Moving On Up: Banking for the Poor through Microfinance

Over time, the notion of microcredit broadened first from microcredit into microfinance then into the concept of building entire financial systems that serve their poor and low-income populations – financial systems that are inclusive. This new, more ambitious and complex vision has captured the attention of governments, international financial institutions, philanthropists, social investors, mainstream bankers, and even some royalty and celebrities.

- B. Helms, E. Littlefield, and D. Porteous, in *Four Scenarios for the future of microfinance*

Abstract

The provision of basic financial services to the poor with the ability to grant credit in its variety of forms has the potential to foster economic development and pull the poor out of poverty and get them on the ladder of development. For many decades now the International Financial Institutions have struggled with development aid, that has been ineffective.

Microfinance Institutions (MFIs) are the intermediaries between the capital markets and the significant fraction of the poor that have no collateral. The latter typically borrow monies in the form of microcredits from the former. Traditionally MFIs have received subsidies from governmental agencies. In addition to subsidies, MFIs are relying on new sources of funding coming from the private capital markets. Innovative financial instruments that have prior succeeded in other asset classes, are now being brought to microfinance. As MFIs and microfinance rating agencies report more reliable data on repayment and default rates, microcredits will become more of an asset class in in its own right.

With new sources of funding, the larger, more successful MFIs are turning into banks, going public, and enlarging the variety of financial services they offer to the poor. Access to basic financial services, may in the end, be the key ingredient for developing countries to grow.

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Related topics: microfinance, microcredits, microloans, microlenders, microfinance institutions, microfinance rating agencies, asset class, finance for the poor, basic financial services for the poor, banking in the developing world, access to basic financial services, hedge fund, private equity, collateralized debt obligation, bond issuance, public equity offering.

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AECI	Agencia Española de Cooperación Internacional
AFD	Agence Française de Dévéloppement
ASA	Association for Social Advancement
CDO	Collateralized Debt Obligation
CGAP	Consultative Group to Assist the Poor
DFID	United Kingdom Department for International Development
IFI	International Financial Institution
NGO	Non Governmental Organization
PFF	Private Financial Funds
MDG	Millenium Development Goals
MFI	Microfinance Institution
MIF	Microfinance Investment Vehicles
USAID	United States Agency for International Development

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Over time, the notion of microcredit broadened first from microcredit into microfinance then into the concept of building entire financial systems that serve their poor and low-income populations – financial systems that are inclusive. This new, more ambitious and complex vision has captured the attention of governments, international financial institutions, philanthropists, social investors, mainstream bankers, and even some royalty and celebrities.

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Microfinance is a phenomenal new development that has deserved much attention since Muhammad Yunus won the Nobel Peace Prize in 2006 for his contribution to a growing niche market in the financial services to the poor. According to Bystrom (2006), microfinance can be defined as "*the supply of smale scale financial services such as credit, savings accounts and insurance to poor and low-income people*".

It was many years ago that Yunus decided to give away the equivalent of $27 from his own pocket in the form of a loan, to a group of women who at the time manufactured bamboo furniture in southern Bangladesh (Giussani, 2006). The numbers since Yunus founded Grameen Bank in Bangladesh have grown to considerable figures reaching some $5 billion borrowed by some six million Bangladeshis, a majority of women, with repayment rates above 98%.

The Spanish *Montes de Piedad*[1] were a precursor of microfinance in the early 18th century. The first *Monte de Piedad* was founded in 1703 to grant access to credit to those individuals lacking collateral and in risk of exclusion (Perez Fernandez et al., 2007). Later during the mid-19th-century the *Morning Chronicle* of journalist Henry Mayhew introduced the idea of setting up a "*loan office for the poor*" (Dichter, 2007).

The concept of microfinance escapes the general belief that the poor lack the ability to move up the ladder, that the poor do not have entrepreneurial skills. Microfinance challenges this vision and lends as much as a few hundred dollars to entrepreneurs in developing countries that aim at setting up local businesses including farming and grocery activities.

Grameen bank was founded under the premise that it would help the poorest to get out poverty. Consequently Grameen's customers were typically extremely poor, as a result earning less than a dollar a day. According to Professor Loic Sadoulet from Insead and contrary to popular belief, Grameen does no longer conduct group lending techniques, the same techniques that made microloans so popular and successful. Indeed group lending allows to overcome the poorest's lack of collateral, and enables group members to monitor each other on a regular basis, reinforcing mutual pressure that aims at repayment (Altman et al., 2008).

[1] *Montes de Piedad* later became *Cajas de Ahorro*, the name Savings Banks receive in Spain.

Table 1 Current Scale in Microfinance

Region (# of MFIs)	Active Borrowers (Millions)	Share of All Borrowers (%)	Loan Portfolio (US$ Millions)	Share of Total Portfolio (%)	Average Loan Balance (US$)
Africa (85)	3	10	$965	11	$322
S. Asia (94)	16.3	57	$1,334	15	$82
E. Asia (44)	4.7	16	$2,218	24	$472
LAC (94)	3.2	11	$2,708	30	$846
MENA (23)	0.8	3	$236	3	$281
Eur. & Cen. Asia (37)	0.7	2	$1,682	18	$2,420
All MFIs (378)	28.8	100	$9,143	100	$319

Source: Rhyne and Otero (2007)

Demand of financial services by the poor has been increasing substantially over the last few years, varying in estimates between 29 million borrowers (Rhyne, 2007) and 93 million borrowers worldwide in 2005 (Attali, 2006). **Table 1** shows a geographic allocation of active borrowers and loan portfolio. Demand of financial services has to be sustainable and based on sound financial robustness. Subsidies play a role in microfinance, but should only help a microfinance institution[2] (MFI) take off in its preliminary stage. "*We want to see a strong financial return from our MFIs but also a high social return*," comments Maria Otero (Tully, 2007), chief executive of Accion International, a private non-profit organisation operative in 23 countries where it works with 30 MFIs. James Wolfensohn, a former president at the World Bank once pointed out that "*helping 100 million households means that as many as 500-600 million por people could benefit*" (Morduch, 1999). **Table 2** shows the percentage of the population in specific developing countries with access to microloans.

Microfinance has a clear social component that aims at providing funding for poor entrepreneurs that lack collateral. There is however not a consensus to assess the social performance of MFIs.

Microcredits also help the poor to get on the ladder of develoment. It is the case of Alvaro Avelar Lopez, a Mexican who had access to Mexico's Compartamos microloans (Lapper, 2007a). Traditional banks had rejected Avelar and local lenders would have charged up to a 10% monthly interest rate. Avelar has expanded his late father's recycling business, tripling personnel and revenues in the last seven years, and now exporting to foreign countries. Compartamos is one of Latin America's success stories in microfinance, having started 17 years ago in Chiapas and becoming one of Mexico's promising financial institutions. Last June 2007 Compartamos received the approval from the Mexican government to transition into a bank.

[2] An MFI is the entity in charge of originating the microloans.

Table 2 Active microcredit accounts per capita (2000)

Country	Loan accounts	Population	Loan accounts
	(thousands)	*(thousands)*	*(percentage)*
Bangladesh	17,300	130,407	13.3%
Indonesia	15,159	224,138	6.8%
Guatemala	833	12,820	6.5%
Bolivia	494	8,153	6.1%
Nicaragua	220	4,932	4.5%
Gambia	50	1,367	3.7%
Tunisia	313	9,564	3.3%
Niger	322	10,174	3.2%
El Salvador	191	6,123	3.1%
Honduras	183	6,201	3.0%
Thailand	1,728	62,352	2.8%
Ecuador	345	12,505	2.8%
Sri Lanka	524	19,239	2.7%
Malawi	260	10,874	2.4%
Senegal	233	9,784	2.4%
Mongolia	61	2,601	2.3%
Peru	588	25,980	2.3%
Nepal	492	24,702	2.0%
Cambodia	243	12,433	2.0%
Benin	122	6,428	1.9%
Togo	90	5,033	1.8%
Colombia	699	39,686	1.8%
Uganda	407	23,496	1.7%
Bosnia	59	3,836	1.5%
Paraguay	69	5,586	1.2%
Dominican Republic	97	8,354	1.2%
Georgia	54	4,777	1.1%
Samoa	2	179	1.1%
Ethiopia	638	62,651	1.0%

