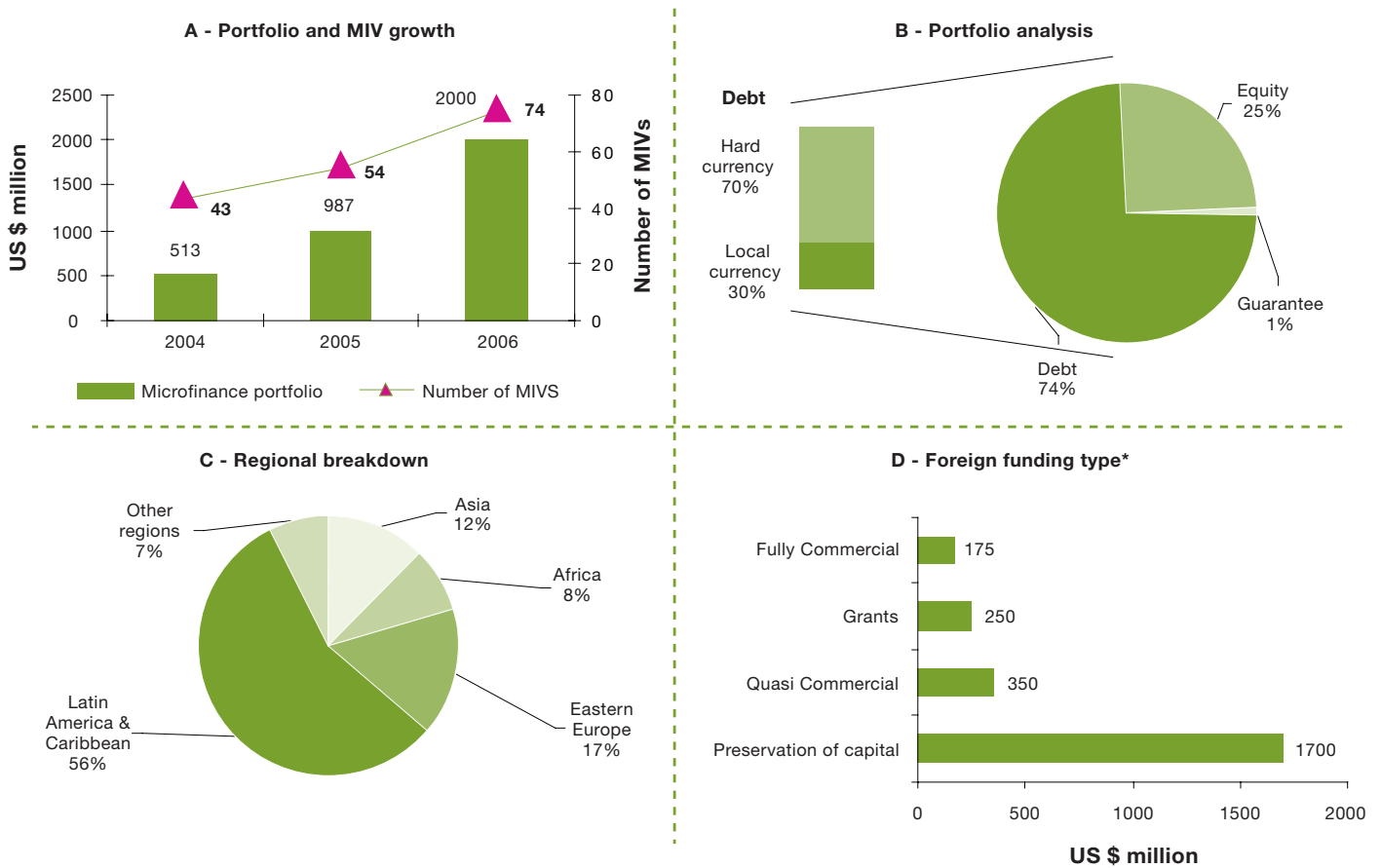
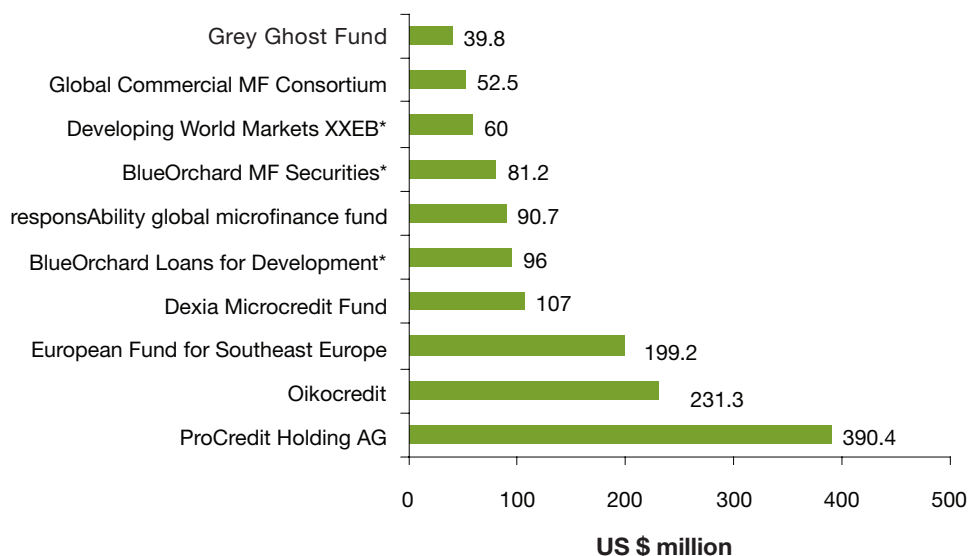


Chart A and B from CGAP 2007. Chart C refers to 14 largest MIVs. Source: Microrate 2006. *Note chart D refers to overall foreign funding including MIVs and direct donor and foundation investments. Source: McKinsey 2006.

