PROPOSAL FOR STRATEGIES TO BUILD MISSING FOUNDATIONS OF THE CURRENT MICROFINANCE INDUSTRY

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ABSTRACT: *As microfinance approaches the status of mainstream asset class, it inevitably starts to entice Socially Responsible Investment*[1]. *However, precoscious capital inflow can be detrimental to all players involved. The industry is unprepared for global SRI arena. The gap between different microfinance concepts is widening, while identic terms are being used to describe different contents. The term „microfinance" continues losing its informative value as divergent development foments nomenclative disorder. Microfinance is becoming too varied to be presented under a single term. MIVs*[2], *States and multilateral institutions must therefore in a concerted action impose basis of unified definitions, methodologies and coordinates, otherwise different concepts might mislead international public. The lack of standartized set of definitions, social impact reporting, bankrupcy procedures and evaluation infrastructure, while overstating development benefits can discredit microfinance, once SRI systems open their gates.*

KEY WORDS: *microfinance; funding; inefficiency; coordination; centralization; development; FX risk; guarantee; SRI.*

JEL CLASSIFICATION: *G21, L26, O16.*

ABBREVIATIONS: *ESG - environmental, social, governance; GMFA - Global Microfinance Financing Authority; MFI - Microfinance Institution; MIS - Management*

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[1] Sustainable and Responsible Investment concept incorporates Environmental, Social and Governance issues into fund management.
[2] MIV: microfinance investment vehicle

Information System; MIV - Microfinance Investment Vehicle; SRI - Socially Responsible Investment.

1. INTRODUCTION

The capital flows originating in developed countries provide key link between local needs and international capital sources. 29% of the total of microfinance funding today is channeled internationally. The total investment to microfinance is expected to triplicate from USD 6.6 bn in 2008 to USD 20 bn by 2015. (Harris, 2009)

SRI market, opening to microfinance, is today an enormous market, encompassing almost a tenth of all professionally managed assets, reaching €7.5 trillion in 2009. [3] Ever more investors are conscious of impact of their investments and seek double bottom line.[4] So far, among ESG[5] issues, the environment and governance have attracted most attention, while the importance of the social issues lacked behind. Microfinance is therefore a logical target of SRI. While mere 0.02% of the total of European SRI flows in 2009 were channelled to microfinance, Eurosif [6] concludes that microfinance will be of significant interest to SRI investors in the near future.