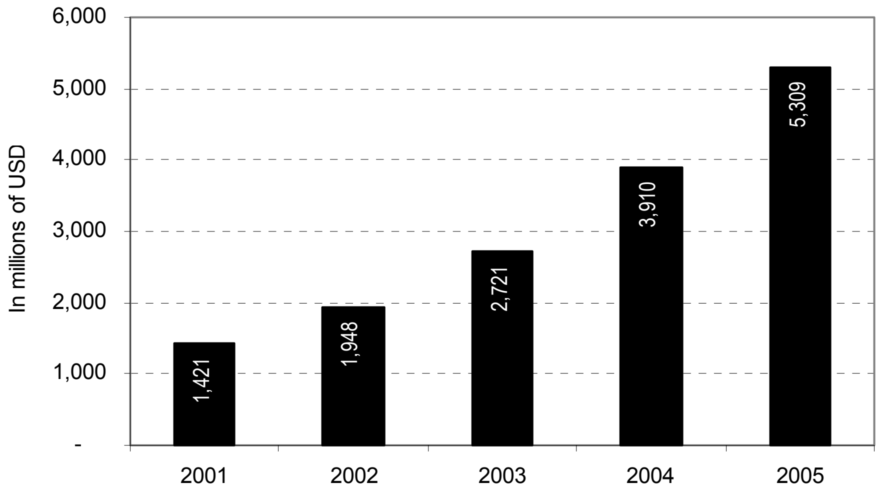
Source: Center for Global Development based on CGAP

Meet Hellen Njeri Mata is a successful Kenyan female entrepreneur who first took a $250 loan in 1997 from Faulu Kenya. She quickly repaid the loan in three months. She later took a second $400 loan that she repaid. She is now on her eighth loan worth $725. She has purchased two trucks that her husband drives into the forest to search for timber. Njeri is optimistic about the future. She hopes to expand her timber business and own a hardware shop (Faulu, 2007).

Microfinance is promising and has great upward potential. Whether or not it gets established as an asset class will depend on the ability of MFIs to demonstrate a strong track record that does not rely on subsidies, and the reliability to proof the very high repayment rates (and hence low default rates) that are well known in specific cases such as that of Grameen in

Bangladesh. **Figure 1** shows the portfolio growth of 40 MFIs in Latin America from 2001 to 2005.

Figure 1 Portfolio Growth in Latin America (40 MFIs)



Source : Compromiso Empresarial (2007) based on data from CGAP, The Mix, ADA

Doing business with the poor is not a sin. It is perhaps the best way to pull them out of poverty in a win-win, sustainable scenario, able to grow over time (Diaz, 2007). The current scenario of turmoil in the financial markets caused by the subprime mortgage crisis in the United States, coupled with the increase of consumer credit and the predatory lending linked to lax underwriting has made certain ideological groups denounce microfinance as anti-poor (Helms et al., 2006).

The more established MFIs need to stop relying on subsidies to finance their operations and lending activities, if their intent is to establish themselves as banks-to-be on the mid run. A majority of the current MFIs started as non-profit non governmental organizations (NGOs) and have now become semi-commercial units that look at both economic and social returns. Uneconomic activites are not sustainable from an entrepreneurial point of view, as they require the maintenance of subsidies. Commercially viable MFIs need as a result to literally make money out of the poor, which is not in conflict with the original intent of Yunus. Westerners will only massively invest in the developing world.

The paper is structured as follows. Section I looks at microfinance more in detail. Section II overviews subsidies to the microfinance industry coming from philanthropers and development agencies. Section III studies the role played by the International Financial Institutions, particularly when it comes to subsidies. Section IV considers whether MFIs might enlarge the variety of financial services they provide, going well beyond the typical approach of granting microcredits, the industry would then become eyewitness of a new revolution of banking for the poor. Section V summarizes the new sources of funding available to the more successful MFIs. Finally Section VI concludes.

I. An Emerging Asset Class

An asset class in the financial markets is defined as a unique sort of collateral with structural attributes that differentiate it in terms of risk, return and correlation with the market. In this sense (Hudon, 2006) presents microfinance as "*new form of decentralized development tool aiming at serving excluded from the formal banking system*". The market of microfinance is an aggregation of a variety of regional markets, typically with the prevalence of a specific MFI per region (Portocarrero et al., 2003).

Microloans add up to an outstanding notional between $15 and $17 billion, with borrowers amounting to around 100 million, and about 40 MFIs with loan portfolios exceeding $100 million based on 2006 results (Standard and Poor's, 2007). The staggering numbers confirm the potential of microfinance to become an asset class in its own right. However the microcredit activity has to mature before becoming an asset class, deserving as a result much attention from the investor community. Portocarrero et al. (2003) cite the stages in the evolution of the microcredit market:

1. A small number of MFIs enters the market and provides basic financial services to a group of the population excluded by the more traditional banking sector. This stage is characterized by very high interest rates and a concentrated sector.
2. In a second stage, some of the starters consolidate.
3. A competitive market prevails, with new growth strategies targeting the acquisition of the competitors' customers.

The Peruvian market represents an example of market where the new entrants adopt a price strategy in terms of interest rates of the market leader (Portocarrero et al., 2003). As a result there is an alignment in the rates charged on microloans. **Table 3** shows a suspicious alignment across microloan lenders.

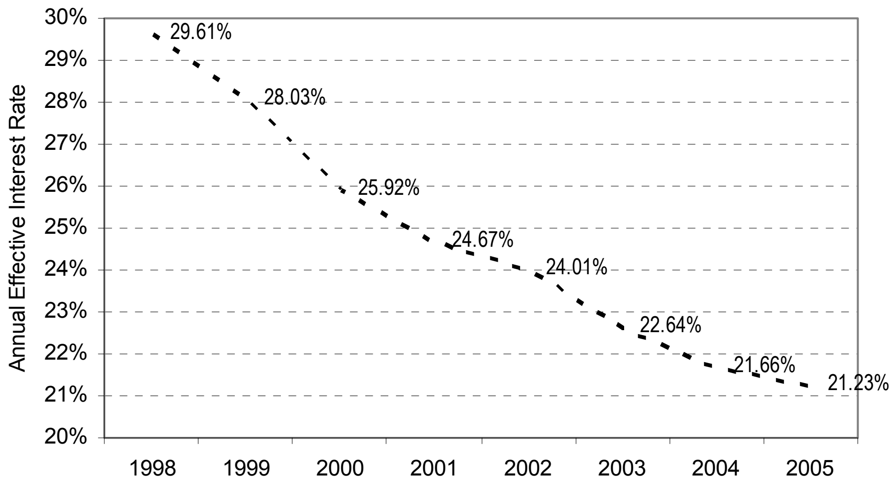
Table 3 Effective Monthly Interest Rates by MFI in Peru (2002)

Loan Range *(soles)*	CMAC de Arequipa	CRAC Caja Sur	Banco MIBANCO	Edpyme CREAR Arequipa	Edpyme EDYFICAR	Financiera Solucion	Banco del Trabajo
500 - 2,999	67.65%	60.10%	69.98%	77.34%	75.52%	77.54%	92.29%
3,000 - 5,000	56.45%	60.10%	59.92%	69.59%	69.59%	77.54%	81.65%
5,000 - 10,000	56.45%	56.45%	50.06%	59.95%	60.10%	69.59%	79.59%
10,000 - 20,000	51.11%	51.11%	50.06%	56.45%	60.10%	60.10%	79.59%
20,000 - 35,000	51.11%	51.11%	44.92%	51.11%	60.10%	60.10%	79.59%
35,000 - 70,000	51.11%	51.11%	44.92%	51.11%	60.10%	60.10%	79.59%

Source: Portocarrero and Byrne (2003)

In the third aforementioned stage of the microcredit activity, an increasing competition leads to a reduction of interest rates and the cease of activity of the less efficient MFIs. An optimal scenario is then reached, with a limited number of MFIs offering a homogeneous product at a price that matches marginal revenue with marginal cost (Portocarrero et al., 2003). In other countries where microfinance is considered to be competitive, interest rates have remained high, as it is the case of Bangladesh, where rates on loans have averaged 15 percent, in spite of fierce competition among the major MFIs. Uganda resembles Bangladesh whereas Bolivia represents the opposite case, where a variety of lending modes (group and individual) were available from early on (Porteous, 2006) in a more competitive environment leading to a significant reduction in interest rates, as shown in **Figure 2**.