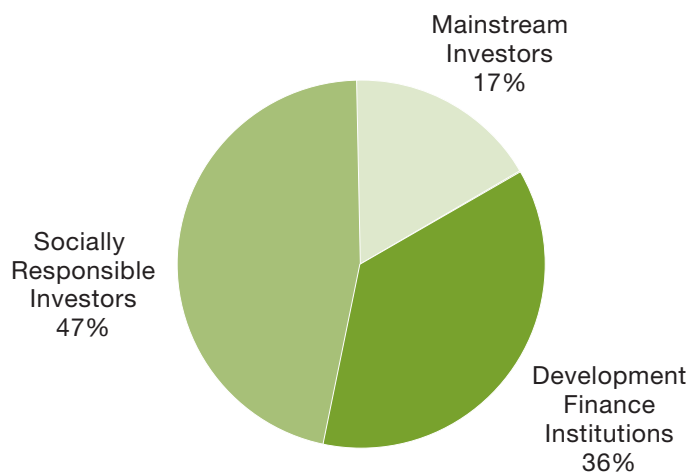
Most MIVs are relatively small. This makes it difficult to absorb management costs. 86 per cent have less than \$20 million under management, while only 8 per cent have more than \$50 million. The top ten account for 67 per cent of total investments.¹³ The largest MIVs - ProCredit (a holding company for a group of 19 microfinance banks in Eastern Europe, Africa and Latin America based in Germany) and Oikocredit (a Dutch 30 year old privately owned cooperative society that offers investors a capped 2% dividend return) are mainly development MIVs but more commercially driven funds (such as Dexia) and CDOs are becoming increasingly important.

MIVs are also very reliant on funding from social investors and development finance institutions. 'Preservation of capital' investment - where investors want to protect their principal but do not demand market returns - dominates foreign microfinance funding both directly and through MIVs. Socially Responsible Investment (SRI) is a growing force in private MIVs, accounting for about 47 per cent of total investment. Seventy per cent of this comes from European investors with a wide variety of investment styles and return targets, from near-market rates through to minimal returns. Almost all MIVs - except for the CDOs which provide a range of risk-adjusted returns according to their tiered structure - offer sub-commercial returns of around 1-3 per cent. The more mature MIVs that focus on debt offer returns of between 2.6 and 5.1 per cent in US dollars.¹⁴

figure 4. (a) Top ten microfinance investment vehicles



(b) MIV investors by type



*Refers to collateralised debt obligations (CDOs). Does not include \$108 million Blue Orchard 2 issue in May 2007. Source: CGAP 2005 MIV Survey, CGAP 2007.

Some MIVs are trying to expand their investor base by creating investment propositions that will attract a wider range of commercial investors. One approach is to tap retail and high-net-worth investors. Dexia Microcredit Fund, a Luxembourg-registered mutual fund that is sponsored by the Belgian group Dexia, offers investment in US dollars, Swiss francs and Euros. It has grown to \$169 million in total assets since 1998.¹⁵ Credit Suisse is among the main sponsors of the responsibility global microfinance fund, which grew by 455 per cent in 2005 and now has a total fund volume of \$96 million.¹⁶

These registered funds can be distributed using traditional channels. They follow mainstream fund management processes, including daily or monthly pricing, and have International Security Identification Numbers. They are usually sponsored by well established mainstream commercial institutions, which provides credibility.

Efforts are being made across the industry to improve transparency and develop a standard set of disclosure guidelines. Although still at a draft stage, the proposed guidelines include a set of robust performance metrics, valuation procedures, cost structures and a classification scheme.¹⁷

2.1 the promise of new financing solutions

Innovations are emerging in both onshore funding (where the transaction is based solely in domestic jurisdictions) and offshore funding (where the transaction is across national borders). Bonds, guarantees and syndicated loan facilities are some of the main onshore innovations.

Some larger MFIs have successfully issued bonds in their local capital markets – mainly in Latin America, although Faulu in Kenya issued the first African microfinance bond in 2005. This approach is only viable where the MFI is large and profitable enough to attract local commercial investors and where local bond markets have developed far enough to facilitate transactions. The MFIs involved so far have used credit enhancement, investment grade ratings and an attractive return above the local benchmark to overcome investor suspicion of microfinance.

A shortage of domestic sources willing to capitalise MFIs has led to several initiatives in which an injection of foreign capital helps tap local funding. Loan guarantees function as a form of insurance, with the guarantor undertaking to pay an agreed portion of any defaults in order to mitigate credit risk to the lender.¹⁸ Guarantees are not always appropriate for all MFIs or countries, and can sometimes be more expensive and less catalytic than intended. But they can be powerful tools for leveraging guarantor capital, enabling local currency funding with low foreign exchange risk, and overcoming regulatory hurdles to foreign investment.¹⁹ The \$75 million Global Commercial Microfinance Consortium (GCMC) arranged by Deutsche Bank in 2005 is an interesting hybrid that uses structuring techniques to create tranches of debt with different risk-return characteristics and offers flexible funding to MFIs, including co-lending with domestic banks, use of deposits, and guarantees.