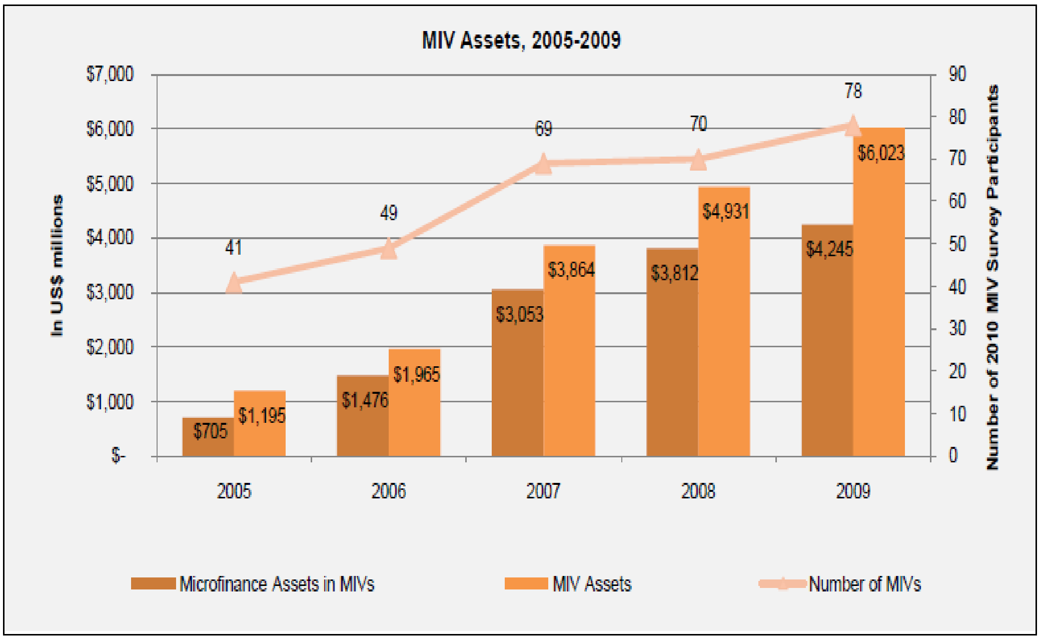

Figure 1. Growth of MIV assets (Microrate, 2010)

[3] CGAP MIV Surveys 2006 – 2008
[4] Combination of financial return and social impact
[5] Environment, Social, Governance
[6] The European Sustainable Investment Forum

Albeit the role of microfinance as SRI asset is marginal for SRI market, it is crucial for the future of microfinance. SRI is already the largest source of international microfinance funding, (47% in 2005) (Eurosif, 2010). Yet despite the importance of SRI for microfinance, the sector is unprepared for the expectations of the SRI investors, who are 92% institutional and who will demand accountability (Eurosif, 2010). Deep differences reign between the corporate presentations and the reality in the field. Growing numbers of practitioners are relying on practices considered unethical in mature financial markets, such as untrue information, usurious interest rates in particular, as well as lack of adequate customer protection, opening the door to exploitation of the poor (Park, C.K., 2007).

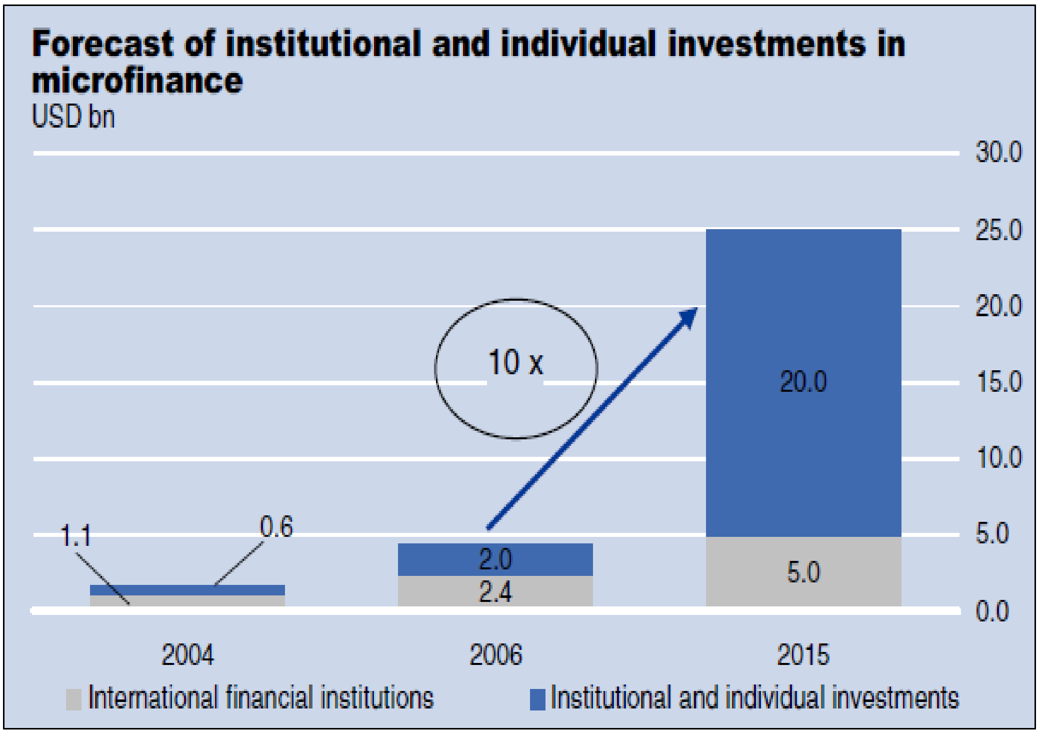

Figure 2. Investment Forecast (DB, 2007)