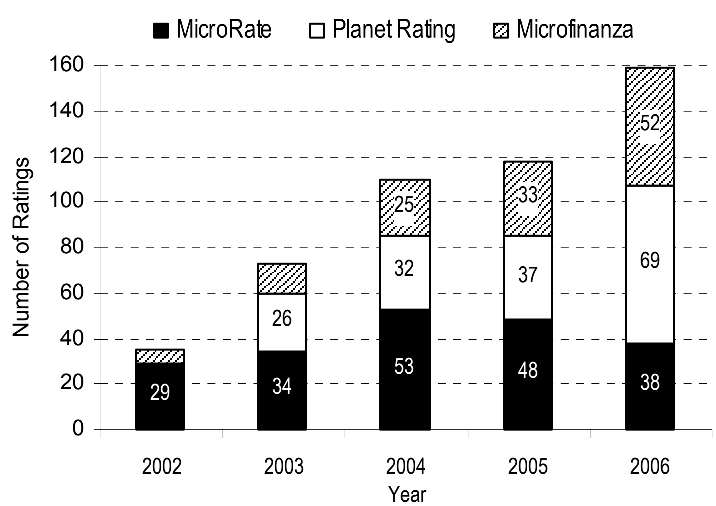
Figure 2 Interest Rates on Microcredits in Bolivia



Source: Rhyne and Otero (2007)

As NGOs become MFIs and MFIs mature into more established financial institutions, the poor wonder whether they will ever have access to basic financial services spanning well beyond the simple concept of microloans. The microfinance rating agencies play a key role in this process as independent third-parties with the ability of rating the credit risk of MFIs. These specialized rating agencies provide, according to Standard and Poor's (2007), "*useful and insightful ratings and evaluations, but in many cases their products have been designed for different users and purposes, such as providing the owners and management of MFIs with an evaluation of the MFI's ability to meet its social and financial objectives*". **Figure 3** shows the growth of ratings performed (either first or update) for the three major microfinance rating agencies.

Figure 3 Number of Ratings Performed

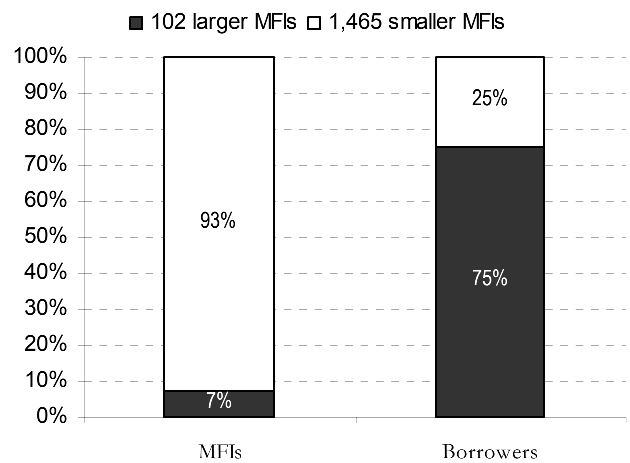


Source: MicroRate, Planet Rating, Microfinanza (2007)

As of year end 2006 the mainstream credit rating agency Fitch Ratings rated a total of 3,078 banks[3], whereas the microfinance rating agencies rated a total of 674 MFIs in the period 1994-2005, a third of which were performance evaluations by specialized rating agencies (The Rating Fund, 2005). The microfinance sector has a long way to catch up, but the growth rates in rating actions performed showed in **Figure 3** denotes the progress made to date.

The larger MFIs are not only more established, but also self sufficient, from the point of view of reliance on subsidies. Subsidies, which will be covered in Section II, are important in the start-up process of an MFI, but do more harm than good in larger MFIs that could perfectly rely on money from private investors. **Figure 4** shows how a majority of borrowers rely on the lending capability of the major MFIs.

Figure 4 Worldwide Concentration



Source : CGAP and The Mix (2005)

MFIs in general rely on subsidies, but the larger MFIs have been able to secure funding from both foreign investment and International Financial Institutions (IFIs) and socially responsible private funds (Standard and Poor's, 2007). According to Standard and Poor's (2007) an MFI has the following two key characteristics: (a) it is a financial organization providing loans and financial services to low income customers; and (b) it seeks both a social as well as an economic return.

According to Damian von Stauffenberg at MicroRate, one of the leading microfinance rating agencies, microcredits do not imply the provision of financial services to the poor, but the lending to productive activities. This feature differentiates the microcredit from the consumer loan, so common in the industrialized world. Before underwriting a loan, an MFI should make sure the borrower has a business able to generate sufficient revenue and cash flow to repay the debt (Martin Cavanna, 2007). **Table 4** shows a set of characteristics for a sample of microlenders rated by MicroRate:

[3] Fitch Ratings Media Group (2007).

Table 4 Characteristics of a sample of microlenders

	Credit Rating			
	Alpha	Beta plus	Beta	Beta minus
Average portfolio of microloans, $million	50	14	9	11
Average RoE, %	28	22	13	15
Average IFI debt, $million	2.1	1.3	0.6	0.1
Average increase in IFI debt, %	88	12	nil	-25

Source: MicroRate, The Economist (2005)

MFIs have to be analized different from traditional banking corporations, since making numerous small loans is more expensive tan the more traditional commercial bank lending. As a result ratios such as operating efficiency will be higher for an MFI that for a commercial bank (Standard and Poor's, 2007). In the business of lending money to the poor, lenders need to overcome the difficulties of the informal sector, where borrowers typically have no formal records, and need to use alternative ways to assess the risk of default.

The larger, more traditional credit rating agencies such as Fitch Ratings and Standard and Poor's have timidly approached microfinance. These agencies are key in today's financial markets and their role of assessing credit risk and giving a neutral, independent opinion to investors is crucial. They have shun the microfinance market because MFIs lack number, volume and purchasing power (Bystrom, 2006).

Fitch is active in Bolivia, where it sees the microcredit market as an aggregation of organizations offering short-term, unsecured, small credit to borrowers that are unable to get financing from the formal banking system (Castro Valdes et al., 2007). A majority of Bolivian microfinance lenders offer short-term loans, most of which are unsecured with no real guarantees. **Table 5** shows the number of active MFIs in Latin America and the Caribbean and the size of their microloan portfolios.

Bolivia is one of the most successful stories in microfinance. The key to success in the Bolivian microfiance is a lesser number of MFIs of bigger size, generating more competition that is translated into lower interest rates, with a portfolio return of 27.1% as of 2002 compared with 45.8% of Peru (Portocarrero et al., 2003). In addition most Bolivian MFIs provide the borrower additional services, such as basic healthcare and social assistance, which strengthens the bond between the borrower and the lender (Castro Valdes et al., 2007).

Table 5 Microfinance in Latin America and the Caribbean (2005)

Country	Number of MFIs	Portfolio (USD Million)	Borrowers	Average Loan (USD)
Mexico	39	471	1,217,920	387
Peru	67	1,516	1,174,361	1,291
Colombia	22	315	608,282	518
Bolivia	21	635	548,242	1,158
Nicaragua	21	261	399,614	652
Guatemala	24	273	363,286	753
Ecuador	20	322	328,065	985
Chile	5	663	297,995	2,223
Brazil	16	91	289,697	313
Dominican Republic	13	158	145,332	1,087
El Salvador	11	138	143,461	964
Honduras	14	80	143,118	560
Haiti	9	24	81,222	374
Paraguay	5	71	59,936	1,193
Costa Rica	19	341	45,607	7,469
Venezuela	5	37	44,969	816
Panama	6	16	28,103	552
Uruguay	3	10	7,155	1,422
Argentina	10	4	10,649	402
Jamaica	3	4	10,401	376
Guyana	1	2	4,184	413
Trinidad & Tobago	1	3	1,733	1,500
Barbados	1	4	384	9,446
Total	336	5,437	5,952,716	913

Source: Inter American Development Bank (2006)

Interest rate caps are common in microfinance and allowed by the regulators. Money lenders have typically lent in the range from 60% to 120%, although in a 2001 study these rates went as high as 400% per annum (Gobezie, 2004). In spite of the fact that national banks will allow MFIs to fix their interest rate, in order to cover the cost of operations, some are still unwilling because they think they might hurt the poor they intend to support (Gobezie, 2004). An interest-rate policy that seeks self-sufficiency and economic return is not contrary to the original *raison d'etre* of an MFI and should not stop it from attaining a socially-driven record. The elimination of caps will foster a more commercial lending practice and transform the current microcredits into an asset class.

II. Subsidies

The current debate in the microfinance industry relates very directly to subsidies and discusses their role, convenience and necessity. When donors support MFIs they select a mix of subsidized loans and grants for the portfolio of microloans, in addition to technical assistance. Sometimes subsidies are transferred to customers. This does often occur in government related MFIs and agencies.

