POVERTY is a global phenomenon. According to the World Trade Organization, the number of people living on less than US$2 per day has risen by almost 50 percent since 1980 to almost one half of the world’s population. In addition, the number of people living in extreme poverty, less than US$1 per day, is also growing in all regions of the world except China.

In fifty-nine countries, the average income is lower today than it was twenty years ago. From 1980 to 1996, only thirty-three of one hundred and thirty developing countries increased growth by more than 3 percent per capita, while the gross national product per capita of fifty-nine countries declined. Around 1.6 billion people are economically worse off today than fifteen years ago.

Over the last forty years, the gap between the rich and the poor has doubled. The richest fifth of the world’s population has 80 percent of the world’s income, while the poorest fifth have only 1 percent of the world’s income, according to the World Trade Organization. Many people see microfinance as a viable and sustainable method to combat poverty. Microfinance is the extension of small loans to impoverished individuals, typically women, to provide them with the capital to start up small businesses and to lift themselves and their families out of poverty. The size of microfinance loans tends to be between US$50 and US$100.

DEMAND FOR MICROFINANCE
Seventy-five percent of the world’s 550 million poor families do not have sufficient access to affordable and appropriate financial services. Market demand for microfinance services is estimated at more than US$300 billion while market supply is only US$15 billion. For microfinance to continue growing at average rates of 15 to 30 percent, US$2.25 to US$5 billion in new portfolio financing and US$300 to US$400 million in new equity will be required annually. To meet this demand, microfinance institutions (MFIs) will need to access capital markets to close the supply-demand gap. MFI leaders and potential investors need to know about the market mechanisms that are emerging to help them learn a common language that will facilitate funding.

INFORMATION INTERMEDIARIES
Bridging the gap between MFIs and capital markets are three main intermediaries: rating institutions, the MIX Market, and financial intermediaries. Rating institutions help identify and assess the state of MFI operations. The MIX Market is a global, Web-based microfinance information platform that links MFIs with investors and donors. MFI financial intermediaries are specialized private investment funds that specifically target MFIs.

Rating Institutions
One of the greatest challenges MFIs encounter when seeking access to capital markets is legitimacy and proof of stability. It is therefore necessary for MFIs to utilize reliable rating and assessment services like the financial markets. The Microfinance Rating and Assessment Fund was established in 2001 as a joint initiative of the Inter-American Development Bank (IDB) and the Consultative Group to Assist the Poor (CGAP). The primary objectives of the Rating Fund, as listed on its Web site, are:

- To build markets for MFI rating and assessment services by encouraging greater demand from MFIs for professional external evaluations, as well as by strengthening the quality of supply.
- To improve transparency of MFI financial performance as a basis for improved performance and increased flow of commercial funding.

by Isaac H. Smith, Michael A. Broderick, and Richard G. Winsor
The fund will finance 80 percent of the cost of a rating/assessment of an MFI by a preapproved institution (See Table 1).

For an MFI to qualify for rating/assessment funds, it has to have provided financial services for clients for at least three years. Hundreds of MFIs have already received ratings and assessments—lending credence to the notion of MFIs as an emerging asset class by improving the reliability and availability of information on the risk and performance of MFIs.

### The MIX Market

The MIX Market serves as a Web-based link between MFIs and the public at large. It provides information on public and private funds that invest in microfinance, MFI networks, raters and external evaluators, advisory...
firms, and governmental and regulatory agencies. The goal of the MIX Market, as worded on their Web site, is “to attract more public and commercially-oriented investors to microfinance by promoting financial transparency, accountability, and increased disclosure standards.” It provides MFIs with an opportunity to post a profile on the Web to market their organization to investors and donors. Likewise, investors and donors can post profiles in an effort to develop potential microfinance investment opportunities. As of July 2007, the MIX Market has profiles of 973 MFIs, 93 investors, and 163 partners.

Financial Intermediaries

MFI financial intermediaries are specialized investment funds that specifically target MFIs. Private investors are given the opportunity to invest in a fund, which in turn, is managed by a third-party organization that invests in multiple MFIs.

The ACCION Bridge Fund and the Wisconsin Coordinating Committee for Nicaragua Fund were pioneering MFI financial intermediaries, providing debt financing to partner MFIs by selling promissory notes to the public. Later, in 1995, ProFund was created as a private equity, venture capital fund that invests in fifteen Latin American MFIs. In 1999, LA-CIF was created and is managed by Cyrano Management. Cyrano has since launched numerous funds that offer different types of capital to MFIs and different investment risk portfolios to investors.