Some international banks, notably Citigroup, are pursuing an alternative funding strategy by developing syndicated loan and local currency funding facilities. A \$100 million term facility supported by a \$70 million guarantee by OPIC (a US government agency that provides guarantee services) will enable funding to a broader set of tier-1 and tier-2 MFIs through Citigroup's global branch network).

Innovation is emerging in onshore and offshore funding.

Structured finance techniques such as securitisation²⁰ have been used in offshore deals to tap international investment. But 'true' securitisations that aggregate and securitise microloan portfolios are rare in microfinance because of the complexity and poor data quality of the sector.²¹ The majority of instruments so far have used a CDO structure to pool together loans to a set of MFIs. The \$180 million securitisation of the microloan receivables of BRAC (a large MFI in Bangladesh) in 2006 is the first 'true' microfinance securitisation. FMO (Netherlands) and KfW (Germany) are the public agencies involved in the deal, with FMO providing a guarantee and investing in a third of the securities. Citigroup is acting as both co-arranger and investor. This is a landmark onshore transaction and the first securitisation in Bangladesh's capital markets. It may help enable other large MFIs to securitise their microloan portfolios in the future, or allow domestic banks to securitise their loan portfolios to MFIs.

In offshore deals the microfinance CDO model is becoming more standardised. These ground-breaking deals have introduced new tranching capital structures that enable a wider range of international commercial investors to invest in senior layers of microfinance debt. Social investors and development agencies, meanwhile, purchase the more risky 'junior' layers – and sometimes take on first loss positions.

In May 2007, Morgan Stanley arranged the first rated microfinance transaction for the international capital markets. Standard & Poor's assigned an AA rating to the top tranche sold to mainstream investors.

Over \$500 million of structured microfinance paper has been issued since 2004. A broad range of investors has bought into these instruments, including large institutions such as AXA and Standard Life, hedge funds, foundations and private investors. CDOs offer a range of risk-adjusted market returns. Senior-note investors are well protected and so are offered a narrow spread over the relevant benchmark while junior-layer investors receive higher returns for assuming more risk. The BOMFS transaction arranged by Blue Orchard and Developing World Markets, for example, offered 55 basis points over the benchmark for the senior notes, 8 per cent on the subordinated C notes and 12 per cent for equity. Deutsche Bank's GCMC offered LIBOR + 1.5% on senior notes and returns between 8 -12% on the three junior and equity tranches.

The \$108 million BOLD-2 transaction in May 2007, arranged by Morgan Stanley and Blue Orchard as a follow up to the \$98 million BOLD-1 in 2006, is a significant step forward because it is the first such instrument to be rated by a mainstream agency. Standard & Poor's, which has been working to develop a microfinance rating methodology, has assigned a preliminary AA (third highest) rating to the top tranche of \$42 million. This means that mainstream investors can now purchase this paper because it is risk weighted for Basel capital adequacy rules.

Standard & Poor's expects to rate two to three additional CDOs in 2007. This will deliver around \$500 million, and Morgan Stanley believes that annual microfinance CDO issues could reach \$3-4 billion in the next five to ten years.²² Deutsche Bank has announced plans for a \$200 million CDO on a similar model to the Global Commercial Microfinance Consortium in summer 2007.

These transactions could herald a healthy future for commercial investment in microfinance but there are still considerable challenges to overcome. Most rely on credit enhancement and the participation of public agencies to create an attractive product. Issues of documentation, small transaction size and a lack of industry data all need to be addressed. At the moment most of the mainstream involvement in these deals is primarily driven by reputation and brand concerns. Crucially, secondary markets do not yet exist for microfinance debt securities.

Cross-border CDOs also need to address the challenges of operating with tier-2 MFIs, managing country risk and providing local currency funding.²³ The recent BOLD issues used currency swaps provided by Morgan Stanley: for BOLD-1 20 per cent of the funding was in local currencies, including Mexican and Colombian pesos and Russian roubles. Reports of other local currency funding and currency hedging facilities in the pipeline are an encouraging sign of progress.

The products and structures are very diverse and not yet standardised, there is not enough volume, poor liquidity and a collective track record is yet to emerge. Most institutional investors require a defined asset class (where products have similar structures, enabling quantitative analysis and modelling) to fit into asset allocation decisions.²⁴

2.2 what about equity?

MFIs can only borrow up to a certain multiple of their total equity, so equity investment can help to strengthen balance sheets and raise additional debt. Equity ownership allows investors to exercise their influence through membership of boards of directors, enabling them to encourage best practice and support organisational capacity building. Equity funding also means fewer regular cash outflows for interest payments.

Equity investment makes up about 17 per cent of the \$30 billion microfinance portfolio. High risk, a lack of exit opportunities and the scarcity of publicly listed equity make investment difficult but the landscape is changing rapidly. In April 2007 Compartamos floated a third of its equity in Mexico in a \$407 million issue, 85 per cent of which was successfully placed in the international equity market by Credit Suisse.