Concerns dealing with excessive subsidization have been commented since microfinance became popular in the 1980s (Morduch, 2005). It is overall obvious that only a few programs in microfinance require borrowers to put up collateral (Morduch, 1999). In this way guarantees and borrowers can perfectly decrease the incentive for borrwers to repay (Standard and Poor's, 2007).

Hermes et al. (2007) distinguish between the *poverty lending* approach and the *financial* approach to microfinance. In particular the former focuses on granting credit to help overcome poverty through subsidised interest rates, whereas the latter stresses the importance of financially sustainable microfinance programs. This brings into consideration the debate of whether subsidies are justified in microfinance, and whether microfinance is a non-profit or a for-profit industry.

The IFIs have been active lenders to MFIs. Their role is controversial because they regularly fund successful MFIs. The poor would be better served if the IFIs and donors overall left the best credits for private investors and focused on those excluded by traditional commercial banks (The Economist, 2007a). Subsidies play a role in certain cases of start-up MFIs or MFIs with activity in rural areas. "*It's difficult for early stage institutions often operating in rural areas where distribution costs are very high, to absorb commercial capital*", says Gary Hattem, head of the community development finance group at Deutsche Bank (Tully, 2007).

A recent study by MicroRate determines that IFIs concentrate their loans on the big MFIs that do not actually need them, increasing their funding by 88% in 2005 compared to a year earlier (Kochubka et al., 2007). Besides in some Latin American countries such as Venezuela or Argentina, the government is announcing its subsidising of microloans, which might put profitable MFIs out of business. (Morduch, 1999) raises the dilemma of whether or not to subsidize microfinance activities, arguing that if microfinance helps to meet social objectives in a more efficient ways that other programs such as direct food aid, there is a reason to continue subsidizing the industry. Rupert Ayton at the Center for the Development of Social Finance argues that subsidies in MFIs may be the reality of banking. Ayton points out that "*banking in a subsidized business, and lending cannot earn a competitive return without higly risky leverage, which is why so few banks have decent credit ratings*".

Wheter or not subsidies are the reality of banking, there seems to be consensus that as an MFI matures it should discontinue the reliance on subsidies to become sustainable, a required sustainability that is generally considered at two levels (Morduch, 1999): (a) operational sustainability; and (b) financial sustainability. **Table 6** shows the decomposition of sustainability into its two components according to a number of categories.

Table 6 Performance Indicators of Microfinance Programs

	Observations	Average loan balance ($)	Avg. loan as % of GNP per capita	Average operational sustainability	Average financial sustainability
Sustainability					
All microfinance institutions	72	415	34	105	83
Fully sustainable	34	428	39	139	113
Lending method					
Individual lending	30	842	76	120	92
Solidarity groups	20	451	35	103	89
Village bank	22	94	11	91	69
Target Group					
Low end	37	133	13	88	72
Broad	28	564	48	122	100
High end	7	2971	359	121	76
Age					
3 to 6 years	15	301	44	98	84
7 or more years	40	374	27	123	98

Source: Morduch (1999)

Relying on subsidies can impact the two levels of sustainability and undercut an MFI's scale and efficiency (Morduch, 2005). As of July 2003 over half of the recorded microfinance lenders were financially sustainable (Morduch, 2005). *Ceteris paribus* the larger the loan size the greater the efficiency. In a study featuring regulated and unregulated MFIs, the average loan size of the former is $858 which compares with that of the $491 unregulated average (Abrams et al., 2002).

Other things equal, MFIs should expand their reach within the urban poor, who are easier to serve. Achieving sustainability should be challenging when addressing serving the rural poor, because of the higher costs involved (AECI, 2006). MFIs that do not rely on subsidies become more efficient applying different techniques that aim at keeping operating expenses low. For instance, the Nicaraguan MFI Fundacion Nieberowski decided to locate its offices outside the cities of Managua and Leon, which enabled to keep rent and salary expenses low (Abrams et al., 2002). The more successful MFIs are the most market-driven.

The industry's donor guidelines favor subsidies for start-up institutions in their first 5 to 10 years of operation (Morduch, 2005). Damian von Stauffenberg at Microrate points out that "*subsidized programs can grow at the pace of subsidies, whereas commercial MFIs grow with the profitability of their financial operations*" (Perez Fernandez et al., 2007). Contrary to what von Stauffenberg would like to see, the Venezuelan government has recently announced the investment of $223 million that will help to create 800 new microbanks, which might drive many existing private MFIs out of business (Helms et al., 2006).

The fact of the matter is that in a document generated by IFIs, public donors agree on a common ground of guidelines to fulfill when approaching donations to microfinance institutitions (CGAP, 2004). One of the eleventh principles is related to subsidies from IFIs to MFIs. The statement refers explicitly to subsidies able to help the MFI in its initial stage. These subsidies should help the MFI to build its institutional capacity and should not interfere with private funding. Longer-lasting subsidies might be justified if an MFI needs to reach rural areas that typically involve higher operational costs. Subsidies can otherwise be used to enhance the infrastructure of rating agencies, risk management center and auditors, what is called the *mezzo* level (CGAP, 2004).

Emmanuelle Javoy at Planet Rating suggests an interesting approach to determine whether the necessity of subsidies is clear. Javoy notes that "*it could be interesting to try and redo the history and see what would have happened if all these subsidies had been provided by commercial equity investors. For the most successful MFIs, would the rate of return have been a reasonable one?*".

A handful of studies dig into the relation between subsidies and a variety indicators with the intent of delineating whether subsidies are indeed necessary or however counterproductive for the consolidation of the microfinance industry.

Hudon (2006) tests whether subsidies are awarded to the well-managed MFIs. The fact of the matter is that a majority of MFIs have been created with subsidies, and there is a consensus among donors that subsidies are necessary to fund new entrants in the industry. The study concludes that the level of subsidies has a limited impact on the quality of management.

Hudon et al. (2006) give empirical evidence on the impact of the performance of an MFI. Very few successful MFIs have been created without subsidies. The data of the study is based on rating reports from the two rating agencies Planet Rating and Microfinanza. The main conclusion of the study is that subsidies to MFIs are associated with lower sustainability, because the latter target poor borrowers involving higher administrative costs.

Karla Hoff and Stiglitz (1998) and Pinaki Bose (1998), present cases in which the entry of a subsidized program worsens the terms and availabity of credits offered in the informal sector (Morduch, 1999).

III. The Role of International Financial Institutions

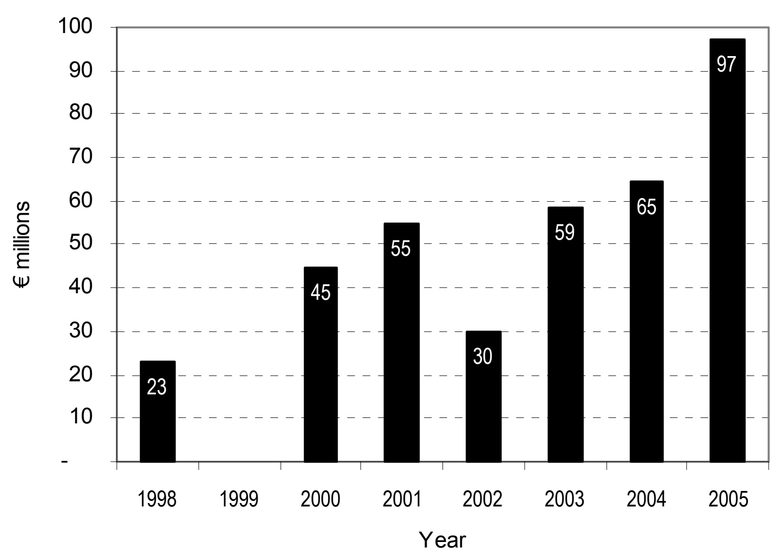
The role played by IFIs is controversial, as they are funding the larger, more successful MFIs, leaving private investors looking for riskier opportunities elsewhere (Abrams et al., 2007). The target of private investors is precisely the type of investor IFIs are funding.

IFIs are in the first place public institutions that do not seek a profit. Their success is measured by the percentage of the funds that are allocated. Accordingly if a budget has been allocated to microfinance, the budget should be spent appropriately, and according to Abrams et al. (2007), this budget will be spent better and quicker on the larger, more established MFIs that have a strong, positive track record in terms of repayment and default rates. IFIs value microfinance because the access to financial services by the poor has the potential to make a significant contribution to poverty reduction and the fulfillment of the United Nations Millenium Development Goals (MDGs) in 2015 (CGAP, 2004).