In consequence, the global media focusing on few salient cases, antagonistically oversimplify the industry as a profit-making financial predation, while at the same time denoting microfinance as the most promising tool to combat poverty. Abysmal differences can be found not only in terminology used by MFIs, but also in nomenclature applied by MIVs and rating agencies. In order to establish microfinance as a social development promoting industry, the sector evolution needs to be guided from above, through a set of standards and criterias, defining expectations and setting the bar for acceptable lending policies, excluding profiteering MFIs. Microfinance funders, government agencies, and technical assistance providers, must in a concerted action define „social microfinance“. If they do not, the reputation of microfinance as social industry, may reap unwelcome volatility of SRI sources, leading to detriment of all involved. This paper proposes creation of a Global Microfinance Financing Authority (GMFA), formed by representatives of the sector, multilateral institutions and states, in order to establish sectorial standards related to social impact measurement, unification of terminology, audit certification, ratings and bankrupcy procedures. Such multitasked endeavour could synergically concentrate knowledge, strategically act on planetary level, create transparent space for microfinance evolution as a strategy to fight poverty.

2. MISSING FOUNDATION OF MICROFINANCE

2.1. Insufficient Poverty Impact Assessment Tools

Although robust poverty assessment tools have been available for more than a decade, they have failed to become used on daily basis by MFIs. Standard methods for measuring poverty have proven impractical given the scarce resources and technical constraints, problems with data collection, analysis, and interpretation. Zohir and Matin (2004:301) argue that the ‘impact of microfinance intervention is being under-estimated through conventional impact studies‘. Thus, three decades after global popularization of microfinance, claiming to be an essential component of the fight against poverty, there is still no convincing social impact measurement tool readily used by MFIs. Yet, routine day-to-day reporting is the only way real impact of microfinance can be identified in the long term and provide robust feedback to investors. MFIs are recently starting to report en bloc on social performance, due to requirements of the funders. Nevertheless, recently invented social performance[7] indicators, only speculate on achieved social impact.

The frequently used indicator, CERISE, considered the pioneer of social audits, is today used is by over 250 MFIs. CERISE assesses the social impact trough a thorough questionnaire of the principles, actions and measures implemented by MFIs to achieve social aims in the light of outreach, adaptation of products, socio-economic benefits for client’s families, staff, community and environment. The results transform into quadrangles permitting quick assesment of the MFI social performance. In real conditions, CERISE questionaires are considered a „must“ by the MFIs, obliged to fill the sheet as a pre-condition for funding. Without control nor feedback of the data in the field, the value of CERISE is hardly representative.

The IRIS - PAT developed by USAID, and PPI created by Grameen Foundation, are poverty measurements based upon matching the data collected in field with national expenditure surveys. The survey data analyzing rank indicators that correlate with poverty, such as family size, the number of children attending school and others, are collected in the homes of clients during short interviews. Each indicator receives a score reflecting client response. The total score is combined with the

[7] Social impact refers to outcomes that can be directly attributed to programs. Social performance encompasses the process by which impact can be achieved.

country's national household survey, serving as a baseline from which client progress is measured. Unfortunately, the PAT and PPI are limited to the relatively small sample of countries with available household expenditure data, are expensive corroborate and make no distinction between urban and rural households, with different poverty characteristics.[8] Social ratings provided by rating agencies[9] are dynamically developing products of the consulting industry complementing financial ratings of MFIs.

The rating agencies provide an analysis of the development context, MFI services, systems, portfolio and a statistical field sample to analyze outreach and services of the MFIs. Based on quantitative and qualitative analysis, the social rating report includes an analysis of the performance, an assessment of strengths and weaknesses and a final opinion of the MFI's social performance. The major weakness of the social rating lies in its cost and superficiality of the validation of data provided by MFIs, but also in the fact that rating agencies view the social ratings as their core business. Their interest, is thus to maximize profit, supposing minimization of the costs (time of the analyst spent in field) and reduction of reputational damage caused to a paying client (MFI).