Large mainstream players are also starting to purchase equity in successful MFIs. Standard Chartered recently took on equity stakes in MFIs in Nepal and Pakistan. ABN AMRO invested in ShoreCap International, a microfinance equity fund that invests between

\$500,000 and \$2 million in local currency equity in MFIs in Africa, Asia and Eastern Europe. TIAA-CREF, a large US institutional investor, has recently set up a \$100 million Global Microfinance Investment Program. As part of this it has taken a \$43 million private equity stake in ProCredit Holding AG, a group of 19 large commercially driven MFIs in Eastern Europe, Latin America and Africa. This is one of the first cases of direct equity involvement by an international institutional investor.

There are several barriers to equity investment, particularly in the smaller MFIs that arguably need it most. As NGOs, many MFIs are legally unable to accept equity unless they can form an eligible commercial entity. Management quality, corporate governance processes, organisational capacity and scale are unlikely to satisfy investor demands. Out of thousands of active MFIs, only about 220 have the regulatory permission and are structured to issue share capital and attract equity investors.²⁵ As with debt, public and private equity investors have tended to cluster at the top end of the microfinance market.

A handful of new funds - such as Aavishkar India, Unitus LP, ShoreCap, Andromeda and Microvest - are starting to show the potential for microfinance venture investment by investing in early-stage MFIs with good growth prospects. In April 2007 Sequoia Capital, a prominent American venture capital firm, made a landmark \$6.5 million investment in SKS, a for-profit Indian microfinance start-up. The following month Legatum Capital, a Dubai-based private equity fund, invested \$25 million in SHARE, another Indian MFI.

The Sequoia deal has an exit clause stipulating that SKS will either be floated on the stock market or acquired within the next three to five years.²⁶ Developing creative exit strategies such as this is essential if MFIs are to attract more venture capital investment in the future. Most funds have only made a few investments and have not exited from any yet. But there is hope for the establishment of an effective exit environment in a number of current developments - the growing interest in acquiring MFIs among some banks; the initiatives that provide options to finance management buy-outs (such as those offered by ICICI Bank in India); and the opportunities (though modest) that exist for some MFIs to float on local stock markets.

High risk and a lack of exit opportunities make equity investment difficult but the landscape is changing rapidly.

3 developing and delivering financial services

Direct provision of retail financial services to low income clients is not currently viable for most mainstream international players, even those with local subsidiaries. The biggest institutions have steered clear of microfinance because they lack customer and market knowledge, they do not have a branch network infrastructure in the target customer areas, and their business model has high overheads that cannot absorb high transaction costs.

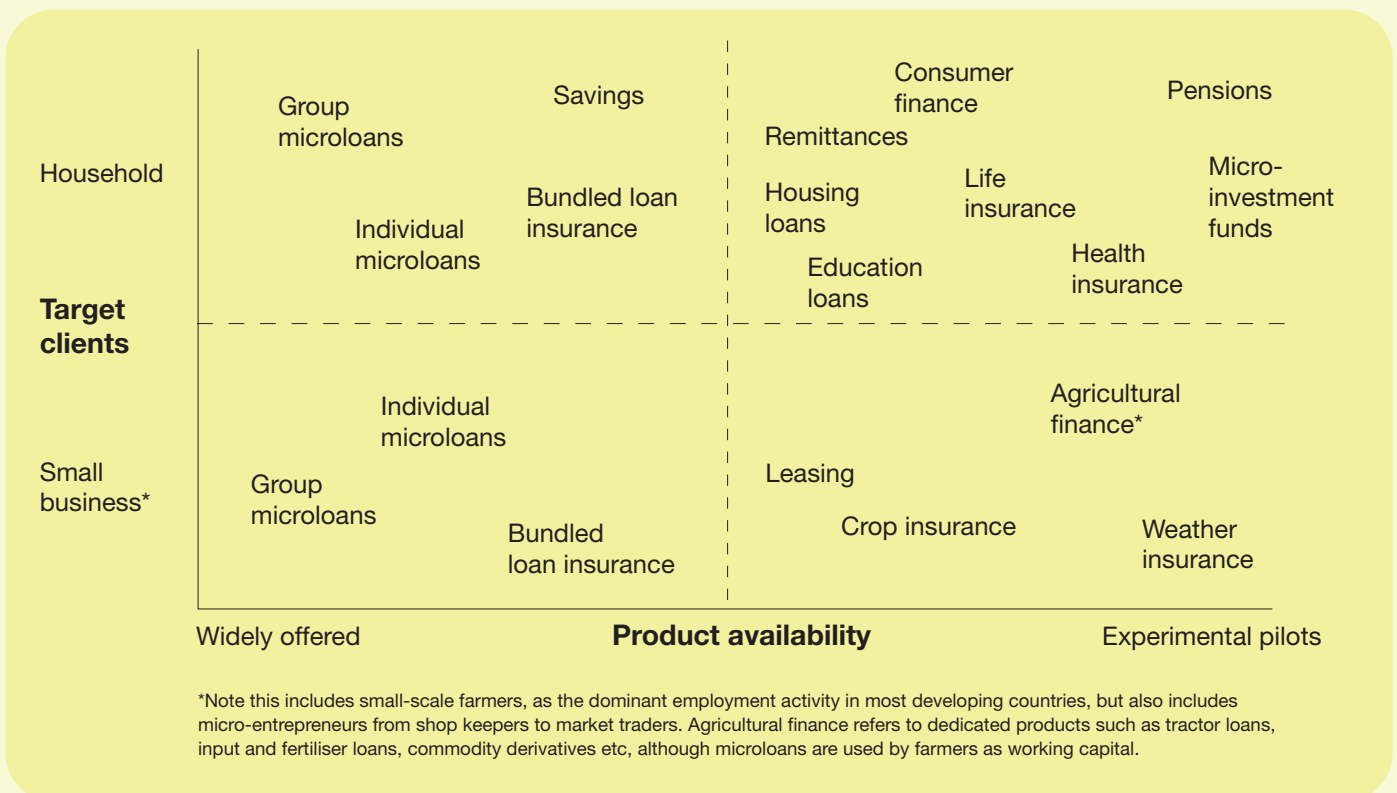
This is starting to change as the big players explore the opportunities emerging through the development of dedicated new products, technologies and business

models. While these innovations are not without risk and many projects are no more than experimental pilots, a momentum is building that could eventually revolutionise the microfinance sector.