The Agencia Española de Cooperación Internacional (AECI), the Spanish aid agency, is a good example of public funder allocating large amounts of funds to microfinance. Damian von Stauffenberg at Microrate strongly argues against AECI because it has earned a reputation of funding the best MFIs at very favourable terms. Von Stauffenberg adds that "*the only criterion is to allocate funding and do it very fast, fulfilling the goals of its budget policy, but from the point of view of development, AECI has become a serious threat for microfinance*".

AECI's microcredit fund has lent €330 million over the last 8 years in 26 countries (AECI, 2006). The funding for the fund comes from the budget of the Spanish Ministry for Foreign Affairs, and the repayments of the outstanding loans. According to AECI, the MFIs that receive funding are selected according to their ability to manage a microcredit program. AECI does not ask for an unconditional guarantee to the sovereign where the MFI is located.

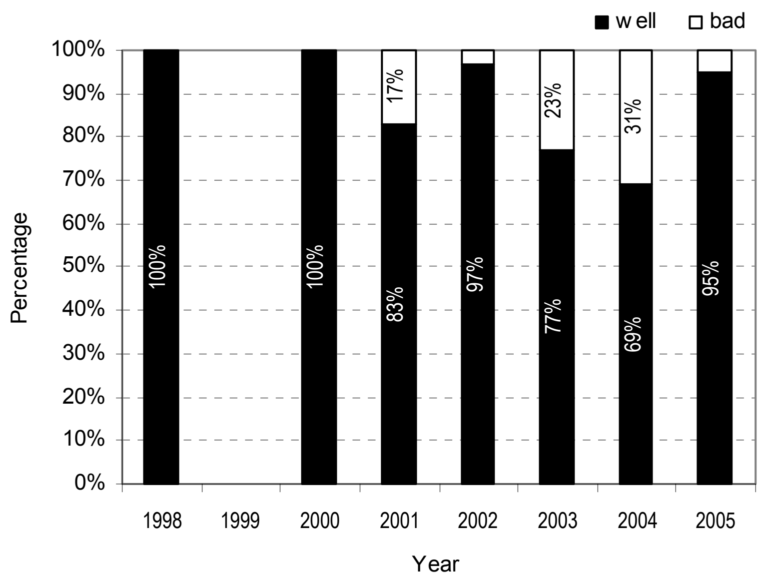
Figure 5 AECI Subsidies to MFIs 1998-2005



Source : AECI (2006)

Figure 5 and **Figure 6** follow on von Stauffenberg's comments and the role played by AECI. According to Barr (2005) about forty percent of the 150 strong MFIs the Microfinance Exchange (The Mix) tracks performance for are financially self-sufficient. This confirms the study of Patrizia Moggia at ADV Equity Fund, a private equity fund based in New York that invests in MFI equity. ADV tracks the best performing MFIs in terms of return on assets and equity. Except for the year 2004, AECI does not seem to be crowding out the better MFIs.

Figure 6 Well vs. Bad Allocated Subsidies



Source : AECI (2006) and ADV Database (2007)

The mission of public government agencies and IFIs has been discussed. They have an important role to play, both at a local and global level. They have the responsibility to put an end to funding the larger, more successful MFIs through subsidies, and instead spend the money on the development of an efficient and competitive microfinance securitization and credit derivative market (Bystrom, 2006).

IV. From Microfinance to Banking for the Poor

The demand of basic financial services by the poor is evident. Estimations from the World Bank[4] target over 2 billion people, of which a quarter of the Asian population, a quarter of the population in Africa and the Middle East, and a quarter of the population in Latin America, Eastern Europe and Central Asia. These individals lack access to adequate forms of financing, many of whom are already borrowers of microloans. Overall the market size for the poor is estimated at $300 billion, of which only about 4% is met.

The market for microfinance is expanding. According to Attali (2006) as of 2006 there were 2.8 billion people worldwide living on less than 2 dollars a day, 10,000 MFIs and 93 million of microfinance beneficiaries. The potential market is huge, with an upside of $100 billion and a sector growth of 20% per annum. "*I think it is quite important to get more of our traditional banking institutions involved in bringing microfinance to the necessary level of density to have an impact on the individual lives of those who receive the loans*," says President Bill Clinton (Baue, 2005).

Austrian economist Joseph Schumpeter already made it clear that banks are the key to economic development because they channel society's savings to entrepreneurs. As a result microfinance can play an important role in financial development, strengthening the link between economic growth and poverty alleviation (Barr, 2005).

MFIs need to go beyond the traditional approach of granting microcredits to the poor with no collateral, to span an array of services beginning with a core package: savings, credit, insurance and payment products such as money transfers (Rhyne, 2007). A greater number of poor people have increasingly demanding savings, insurance, leasing and other financial services (Meyer, 2001).

Helms et al. (2006) perfectly capture the essence and rationale behind the transition from microfinance to the provision of basic banking for the poor:

> Over time, the notion of microcredit broadened first from microcredit into microfinance then into the concept of building entire financial systems that serve their poor and low-income populations – financial systems that are *inclusive*. This new, more ambitious and complex vision has captured the attention of governments, international financial institutions, philanthropists, social investors, mainstream bankers, and even some royalty and celebrities.

In a majority of developing countries, the barriers that banks face are clear: high inflation, incompetence and government corruption, lack of legal framework, and missing property rights (The Economist, 2005a).

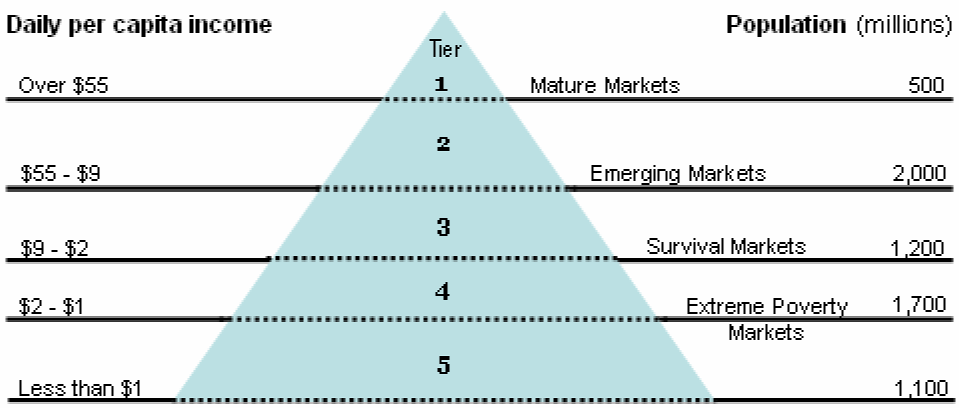
The Spanish bank BBVA with a strong presence in Latin America, has targeted microfinance as a niche market with enormous growth potential. BBVA estimates that only in Latin America the cumulative growth of MFIs in the period 2001-2005 has been 83%, whereas in the same period the microloan portfolio has experienced a growth of 358% (BBVA, 2007). BBVA has planned to invest up to €200 million as part of the activities of their non-profit foundation. In addition some of the world's largest banks like ABN Amro, HSBC and

[4] World Bank Data and Statistics, Financial Sectors (2004).

Citigroup, all with presence in India, are moving into the microfinance sector (Lakshman, 2006).

The world's poor are a majority of the human kind. As such they have no access to basic financial services that have allowed the West to develop credit markets that are crucial for the development and operation of the entrepreneur and the private entreprise. **Figure 7** shows the 5 tranching levels of banking service as a function of the daily per capita income.

Figure 7 The world's economic pyramid



Source: World Resources Institute (2006)

Most individuals below *survival* markets are underserved or totally neglected by the more traditional banking industry mostly active in *mature* and *emerging* markets. The poor have no collateral and live in nation-states that lack the most basic regulation and property rights, where conducting business and investment is risky and unsafe. The poor live in nation-states unable to enforce regulation and conduct banking supervision.

According to Peruvian economist Hernando de Soto the poor in emerging economies lack access to credit because they cannot use their real estate as collateral (de Soto, 2000). Most dwellers in the developing world are owners of the properties they live in, but they live in an unregulated world with no central registry, an unregulated world where banks cannot operate and use the real estate as guarantee to grant credit. De Soto argues that the ability to leverage for both individuals and commercial enterprises is the most important factor in understanding why some economies are developed and others are not (Altman et al., 2008).