Only few MFIs measure their social performance. Out of 1928 MFIs reporting to Mixmarket as of 12/2010, 350 MFIs (18%) reported on their social performance. Most of those committed use the methods described above, exemplifying lack of the microfinance social impact measurement at present. Applied measurements focus on social performance of the MFIs that may or may not result in a social impact. Althouth lenders are becoming conscious of the non-income aspects associated with poverty, in the sector reigns an anecdotal absence of an industry-wide framework for social impact reporting and it is arguable if any MFI could stand the test of external social auditing, since the current auditing tools for such task are either frail, speculative or non-existent. (Lapenu, 2009) The lack of accountability may in the future cause reduction of credibility for public investors.

2.2. Insufficient controls over veracity of microfinance data

Investment placement in immature or weakened MFIs, unfit to manage private capital, leads in the long run to moderation of performance standards, harming MIVs, as probability of default increases. Wellperformed due dilligence is therefore in interest of all stakeholders of the microfinance industry. The control of hard data presented by MFIs, executed during due dilligence, is at present as diverse as the pool of MIVs, in most cases deficient and speculatory. The control is typically performed prior to disbursement on behalf of investors verifying that performance is accurately reflected in the financial statements and reports, and that management and operating systems are robust enough to sustain the capital inflow and handle its performance.

Unfortunately, financial statements are often compiled to present the positive face of the MFI. Auditors, who approve the financial statements, often belong the acquaintances of those interested in disbursement. In many cases, even international

[8] PAT = Poverty Assesment Tool; PPI = Progress out of Poverty Index
[9] Currently PlanetRating, Microfinanza, M-Cril and Microrate

auditing firms fail to discover structural problems of the institution, due to lack of profundity or sufficient experience in social finance. Due diligence methods learned in regulated financial sectors in developed markets, where the analysts rely on the information provided available, are insufficient in social economy in developing countries.

The inaccurate representation of portfolio quality belong to the principal weakness to disclose. Discrepancies between real and reported portfolio quality are common in MFIs. In fact, many well-known MFIs have experienced at least one significant portfolio crisis, sustaining delinquency and default rates well above what they reported to the public (CGAP, 2009). Out of the methods currently used for MFI appraisals, there is currently none that entirely faces the portfolio control issue, the key element for a stability of any MFI.[10]

The sample controls, during which the analysts compare randomly chosen client files against the interviews in the field, are often orchestrated to fit in the funders expectation. Also, the riskiest regional portfolios are usually geographically distant from the headquarters and not likely to be visited for time and cost reasons. It is truly impossible for a single analyst to acquire a complete picture of a microcredit portfolio, consisting of tens of thowsands of clients, in a few days. No concerted approach towards this issue is being developed at present, also because the MIVs guard their methodologies as a commercial secret.

2.3. Failing ethics and client protection

Failures of microfinance become threatening, once the MFIs funded by MIVs, cause damage to the clientele, due lack of ethics, despite proclamations expressed during the fundraising. The ethical failures usually concentrate in lack of pricing transparency, excessive interest rates and abusive loan recovery. The effective interest rate paid by a borrower may be different from the stated interest rate. Non-transparent pricing, common in microfinance, creates imperfections generating opportunities for higher profits. Pricing transparency is therefore essential to promote efficiency.

MFIs organizations routinely hide the actual interest cost by charging interest on the original value of the loan rather than on declining balance, charge up-front fees, force security deposits deducted from the loan amount and compulsory savings as well as insurance premium charges. The potential for consumer exploitation in the case of microcredit is a direct result of market failure, caused by little competition as some MFIs exercise significant local market power resulting in high interest rates, or by the ill information of the consumers of microcredit.

[10] Several public tools exist, such as ACCIÓNs CAMEL, WOCCU's PEARLS, CGAP's Tool for appraising MFIs.