3.1 product innovation

Microfinance institutions tend to focus on credit, often using the Grameen model of group lending. They lack the capacity to offer a suite of financial products designed for low income clients. Commercial players are exploring opportunities to develop a wider range – particularly critical products such as life and general insurance, remittances and dedicated agricultural finance and risk management.

Figure 5. Microfinance product range and availability



Mainstream institutions are starting to see valuable product distribution opportunities in partnership with MFIs. Most MFIs lack the ability to develop and deliver products in house but have the customer relationships and infrastructure to deliver mainstream products to the

customer. There is potential to redesign almost every type of retail financial product for low income customers, including life and general insurance, savings, investment and remittances.

Most activity so far has taken place in two specific priority areas:

- **Remittance-related services.** The volume of remittances from those working abroad to their home regions in developing countries has rocketed as the use of migrant labour has increased. It is now the second most important capital flow after foreign direct investment, and arguably has a more immediate development impact as the money flows straight to migrant workers' families. Vodafone has recently announced a global partnership with Citigroup to launch mobile-based remittance services, with the first trial planned for remittances from the UK to Kenya. A consortium of 19 mobile operators announced a pilot project to create a global money transfer platform – managed by Mastercard – for the \$230 billion migrant worker remittance market.²⁷

- **Insurance and risk-management products.**

The poor are more exposed to both systemic risk (natural disasters, drought, fluctuations in crop prices) and idiosyncratic risk (illness, theft, fire) than more affluent groups. They tend to rely on inefficient informal insurance mechanisms such as savings, distress sales of assets, and borrowing, which often offer only limited cover. Microinsurance is a growing area as providers experiment with ways to provide a host of insurance products from simple bundled loan insurance to more complex crop and weather products. The US insurer, AIG, covers 1.6 million policies through a network of 26 MFIs in Uganda. Citigroup/Banamex worked with the MFI Compartamos to add 550,000 new life insurance policies in Mexico and Basix, an Indian MFI launched weather index-linked rainfall insurance for rural farmers with ICICI Lombard in India.²⁸

Many players, including new entrants from the telecommunications and retail sectors, are examining the potential offered by new business models and technologies to create a viable and cost-effective delivery infrastructure for financial services. To be profitable, any new products introduced will need to be adapted to local conditions and customer needs.

Insurance, savings and remittances are key financial products for low income groups.

3.2 new technologies

An increasing number of MFIs are using technology developed for mainstream financial service firms (such as ATMs and smart cards) and introducing handheld computing and mobile banking and transaction services. Technology has an impact on microfinance in three main areas:²⁹

- **Credit methodologies.** As credit scoring becomes more advanced in developing countries, there may be potential to move to automated credit processing, which reduces transaction costs and the burden on loan officers. Some MFIs are using handheld computers for their field personnel.
- **Back-end processing.** Technology has revolutionised banking operations. As costs continue to fall, it could have the same impact on MFIs by offering secure, cheap processing and management information systems.
- **Automated payment systems.** A host of devices are being used to develop electronic payment systems, including point-of-sale (POS) terminals, low-cost ATMs, biometric smartcards and mobile phones.

Technology provides an alternative to the traditional (and expensive) bricks-and-mortar bank branch model. In Brazil, for example, it costs approximately 0.5 per cent of the cost of establishing a typical bank branch to use POS terminals that can read cards to offer credit, savings, insurance and money transfer services.³⁰ Using a branchless banking model has been very successful in Brazil, where approximately 58,000 agents such as small neighbourhood shops offer a range of financial services.³¹

The rapid expansion of mobile telephony in poorer countries is another development that is creating opportunities to broaden financial services. A number of mobile-based services are being used to offer financial transactions and mobile banking services across the developing world.³² While many of these are still on a small scale or at the pilot stage, lessons are being learned about how mobile banking can work to expand access to finance. M-Pesa, WIZZIT and CelPay are African initiatives that bring mobile operators, banks and MFIs into partnership to offer competitively priced money transfers, bill payments and access to credit and deposit services. It is the Philippines that is leading the world in providing mobile-based financial transactions, particularly in payments and money transfers.

New business models and technologies could revolutionise the delivery of financial services.



Vodafone launched M-pesa, a mobile banking service that allows transactions over handsets in Kenya. It plans to roll out similar services in other markets. Source: Vodafone.