Another innovative MFI financial intermediary is BlueOrchard Finance. It was incorporated as the world’s first investment company that targeted MFIs exclusively. By soliciting investments from social investors, BlueOrchard manages millions of dollars, which it is able to invest in MFIs.

One of the major constraints of an MFI in reaching the estimated 2 billion people living below the poverty threshold is the lack of capital. Historically, capital was only accessed through private or government donations. In the last decade, MFIs have pushed to limit the dependency on donor capital and to access funding through the capital markets.

FUNDING VEHICLES

Microfinance Funds

Approximately seventy-five private social investment funds raise money to distribute to MFIs. Many funds are affiliated, in varying degrees, with established development organizations—mostly NGOs.

Historically, these funds relied solely on philanthropic funding. Currently, most funds are not and do not seek to be self-sustaining. However, a few successful funds are emerging that offer returns at or near market rates, and another fifteen to twenty offer modest or below-market returns.

The leading example of a market-sustainable microfinance fund is the Dexia Micro-Credit Fund. Dexia Bank International of Luxembourg created the fund in 1998; it was the first commercial investment fund designed to refinance microfinance institutions. Investors in the fund range from retail banking customers to institutional investors. The fund is active in twenty developing countries in Latin America, Asia, and Eastern Europe, and finances forty institutions.

To manage its microfinance portfolio, Dexia Asset Management relies on the Swiss firm BlueOrchard Finance. BlueOrchard selects the MFIs through a comprehensive network of contacts. In order for BlueOrchard to select an MFI, the MFI first must have an independent external rating. Then BlueOrchard initiates a field visit and a data collection process for the prospective MFI. On the basis of BlueOrchard’s on-site evaluation, the financing committee decides to invest or not. If they do invest, the selected institution reports on a monthly basis over the whole life of the investment and is visited every year.

Asset-Backed Securities

Another emerging asset class in microfinance is asset-backed securities. A microcredit asset-backed security is a bond that is collateralized by the future cash flows of principal and interest repayments from an MFI’s clients. The nature of this financing instrument does require the setting up of a new special purpose company to manage the loan portfolio that has been set aside to make payments.

One such special purpose company is BlueOrchard Microfinance Securities (BOMFS) I, formed by Developing World Markets and BlueOrchard. In what was the largest transaction in the United States capital markets to fund microfinance, BOMFS I, in July 2004, issued a US$40 MM bond to support MFIs in nine developing countries. In February 2005, BOMFS II raised another US$47 MM in the capital markets.

JPMorgan helped place BOMFS I securities on Wall Street. Microfinance debt, as with other new asset classes, allows Wall Street to profit handsomely from underwriting these new securities and selling them to brokerage clients. BOMFS I was no exception and paid fees around 3 percent, falling in the middle of the typical span demanded by investment banks.
**Bond Issues**

In 2002, three microfinance institutions in three different countries in Latin America issued bonds in local capital markets, raising approximately US$25 million in new debt financing on terms more favorable than those available from banks. One of these MFIs, Compartamos, issued a 100 million MXP (approximately US$10 MM), three-year, 13.1 percent coupon bond. In 2004, Compartamos tapped the capital markets with a US$44 MM bond rated AA by Fitch and S&P. Both bond placements were issued to individual and institutional investors and both placements were oversubscribed (i.e., investor demand exceeded the supply of bonds).

**Strategic Partnerships with Commercial Banks**

In 2003, CASHPOR, an MFI working in the poorest region of India, and ICICI Bank, India’s second largest bank and largest private bank, entered into a mutually beneficial, strategic partnership agreement to provide microfinance services to the poor. CASHPOR, with its market knowledge of poor customers, originates and services loans, while ICICI, with its strong balance sheet and vast financial resources, provides capital—including working capital—for CASHPOR to carry out its work. Underpinning this agreement is CASHPOR’s approval of loan proposals. In the first year of joint partnership, CASHPOR recruited six thousand new customers and distributed US$650,000. The at-risk portfolio (i.e., greater than thirty days past due) was 0.02 percent. For ICICI, this investment has been very advantageous, and ICICI plans to commit the equivalent of US$1 billion to this sector over the next five years.

**Looking Forward**

“We are changing the perception that microfinance institutions are funded only by charitable donations,” said Drew Tulchin, manager of GF-USA’s capital market programs. Currently, only an estimated 20 percent of microfinance funding is made by commercial operators, according to GF-USA. “This success expands the equation to include investors as viable partners through commercial financing.”

**For Investors: A Unique Combination of Social and Financial Returns**

One important distinction between microfinance debt and other asset classes is that microfinance debt offers what is called double bottom line returns—which means that microfinance not only offers an attractive financial risk-return profile, but it also offers a significant social return. Microfinance is widely recognized as one of the most effective poverty reduction tools. In 2005, the United Nations declared 2005 as the Year of Microcredit.