IV.1 Regulatory Framework

Professor Loic Sadoulet at Insead thinks that credit is one of the key elements to tackle extreme poverty. Sadoulet continues arguing that "*as soon as an institution starts receiving deposits, it needs to be regulated*". As MFIs grow and start taking retail deposits, questions arise as to whether or not to regulate them (Barr, 2005). The ability of regulation goes along that of supervision. In addition smaller, rural-based MFIs, that often serve the worse off, are more costly to regulate than their urban counterparties. It is not certain that a developing economy has the capability of doing both.

Economies of scale could justify the creation of an international regulator in charge of enforcing regulation and supervising financial institutions in developing economies that would voluntarity decide to join in. The reality is that microfinance will progress only if the enabling environment is supportive (Rhyne, 2007). In certain countries like Uganda, Indonesia, Peru and Bolivia, specific microfinance regulatory frameworks have been very helpful.

In particular Michael Mithika at the School of Applied Microfinance in Nairobi, Kenya, points out that *"in spite of the Microfinance Deposit Taking Institutions Act passed in Uganda four years ago, there have not been many MFIs that have applied to become deposit taking, and contrary to governmental belief, only a handful of those that applied have experienced significant growth*". Mithika points out that savings are not automatic, because individuals choose who to lend to, contrary to the way financial institutions lend. Even if an institution becomes deposit taking, in a competitive environment it is necessary to learn how to brand, develop and sell innovative, competitive banking products, what many financial institutions have not done appropriately.

Another area that is experiencing tremendous growth is cell phone banking. Cell phone banking is emerging but its potential and risk are humongous. The issue is complex because it involves the banking regulator on top of the telecommunications regulator. The former should verify whether cell phone banking meets minimum standards of security, working hands-on with providers and the latter to make sure their systems are up and running at acceptable levels (Rhyne, 2007).

Bolivia's *Superintendencia de Bancos y Entidades Financieras* is in charge of regulating the microfinance industry. In their origins in the 1980s, the microcredit-granting NGOs were not regulated in Bolivia (Superintendencia, 2007). As a result of remaining unregulated, they could not take deposits, which stopped their expansion. In this context the *Superintendencia* moved forward and approved the regulatory framework for the so-called *Fondos Financieros Privados*, or Private Financial Funds (PFFs) according to the English translation. This regulatory framework incorporates a specific norm for the provision of services through mobile telephony, and authorization for a money transfer scheme between regulated and unregulated institutions. Finally specific regulation dealing with credit-scoring bureaus is also in place. The regulation also includes aspects regarding corporate governance and customer service. Since the PFF Regulation was passed, there are in Bolivia six intermediaries operating as PFFs, on top of Banco Solidario and Banco Los Andes Procredit, that although are regulated as banks, also operate in the microfinance sector. Always according to Superintendencia (2007) during the political turmoil of the years 2002 to 2006 the only institutions that did not suffer from massive deposit retrieval were precisely the PFFs, which denotes the importance of the approved regulation.

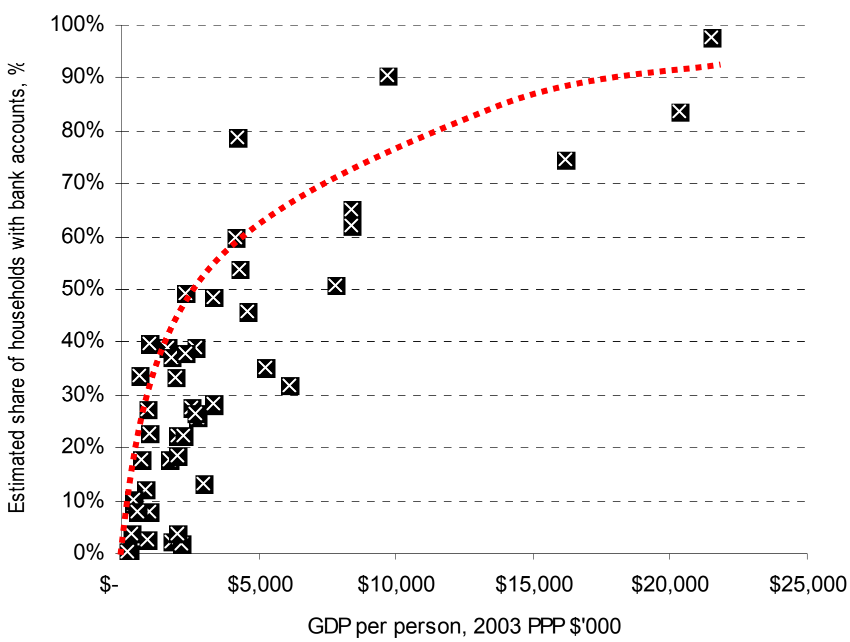
The Association for Social Advancement (ASA) was a microcredit institution based in Bangladesh that faced the challenge of converting into a financial intermediary, undertaking significant changes aimed at the incorporation of savings services (Meyer, 2001). ASA is currently the third largest MFI in Bangladesh only after Grameen and BRAC. In the mid 1990s it had developed a reputation as the fastest growing MFI in the world. The profound changes involving voluntary savings implied unexpected difficulties ASA had to deal with, including some of the following: change in attitude and behaviour of staff, high degree of cannibalisation, and limited potential for mobilising savings among borrowers (Wright et al., 2001).

IV.2 Financial Development

The lack of financial services to the poor is sometimes seen as market failures for credit, insurance, land and human capital, that result in underinvestment by the poor, overinvestment by the rich, and a less efficiency economy (The Economist, 2005b). Elizabeth Littlefield, chief executive of the Consultative Group to assit the Poor (CGAP) at the World Bank is worried that "*foreign money, public and private, is not necessarily catalysing the creation of a sustainable, savings-based financial system in poor countries*" (The Economist, 2007b). Maria Otero, chief executive of Accion International, thinks that "*to obtain scale, microfinance must be considered a serious asset class and that more companies, banks and non-profits should form alliances to maximise their potential impact*" (Tully, 2007).

More than 80 percent of households in developed countries have bank accounts compared to less than 20 percent in developing countries (Helms et al., 2006). In recent success stories of economic development over the past few decades, such as Singapore, Korea or Taiwan, the sequence seems to have been first economic development, then access by the poor to formal savings institutions, and then access to credit for consumption (Dichter, 2007). This argument would challenge the view that access to basic financial services by the poor can bolster development.

Figure 8 Share of bank accounts at different income



Source : Beck, Demirguc-Kunt and Martinez Peria (2005)

In an exhaustive study, Beck et al. (2005) present indicators of banking sector penetration across 99 countries, finding that greater outreach is correlated with financial development and economic activity. **Figure 8** shows the strong correlation between the per-capita income and the share of households with access to bank accounts.

In the last 5 years, microfinance NGOs have entered a state of consolidation, with three structural features that prove the trend leading to a more proffessional management (Attali, 2006). In a survey conducted by Rhyne (2007), a majority of respondents suggested that the microfinance field will move toward regulated financial institutions, and that NGOs will transition to regulated MFIs and continue to grow over the next decade.

There has been a decrease in newcomers, as donors are not encouraging the creation of non profit MFIs, that are accordingly heavily subsidized, except for countries where microfinance is still in an initial stage of development. The more successful NGO type MFIs have become profit institutions. Fierce competition is decreasing the number of microfinance NGOs in a handful of countries.

V. New Instruments

New instruments in microfinance are related to the wave of sophistication and financial engineering that has spread out in the financial markets and the banking industry over the last two decades. Technicisms well-known among financiers are entering microfinance, helping bolster the funding side of this emerging asset class.

There is no reason to think that the financial instruments and investment vehicles that have succeeded in the West will not follow in the developing world. The rationale behind the functioning of certain products could well apply to the poor as long as investors are confident that the repayment rates are as high as they are said to be.

This wave of sophistication and financial engineering brings new capital to microloans and as a result to the developing world. It allows for the spreading of risk and the diversification of potential losses. It is not sufficient, although it is a necessary condition for the basic financial services for the poor to take off once and for all.

An example of innovation in the financial markets that could positively impact the financial services in the developing world is credit scores. A manager of a credit bureau in Peru, claims that the use of credit scoring systems has shortened the waiting time for loan applicants from one week to 24 hours (Campion et al., 2001).

Philanthropers and socially responsible investors demand new financial instruments that allow for the maximization of the social return. Pierre Omidyaer, founder of Ebay, recently donated $100 million to Tufts University to invest in MFIs (The Economist, 2006). His intent is to attract private capital and turn it profitable.