3.3 innovative business models for service delivery

Mainstream commercial players are exploring opportunities to form partnerships with agents, MFIs and NGOs already active in low income markets. Such partnerships are being made possible by technology that helps reduce costs and provide cheap, fast and reliable documentation through the use of POS terminals, mini-ATMs and mobile phones. Citigroup's Global Consumer Bank recently launched a micro-savings account in India in partnership with MFIs, using smartcards and biometric ATMs. The MFIs service the client but technically each account is held on Citibank's book, meaning that the individual is a client of a large global institution. ICICI is expanding its ground-breaking partnership model to around 250 MFIs, using a similar arrangement in which the MFI acts as an agent but the loan is offered by the bank. It is also establishing a network of internet-enabled kiosks at village level. Barclays has developed partnerships with traditional 'susu' microbanking agents in Ghana.

The potentially revolutionary impact of technology has yet to be fully harnessed in microfinance. Numerous pilot projects are starting to build an evidence base but it is still too early to know what works best and which models will prove profitable and scalable. There are significant technical, economic and regulatory hurdles to overcome but there is enough emerging potential to suggest that it will eventually be possible to offer financial services profitably to the poor on a significant scale.

4 technical assistance

Microfinance institutions need significant technical assistance to professionalise and scale up their operations. The organisations themselves need help to improve their governance, operations, liquidity management, credit methodologies and more. The broader financial architecture also needs support in areas such as rating methodologies, performance standards, consumer protection and enabling regulatory environments.

The need for technical assistance varies according to the MFI's status and operating context. Large tier-1 MFIs may require very specialised assistance in specific products or treasury management, and can often pay for consultancy assignments. Small-scale and start-up MFIs require a much broader range of technical assistance and are not in a position to pay for services. The microfinance industry has a wide range of technical assistance providers – development finance agencies; microfinance networks such as Accion and WWB; NGOs; foundations; private players and some microfinance funds. But much more and better assistance will be needed if a broad group of MFIs are to become credible members of the wider financial sector.

Large development finance institutions such as the IFC are said to have allocated around \$750 million to microfinance technical assistance in 2006.³³ There is an emerging trend towards offering commercially priced technical assistance, and many providers are starting to separate their technical assistance from their investment activities. This creates an enabling environment for commercial banks to offer technical assistance to MFIs.

The transition to more commercial microfinance will put additional burdens on institutions, particularly those accustomed to philanthropic or donor funds. MFIs will need to professionalise to attract private capital and grow their businesses successfully. Mainstream financial institutions have a lot to share with MFIs but the practicalities of technical assistance need to be addressed. Is it a philanthropic gesture – using grants and in-kind support from employees – or should it be provided commercially? The answer will depend on the institution, but for many international and large domestic players it is likely to be a mix of both philanthropy and commercially driven assistance.

Developing the right regulatory frameworks for commercial microfinance will be challenging. New business models and partnerships are stretching the boundaries for regulators. New entrants such as telecommunications companies and new concepts such as mobile-enabled money transfers will require new approaches. Consumer protection is vital to ensure that commercial microfinance does not stray into over-indebtedness and predatory lending. Developing financial literacy in poor communities will be critical here, but this will be challenging where many lack basic literacy and numeracy skills. Innovative approaches will be needed, including partnerships with educational institutions, NGOs and community organisations.

5 promise or pitfall: future scenarios for microfinance

The microfinance model has proved itself over the past three decades, and a vibrant industry is starting to develop. As this paper has already indicated, however, commercial capital and mainstream expertise are desperately needed to scale up operations and provide a broader range of financial products. The microfinance industry also needs to adjust to the rigours of the commercial world and the demands of mainstream investors and partners. Lessons are being learned but the hurdles are considerable. Profitability is difficult when you are working among poor communities with a high volume of low-value products.

Private and public players need to agree their respective roles and responsibilities to avoid unnecessary competition and the inefficient allocation of resources. The microfinance sector needs to be both broadened and deepened, with distinct opportunities for more risk-tolerant public and donor capital and for more commercial funding in certain areas.

Based on previous analysis,³⁴ we have developed three future scenarios for the involvement of the UK financial services sector in microfinance. These are not meant to be reliable predictions about the future but instead offer internally consistent stories of alternative paths for the industry over the next eight years. Elements from all three scenarios may come true in the future. The focus should be ensuring that the microfinance industry and its stakeholders take action to resolve underlying weaknesses and set a course for sustainable growth.

figure 6. Three scenarios for microfinance in 2015

1. commercial pullback

The high hopes for scaling up microfinance through involving commercial players have evaporated, leaving a stagnating donor-supported industry with very few commercially sustainable MFIs. The vast majority continue to rely on shrinking grant support. Industry growth has receded dramatically since the boom between 2000 and 2007. The promise of commercial involvement never became reality because of a range of factors:

- donors crowding out commercial players at the top of the industry
- an oversupply of hard currency funds to a few institutions – some of which suffered high-profile collapses in the volatile economic downturn that hit many parts of the developing world in 2008
- a restrictive, heavy-handed and politically charged regulatory framework.

Commercial players rapidly retreated as opportunities dried up, particularly in international investment, although some local banks have built up microfinance operations. The total loan portfolio is around US\$15 billion.

The industry focuses on the easiest products that require the least investment, ie the group lending model. Larger MFIs offer a broader range of products, particularly savings and access to remittances, but there is a massive quality gap across the industry. The promising innovations in insurance and other areas have not been properly developed.