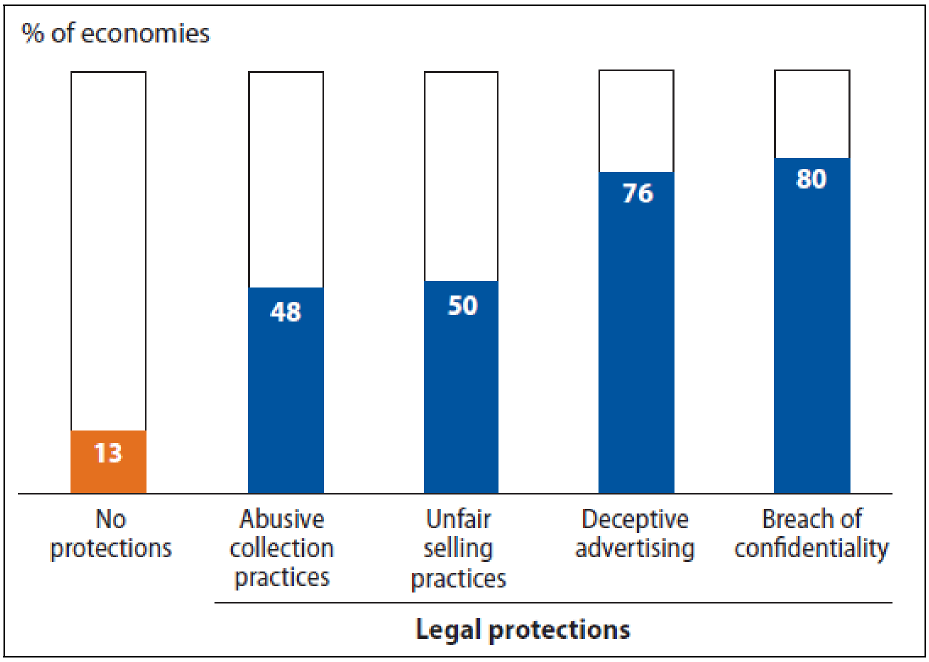

Figure 3. Few economies out of 137 sample group have legal protections against unfair practices in financial sector[1]

2.4. International Bankruptcy procedures

Due to nature of MFIs, leveraging capital without significant own equity or other assets, MIVs take portfolio as a pledge. However, the frailty of the microloan portfolio, due to its integrity-based instead of asset-based character, is paltry and elusive. As a good example serves the case of FINDESA, Nicaraguan MFI that transformed into a regulated bank in 2008. Born out of the non-profit INDE, FINDESA had grown for several years over annual 50%, without belonging to any microfinance network organization, and transformed into BANEX, the 5th largest bank in the country. The Nicaraguan microfinance, hit by the financial crisis, culminated in populist „movimiento no pago"[11] supported by Ortega's government. The excessive growth fueled by investment inflow, inadequate internal controls, over-indebtedness of the clientele and failures of the rating agency,[12] caused collaps of the institution in 2010. Undisclosed losses of MIVs, are estimated in range of tens of millions of dollars, due to the incapacity to sell the microcredit portfolio. Similar cases are frequent in other markets, but receive few publicity, due to confidentiality agreements between MIVs and MFIs.

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[11] "No re-payment movement"
[12] Fitch Rating Agency

3. PROPOSAL FOR CREATION OF A GLOBAL MICROFINANCE FINANCING AUTHORITY

The authors propose creation of a Global Microfinance Financing Authority (GMFA), formed by representatives of the sector, multilateral institutions and states, in order to create on synergy in sectors, where taxonomic and organisational inefficiencies take place. The institution is self-financed by interest margin paid by both MIV and MFI members. MFA as one of its primary function, tackles the issues mentioned above: social impact measurement, customer protection, taxonomy and definitions, audit methodology and imposition GMFA definition of microfinance, as a social development sector open for investments by MIVs, under following rules:

- MFIs, certified according to GMFA criteria regarding transparency, social impact and client protection, are allowed to use the registered mark of Development Microfinance Institutions (DMIs);
- The DMIs are under full scrutiny of GMFA supervisors, regarding social impact measurement as well as audits;
- MIVs can invest into DMIs only under full disclosure of conditions, using standardized loan contracts and capital products according to GMFA imposed limits;
- DMIs acquire access to SRI capital sources. The MIVs, conversely, gain more certaneity on the impact of their investment;
- In case of default, GMFA procedures imply standartized bankrupcy proceedings.