Jacques Grivel is a Swiss financier founder of the Geneva based Symbiotics. Grivel is an entrepreneur who calls himself fin-anthropist, as opposed to the more traditional philanthropist. Grivel would like to see some private funding enter a product that has been heavily reliant on subsidies (Giussani, 2006). Private funding coming from institutional investors, pension funds, and innovative instruments based on hedge fund and private equity structures might bolster an already maturing sector.

Microfinance Investment Vehicles (MIV) are financial instruments that invest in microfinance. In 2005 alone a total of 54 MIVs nearly doubled their investment in microfinance, reaching $1 billion by year end (von Stauffenberg, 2006). These new type of investors will expect the same amount and quality of information that they expect from other more traditional investment opportunities. MIVs are undergoing phenomenal growth, behind which is the expansion of MFIs and their financing needs.

An example of the timid involvement of the banking industry in this new fashion is the agreement by some of the major financial firms such as Deutsche Bank, Merrill Lynch, Munich Re and State Street, to launch the *Global Commercial Microfinance Consortium*, a $75 million facility that will fund MFIs going forward (Baue, 2005). To a certain extent this move is motivated by an increasing concern on behalf of shareholders of a firm's corporate governance and socially responsible investing practices.

Structured finance and credit derivatives are starting to play an active role in microfinance, and may be taking it to the next level (Bystrom, 2006). New sorts of funding brought by innovative investment vehicles like private equity and hedge funds increase investor appetite by an asset class that has remained a niche player so far. Rated structured finance transactions involving microfinance are few to date. "*The potential for this market over time is large but transactions will be small compared to other established asset classes*" points out Gary Kochubka, Director of Emerging Markets at Standard and Poor's in New York. Even if transactions remain small going forward, the ability of MFIs to move microloans out of their balance sheets through securitization is crucial for their funding ability going forward.

MFIs and the international capital markets can meet in different ways. An MFI could borrow directly from the markets. Otherwise an MFI could transfer the actual assets from the balance sheet to the structured instrument, which might attract investors that otherwise would not consider investing in microfinance (Bystrom, 2006). Microfinance faces two challenges that stop investors from investing in structured products that utilize microcredits as collateral.

The first challenge deals with the reliability of the data reported by MFIs. There is not a precise view of how many microlenders exist or how solid they are (Margolis, 2007). "*The microfinance information provider The Mix rates MFIs according to the level of reliability of the data they provide*", notes Emmanuelle Javoy at Planet Rating. As a result, an institution with 5 diamonds has been rated. However an institution with a weak reporting system could be rated and still receive 5 diamonds on The Mix.

The second challenge concerns the impossibility of changing the servicer of the loans, that frequently lies under the responsibility and supervision of the MFI that originated the microloan. David Huntley at Genworth Financial comments that one of the key structural features of asset-backed securities in the more advanced financial markets is the possibility by the arranger of changing the loan servicer if delinquencies climb up. This is typically not feasible in today's microfinance reality, since the MFI that has originated the loan is also in charge of servicing it. As MFIs mature and microfinance providers turn into banking institutions, the structures from the first world should be adopted.

More and more MFIs are turning to the capital markets seeking funding, some of them in pioneering deals like that of BRAC in Bangladesh. With 100,000 employees BRAC is the largest NGO in the world and second MFI in Bangladesh after Grameen. The innovative transaction will provide $180 million of financing for BRAC over a period of six years. The collateral is made up of microcredits granted to low-income individuals from rural areas not reached by the country's commercial banks. "*This transaction underlines BRAC's commitment to be the leading provider of innovative financing solutions to microentrepreneurs. As one of the largest financing efforts ever dedicated to advancing poverty focused microcredit, this is a landmark for the microfinance industry*", pointed out Fazle hasan Abed, Chairperson at BRAC (Citigroup, 2006).

Kiva.org is the latest innovation in microfinance. Kiva teams up with local credit providers to connect low-income borrowers with higher-income social investors (AECI, 2006). According to Kiva's website, Kiva "*lets you connect with and loan money to unique small businesses in* *the developing world*'. In addition and throughout the time up until the maturity of the loan, the borrower can receive updates per email on how the sponsored business is doing.

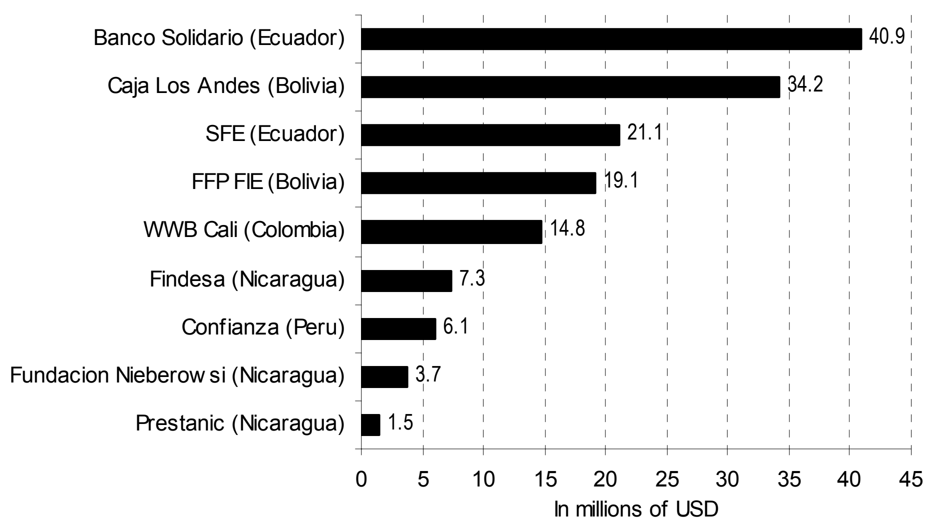
The following five examples show how innovation in the financial markets may be helping microfinance institutions raise additional funding necessary to diversify the risk among a pool of investors interested in these new socially responsible financing possibilities.

V.1 Private Equity

ADV Private Equity Fund (ADV hereafter) is a New York based private equity fund that invests up to $120 million in equity of microfinance institutions. ADV has identified a niche market of MFIs with very good governance, very attractive operating margins and considerable potential, among a universe of 10,000 institutions worldwide that provide lending to client groups with lack of collateral and hence not targeted by the more traditional commercial banking.

ADV studies a variety of MFIs and selects those with an established business model, a good lending track record, profitable to very profitable operations, and senior management willing to receive input on strategy and operations. The prior description would describe what investors would expect from a commercial bank. The typical MFIs that ADV look at, are in actuality banks-to-be, a fuzzy category with the potential to provide basic financial services to the poor on the long run. **Figure 9** shows some of the MFIs in Latin America that investment vehicles have entered.

Figure 9 Investment Funds invest in MFIs

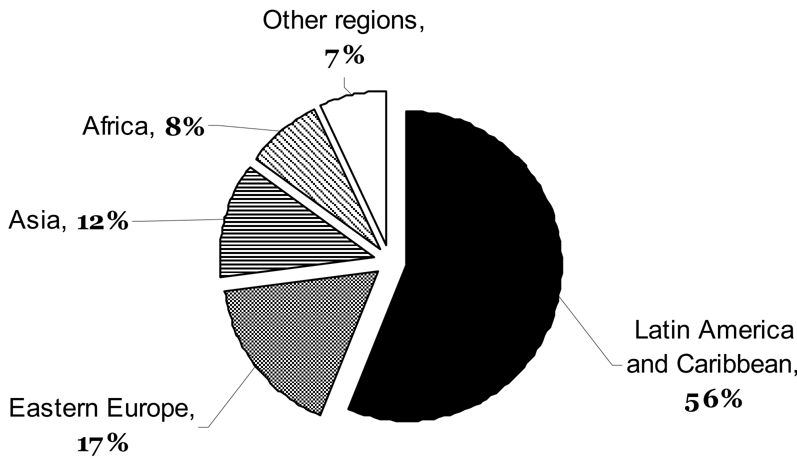


Source: Compromiso Empresarial (2007) based on data from CGAP, The Mix, ADA

Patrizia Moggia is Managing Director at ADV. As such she is responsible for identifying the more successful MFIs with promising outlook. Moggia agrees that the more successful MFIs are located in countries where microfinance naturally works, countries with a high degree of enrepreneurship and honesty, where individuals borrow to launch a project and are commited to repayment.

Private equity is tapping on the doors of the poor. Some of the investors are socially responsible, others might be philanthropers, whereas the greedy investors may be driven by a return not correlated with other more popular asset classes such as fixed income securities or equities. The fact of the matter is that innovation in the financial markets is allowing the funding of MFIs that are today more prepared than ever to enlarge the variety of services they offer to the poor, who need access to the basic financial infrastructure from the West to get on the ladder of development. **Figure 10** shows the geographic allocation of investment funds in microfinance.