2. unequal growth

Microfinance remains a donor-dominated industry but with commercial players also involved - mainly local banks in Latin America, India and China. International banks continue to pursue some strategic opportunities, but this is mainly focused on limited commitments rather than significant commercial involvement. MFIs have become even more fragmented. Some of the larger players now function as banks but the vast majority of the industry is still small scale and inefficient. Foreign investment through MIVs has grown, with a portfolio of about \$8 billion, but MIVs have been unable to attract much mainstream investment because of delays in developing a common industry standard and plugging into formal investment markets. Microfinance debt products continue to appear on domestic and international capital markets but still rely mainly on donor and social investors - microfinance is not yet a formal asset class. The total loan portfolio is around US\$60 billion.

Some leading MFIs have worked with mainstream players to develop dedicated products, especially insurance, but a full suite of services is still missing. There has been hardly any progress in developing pensions, specialised micro-enterprise, agricultural finance and risk management products. The remittances market, however, has been transformed by the entry of new firms and low cost systems that use mobile-phone technology to transfer money internationally, enabled by a supporting international regulatory regime.

3. systematic integration

Microfinance has become a part of the formal financial sector in many countries, with a vibrant and diverse industry built on providing financial services to low income clients. The commercial MFI model has been proven with a massive increase in the number of tier-1 MFIs, including some large specialised regional players that offer services across countries. This has been nurtured through dedicated efforts to provide equity funding and assistance to smaller MFIs since 2005. The microfinance venture capital industry has added real momentum by funding some of the best performers in the industry today. Some of these MFIs are now listed on domestic stock markets, while others have been acquired by mainstream banks. These banks, along with consumer finance companies, retailers and mobile operators, have become very active in microfinance. Small-scale and NGO MFIs are still an important part of the sector, particularly in very difficult operating environments and in providing services to the extreme poor.

Commercial capital is the most important component – mainly domestic savings and investors. But there is also a much more sophisticated and effective collaboration between international mainstream, social and donor investors to offer a broad range of financing solutions. This includes catalytic funding to mobilise and develop domestic capital funding, more local-currency debt and equity for smaller MFIs and a range of other innovations. The total loan portfolio is around US\$130 billion.

Although microfinance still does not match the product range offered to more affluent clients, the industry has worked hard to develop a basic range of credit, savings, insurance and payment products.



6 a role for the UK financial sector

The UK financial sector can play an important catalytic role in microfinance. Banking and insurance groups with a global footprint can share their expertise and provide funding, product development, services and technical assistance through local subsidiaries. HSBC, Standard Chartered and Barclays are among the companies already involved in the microfinance sector. London's capital markets can also offer expertise and help facilitate access to commercial investors. Some capital market transactions have been arranged and placed in London, with investment from mainstream firms such as Morley Fund Management and Standard Life. Industry-wide collaboration, backed by public and non-profit agencies, would make it possible to develop a formalised, integrated strategy that ensures much more is done.

London has a natural role to play in promoting global access to financial services. It is arguably the most international financial centre, with a huge diversity of institutions. Yet at the moment Switzerland, Luxembourg and Wall Street are all more actively involved in microfinance.

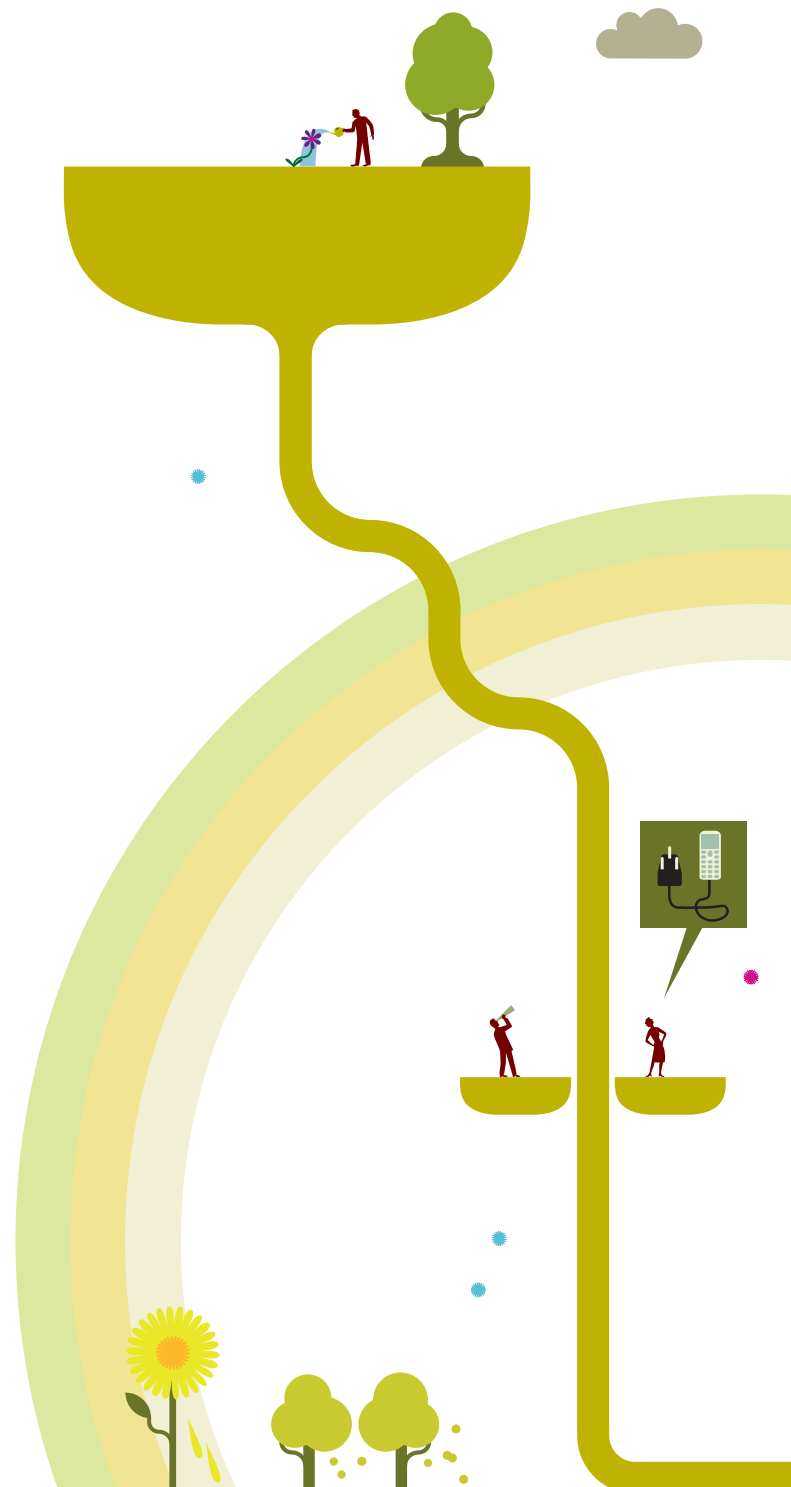
Microfinance will require a lot of assistance if it is to evolve into a mainstream asset class. In the short term some of this will need to be on a non-commercial footing, as microfinance may not be regarded as a compelling investment opportunity. This is where trade associations, aid donors, government and other actors in the UK can play their part – by promoting pilot projects, funding infrastructure and raising awareness.