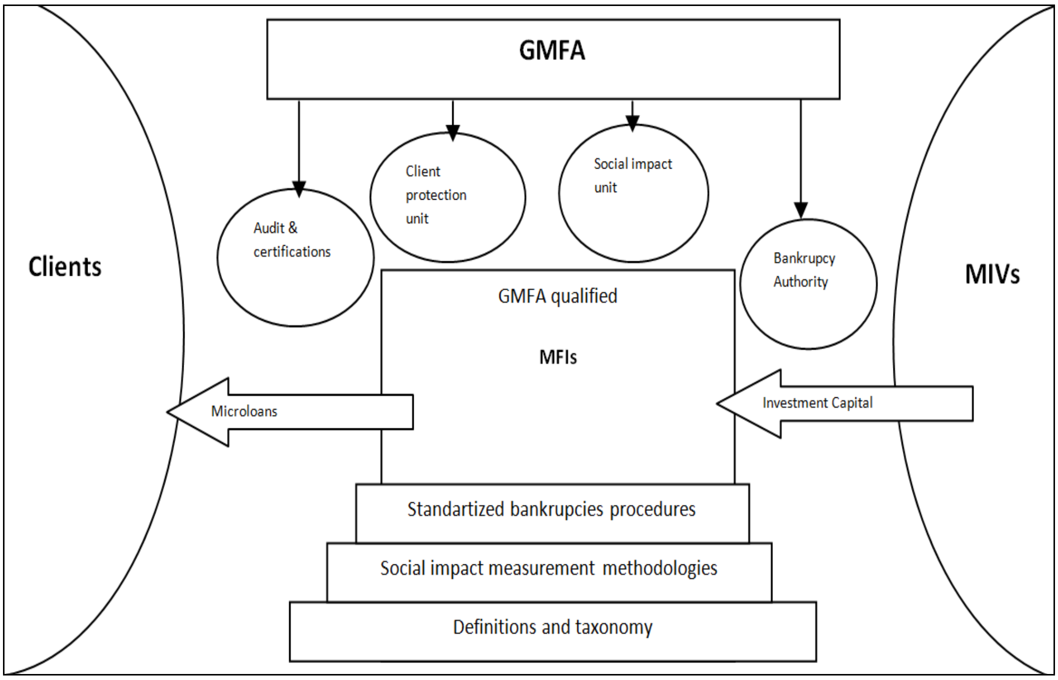

Figure 4. GMFA infrastructure

The multitasked endeavour of social impact measurement making use of economies of scale, unification of global terminology, certified audits, qualification of MFIs, standartization of ratings and bankrupcy procedures, could reap synergies due to its concentration of knowledge, strategic acting on planetary level, creating transparent space for microfinance evolution as a true strategy to fight poverty.

The GMFA membership might snowball, creating benchmarks in the midst of uncertaneity becoming the basis of healthy microfinance industry.

4. CONCLUSION

Microfinance is currently enwrapped in a nomenclative disarray and may not stand the test of a serious asset class claiming social development. Thus, it will deter SRI investors. Concepts without benchmarks will blend and reputation of microcredit may fall prey to dichotomy between rhetoric and reality, highlighted by superficial media reports. The current planetary microfinance groundwork has succeeded in attracting many actors, but has neglected to build the regulatory base, in order to to protect the poor, and investors alike. Thus, it is urgent to set up a central authority, supervise and guide the development of the sector, in order to save its social mission as well as reputation.

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