

## **The Commercialization of Microfinance:**

### **Fostering Industry Sustainability through Social Performance Indicators**

**IAMFI Position Paper - May 2008**

#### Introduction

Commercial investors are increasingly attracted to the merits of microfinance investing, and microfinance institutions (MFIs) continue to seek private sector capital in order to meet the huge demand for financial services among the world's unbanked poor. While the benefits of additional capital to fund microfinance activities are clear, the evolution of the industry toward profit-driven investors and formalized MFIs has stimulated much discussion on balancing financial and social returns.

IAMFI has been gathering investors' opinions on social impact measurement. Like most MFIs themselves, the overwhelming majority of microfinance investors are motivated by social objectives and do not approach microfinance with a pure profit motive, but rather with the dual goal to foster social advancement among the marginalized while also obtaining a profit that may range from below-market to fully risk-adjusted returns.

In terms of social performance, investors have indicated three areas of concern: reputational risk, consumer exploitation and the misguided comparison of the subprime crisis to microfinance with devastating effect for this fledgling investment class. This paper seeks to convey investors' perspectives and offer an approach to social performance metrics that simultaneously helps MFIs develop best practices, protects their customers and supports the long-term sustainability of microfinance.

#### Social Performance Measurement

Identifying and tracking universally accepted social performance indicators is one of the most complex challenges in the microfinance industry. While financial return benchmarks are standardized and universally accepted, social performance metrics are qualitative, not standardized and more difficult to track. Most initiatives in social metrics have originated from the donor and MFI network perspective, e.g. FMO's Environmental and Social Risk Audit, Grameen's Progress Out of Poverty Index (PPI), Cerise, Accion's Social Assessment Tool, SEEP/AIMS impact survey guidance, etc. Indicators track factors as diverse as health, nutrition, education, housing, financial education and customer service. Currently, social indicators are being applied quite unevenly; many MFIs and microfinance investment vehicles (MIVs) have no process in place, some MFI networks have implemented proprietary or third party social performance measurement tools, some MIVs measure social performance using array of basic to comprehensive metrics, and many donors are funding various initiatives to define and implement indicators in partner MFIs.

As an example of MIVs, BlueOrchard and Developing World Markets, among others, track average loan size/per capita GDP (<20% = poorest borrowers), percent of women served (women are generally poorer than men), and rural vs. urban customers (rural poverty tends to be greater and outreach is harder). ProMujer uses the PPI and has added 15 additional questions customized to its business model, which includes health services and human development training in addition to credit. ProMujer estimates that the cost of measuring impact is 4.8% of total operating costs. It may be intuitive to assume that the most non-commercially oriented microfinance practitioners would outperform in social indicators, yet initial results from Incofin's blended financial-social ranking reveals that three of the top five MFI performers are commercial institutions and three of the bottom five are nonprofits. While there is some evidence of mission drift in MFIs that have transformed into regulated entities, other data indicate that commercialization cannot be used as an inverse proxy for development impact.

### Investor Feedback on Social Performance

In its discussions on social metrics with investors, IAMFI has uncovered a spectrum of opinions that reflects the diversity of the investor population itself. Some investors believe that the social outreach aspect of microfinance is sufficient to infer social benefits and they don't need further proof. Others want some sort of metrics – but measured at the MFI, not the client, level for greater efficiency. Still others feel that social metrics unnecessarily distract management and that scarce resources are better spent on product development, client outreach and loan portfolio administration.

Regardless of their place in the social-blended-commercial return continuum, the investors who seek some form of customer benefit tracking concur on what indicators to measure and why. They overwhelmingly prefer the focus to be on consumer protection and responsible finance principles, as these will serve the dual purpose of improving customer impact and strengthening the microfinance industry. The subprime crisis resulted primarily from errors in calculating default rates (35%, not 10%) and assuming collateral values would keep rising, and thus is not directly comparable to microfinance lending; nonetheless over-indebted and uninformed borrowers combined with poor loan management contributed to the sector's demise. It is unclear how long and how deeply similar missteps in microfinance would impact this incipient asset class. Because of its social impact, investors fervently want microfinance to succeed, while the halo effect of microfinance raises concerns about reputational risk and the specter of being pilloried as an investor in a poorly managed or unethical MFI.

Therefore, investors seek impact indicators that address customer protection and ultimately contribute to the MFIs' and the sector's long-term sustainability. Examples include:

- Transparency in product terms and conditions
- Transparency in interest rate policies and disclosure of full product costs (Annual Percentage Rate including all fees)
- Verification against customer over-indebtedness

- Staff code of ethics
- Training and monitoring on corruption, unethical lending and collections (loan promoter kick-backs, abusive collections tactics)
- Policies and procedures for customer grievance resolution

Many investors have voiced concerns that some of the more complex and qualitative metrics will:

- Overburden MFIs or investors
- Divert attention from financial management
- Add complexity in tools and information management
- Increase operating costs

Some investors feel that social performance presents an area in which public and philanthropic actors may play a role in increasing the understanding of microfinance's impact on poverty by funding and conducting research on behalf of the sector, as long as this can be done without overtaxing MFIs.

### Summary

Microfinance represents a nascent investment class and the effects of commercialization on social impact are only beginning to emerge; the interrelationship of financial and social returns will require ongoing observation and analysis. Given the current disparity in social performance metrics, IAMFI and other key actors in the international microfinance community are convening to define indicators and measurement procedures, and to seek industry consensus on indicators that will form the minimum standard for assessing responsible financial practices and social impact by MFIs. It is possible that, in addition to such benchmark indicators, the more socially oriented MFIs will address poverty related indicators. This has its benefits, permitting funders of all types to make asset allocation decisions based on their particular preferences for impact measurement.

The investor community maintains that 1) strong financial performance improves institutional capacity to serve current and new under-banked populations; 2) strong social performance improves customer loyalty, referrals and repayment rates, lowering costs and risks; and therefore 3) financial and social returns are linked and mutually reinforcing. IAMFI's membership has indicated its preference for indicators measured at the MFI level that improve customer protection and service while fostering industry sustainability.