The UK Government may have a role to play in supporting initiatives in partnership with the City and the broader UK financial sector. For example, DFID is an important public funder of microfinance and financial sector programmes through its work on the financial deepening challenge fund, by taking first loss positions in instruments such as the Commercial Microfinance Consortium, in supporting several multi-stakeholder initiatives such as the Consultative Group to Assist the Poor, and via funding to the Finscope studies which provide market intelligence about low income clients in several African countries.

Some of the key areas for further investigation include:

- Establishing a UK-based microfinance product development centre in partnership with industry, government, donors and academia. The expertise and resources within UK institutions could then be brought to bear in the search for solutions in areas such as crop insurance, agricultural finance, climate-related insurance, health insurance and micro-investment products
- Examining opportunities to blend sustainable livelihoods approaches with microfinance and environmental objectives. This could include new methods to finance clean energy, water and sanitation at a domestic or community level. Corporations with extensive global supply chains – primarily those that involve low income producers of agricultural commodities – could be brought in to examine innovative financing, access to markets and risk management
- Setting up a learning network for UK-based financial institutions – possibly with a web presence, an annual meeting and an occasional written update. This would enable interested parties to share information on the rapidly changing world of microfinance
- Developing technical assistance through collaborative projects that pool resources and exploit synergies. Microfinance requires technical assistance on a variety of issues. These include regulation (both at a domestic level and in terms of international rules for risk weighting), consumer protection, legal protocols, accountancy standards, risk management, governance, new technologies and anti-money laundering/terrorism financing regimes. London can offer advisory expertise in all these areas.

For some, the business case for action may not yet stand up on solely commercial criteria, as the potential for steady revenues is still some years away. There is increasing evidence, however, that new investment structures and business models can be profitable, and this is beginning to change the microfinance landscape. The commercial opportunities emerging, coupled with the moral case for action and the growing sense of corporate social responsibility in the UK financial sector, suggest there is good reason to develop an integrated UK initiative to help propel the microfinance sector to maturity.



notes and references

- 1 This is a summary of a final report that contains additional detail and a series of case studies. It is available from www.forumforthefuture.org.uk. This project was supported by the City of London Corporation, Gresham College and Defra, as part of a follow on process to the London Principles project. The London Principles promote banking, insurance and investment for sustainable development and were launched at the Johannesburg Earth Summit in 2002. A progress review in 2005 identified progress on enabling access to finance and risk management products for the poor in developing countries as a key area of future action. Phase II of the London Principles has two work streams; on access to finance for developing countries (this project) and on access to finance for environmental technologies.
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- 16 Source: Microrate 2006. MIVs/ responsibility monthly report, January 2007.
- 17 Draft guidelines include a robust set of performance metrics, standardised valuation techniques and transparent disclosure of fund information.
- 18 A loan guarantee is a form of credit guarantee that focuses on a loan from a bank or lender to a single institution. Broader credit guarantees – for instance covering an entire lending portfolio – are also used.
- 19 Mark Flaming 'Loan Guarantees to Microfinance Institutions: How do they add value?' Consultative Group to Assist the Poor Focus Note 40, January 2007
- 20 Securitisation is a process through which homogeneous illiquid financial assets are pooled and repackaged into marketable securities. Generally, the assets are held in a bankruptcy remote entity termed as a Special Purpose Vehicle (SPV) or are otherwise secured in a manner that gives the investors a first ranking right to those assets. We use the term CDO to refer to pooled loans with a smaller set of more diverse assets rather than true sale securitisations of large homogeneous loan portfolios (such as happens with mortgages or car loans in developed markets). This definition includes collateralised loan obligations as a subset of CDOs.
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