Figure 10 Allocation of Investment Funds in Microfinance



Source : Compromiso Empresarial (2007) based on data from CGAP, The Mix, ADA

V.2 Collateralized Debt Obligations

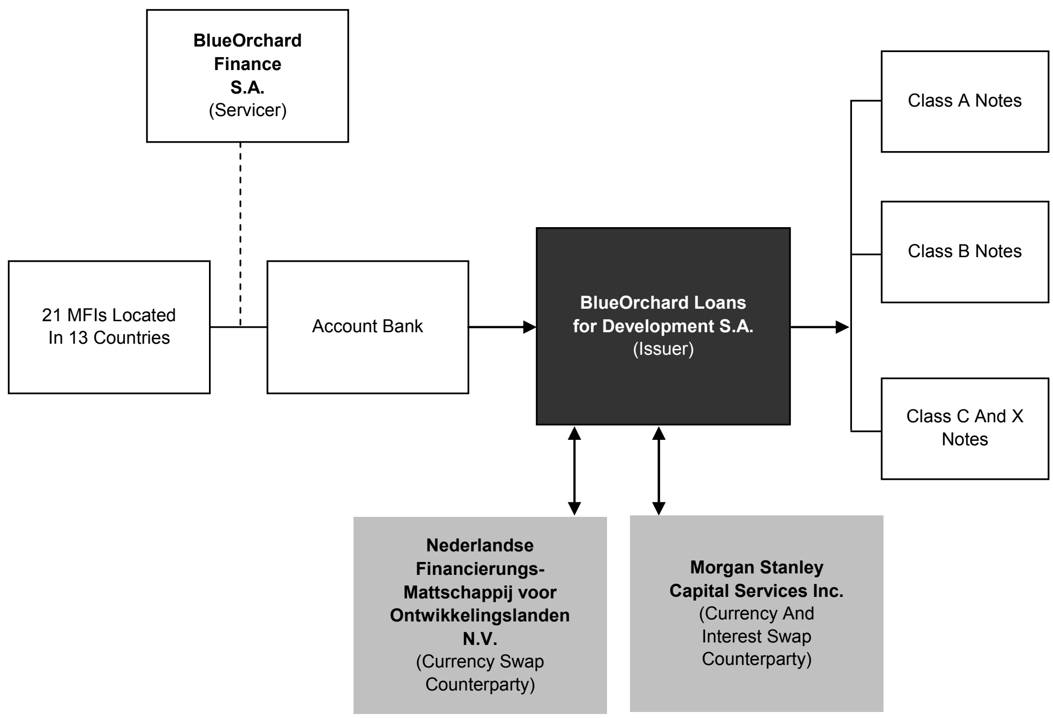
The Geneva based investment shop BlueOrchard is pioneering a new type of securitization that uses microcredits as collateral of the so-called collateralized default obligation[5] (CDO). BlueOrchard Loans for Development (BOLD hereafter) is a $108 million floating- and fixed-rate notes series collateralized by microcredits and recently brought to market.

This type of structured instrument is very common in the increasingly sophisticated financial industry, but typically has different, more reliable collateral such as mortgage loans or commercial real estate assets, originated in industralized nations with strong record of regulation and property rights. The nature of the deal sets a promising precedent and alerts investors of a new asset class. If successful, this kind of deal might allow MFIs to take the risk of holding microcredits away from their balance sheets, diversifying risk across

[5] According to Bystrom (2006) a collateralized debt obligation is "*a particular kind of structured finance instrument where the underlying pool to be securitized typically contains a smaller number of assets (perhaps 50-150) than that of a traditional securitization product.*"

investors. According to Kochubka et al. (2007) this is the first time a microfinance CDO has been rated publicly. This is a big step in the development of microfinance. The main concern of the rating agency Standard and Poor's, the rating agency that has analysed the transaction, is the potential change of the credit quality of the MFI or the sovereign it is domiciled in. **Figure 11** shows the structure of the deal.

Figure 11 BlueOrchard Loans for Development S.A. Transaction Structure



Source: Standard & Poor's (2007)

The ability to put together a microcredit-backed security requires more time than in other asset classes. According to Gary Kochubka at Standard and Poor's, ramping up a deal of this nature and bringing it to market involves the participation of the portfolio manager, the originator, and the servicer, that have to coordinate to successfully market the transaction.

V.3 Hedge Funds

The recent regulation approved by the securities regulator in Spain that triggered the expected marketing of hedge funds and funds of hedge funds, has also fostered some innovation and enabled the offering of alternative products.

BBVA currently markets an unusual hedge fund that invests its proceeds in microcredits in Latin America. BBVA in cooperation with Codespa and a third-party conform the structure of the instrument. The third-party is an auditing company that monitors the four institutions in Latin America that grant the microcredits to relatively poor individuals. The third-party, through its due-diligence process and reports, is able to signal which organisations do what and how. This enables BBVA to have the know-how to lend the proceeds to organisations that will, again, grant the microcredits in the field.

This is a relatively small hedge fund with a principal of €20 million. It is an instrument with a clear social impact that may also diversify the portfolio of a high net worth individual, with a clear social return. The upside is however not obvious. It is questionable to what extent wthis hedge fund will offer attractive returns able to beat the market. The return is linked to the interest rates charged by the four institutions that grant the microcredits and the ability of the borrowers to repay. Products like this one will indeed have a clear impact on the developing world if they become popular.

V.4 Public Equity Offering

Compartamos is the most successful MFI in Latin America. Founded in 1990 by Carlos Danel and Carlos Labarthe in the poor states of Oaxaca and Chiapas, Compartamos now provides microloans to over 600,000 poor with a portfolio of $275 million (Lapper, 2007b). The MFI recently completed a public offering on the Mexico City and New York stock markets, raising $467 million that it will use to fund its lending activities. According to Rosenberg (2007), the Comparamos IPO was 13 times oversubscribed, and the share price climbed 22% in the first day of trading.

V.5 Bond Issuance

Faulu Kenya is a Nairobi based MFI that was launched in 1992 as a pilot micro lending program for the international NGO Food for the Hungry. The pilot program was expanded later in 1995 with funding from the United States Agency for International Development (USAID) and the UK Department for International Development (DFID). Initial funding relied on subsidies from the European Union in 2000 and 2001 and credit lines from two commercial banks in 2002. Later in 2003 Faulu received a loan from BlueOrchard's Dexia Microfinance Fund (Macharia, 2005).

In 2002 Faulu decided to tap the capital markets with a $7 million bond issuance arranged by Stanbic Bank Kenya limited and its parent, the Standard Bank of South Africa. Philip Odera, Managing Director at Stanbic Bank Kenya commented that "*this transaction is one of the most important ever undertaken by any bank in Africa. It addresses one of the major challenges facing Africa: how to direct credit at affordable pricing to enterprising people whom, up until now have been starved of credit*". The bond issuance had the back up of the Agence Française de Dévéloppement (AFD), which guaranteed up to 75% of the bond (Macharia, 2005).

By the time the bond went to market, it had been oversubscribed by 111%, a success story of the African microfinance industry that should become a leading reference for other MFIs in the area.

VI. Conclusions

Microfinance has developed over the last thirty years, and has matured up to a point where it is ready to make the next step. Very likely to be seen as a new emerging asset class, microcredits are beginning to play the role of collateral in structured instruments that may provide additional funding to an industry that has so far strongly relied on subsidies.

The capital markets play an important role because by diversifying the risk they allow for credit to be granted. Microfinance needs to capture the attention of investors, because it is an asset class with structural features that differentiate it from equities, fixed income or hedge funds. Investors look for diversification and like assets that are uncorrelated with the market.

The poorest that have borrowed from MFIs have demonstrated their entrepreneurship, and their ability to repay, with repayments rates that are known to be high. However the industry needs to enforce reporting mechanisms and auditing so that the data that is reported can be trusted by the more established financial institutions in the industrialized nations.

New forms of funding such as debt issuance or public equity offerings are allowing MFIs to approach the business model of commercial banks, that utilize the capital markets to raise both debt and equity. By approaching banks' business models, MFIs will be in a better position to tackle the challenge of offering a wider range of services to the poor, that need financial services as much as they are needed in the first world.

Microfinance and MFIs have an important role to play in this first half of the twenty first century. Only if they succeed may we make extreme poverty a history of the past.

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