**Social Returns**

Microfinance has proven to be a very efficient way to alleviate poverty. It has stimulated grassroots entrepreneurship, job creation, and community and financial infrastructure development; it has raised family living standards and growth of small businesses; and it has enhanced social and economic development by facilitating access to capital markets.

**Appealing Financial Risk-Return Profile**

Wall Street is known to be heartless when it comes to investment decisions. Investors look for high returns balanced with potential risk for an investment. In order to interest investors, microfinance debt must provide an attractive return based on its risk.

BlueOrchard estimates that microfinance debt offers a better return than monetary instruments. Specifically, it estimates microfinance debt to have earned an additional 150 to 200 basis points with only a slightly higher level of risk and concludes it is an excellent alternative to fiduciary deposits or certificates of deposits.

The asset-backed security BOMFS I is an example of a varied risk-return profile in the microfinance investment class. BOMFS I issued a seven-year deal that has four layers of various risks or tranches. The senior debt portion accounts for US$30 MM, or 75 percent, and is guaranteed by Overseas Private Investment Corporation (OPIC),

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**Table 2: S&P 500 Return on Investment**

<table>
<thead>
<tr>
<th>Share Price</th>
<th>1202.22</th>
</tr>
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<tbody>
<tr>
<td>Cumulative Return</td>
<td>18%</td>
</tr>
<tr>
<td>2000 ROI</td>
<td>-2%</td>
</tr>
<tr>
<td>2001 ROI</td>
<td>-17%</td>
</tr>
<tr>
<td>2002 ROI</td>
<td>-24%</td>
</tr>
<tr>
<td>2003 ROI</td>
<td>32%</td>
</tr>
<tr>
<td>2004 ROI</td>
<td>4%</td>
</tr>
<tr>
<td>2005 ROI</td>
<td>2%</td>
</tr>
</tbody>
</table>

an agency of the U.S. federal government—thus making this portion a risk-free investment. The return on the senior tranche is between 0.25 percent and 0.5 percent higher than similar risk-free treasury securities.

Weak Correlation
Another attractive prospect of microfinance debt is the low correlation the returns have with other assets. A key strategy for investors is to try to diversify their investment portfolios in an effort to reduce their overall risk. As the world becomes more global, markets become more heavily correlated—thus making it increasingly difficult for investors to diversify their portfolio risk.

Microfinance weakly correlates with political, economic, or even climatic events. The informal sector is by its very nature a thriving place of permanent business creation, which is less directly linked to the fate of the formal economy. Similarly, it weakly correlates with global financial movements on the major markets. Table 2 and Figures 1 and 2 show the returns of Dexia Micro-Credit Fund and the return on the U.S. market as measured by the S&P 500. The period in question, September 1998 to June 2005, was a severe recession for the U.S. economy following the bust of the dot-com bubble. As seen in the graph the Dexia Micro-Credit Fund performance shows no correlation with the market, with a cumulative return for the period of 34.3 percent compared to an 18 percent return for the S&P 500.

Attractive, Fast-Growing Industry
The microfinance industry is developing fast, both in size and quality. First and foremost, the size of demand is growing exponentially, driven by the millions of micro-entrepreneurs who are still longing for basic financial services. If they are to meet their projected demand, microbankers estimate that in the next five years alone, they will need between US$10 to US$20 billion. Second, new and increasingly sophisticated products (e.g., credit and debit cards, leasing, housing and education finance, and insurance and transfer payments) are being introduced as the industry matures, and the existing clients need to evolve with the growth of their businesses, which

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![Figure 1: Monthly Close for S&P 500](image1)

![Figure 2: Dexia Micro-Credit Fund Performance](image2)
pushes still further the funding requirements of this industry. Competition is currently limited or non-existent in most markets, particularly in Asia and Africa, creating a unique short-term growth opportunity for microfinance service providers to capitalize on the industry’s attractive returns.

The industry has a documented track record of more than fifteen years that shows a global asset quality stronger than other financial asset classes. Over the last five years, “winners” have emerged from the industry’s fragmented marketplace, setting standards for best practice.

REASON NOT TO INVEST
With any unique emerging asset class there is always some uncertainty. Investors and uncertainty do not like each other, and there exist real questions about the quality and safety of microfinance investments.

Some of the criticisms of microfinance debt include:
- The majority of microfinance debt is not traded in a liquid market and is therefore difficult to price.
- There is currently not a large enough amount of microfinance debt for institutional investors to use as a key investment to diversify risk.
- The level of formal financial disclosure is not as formalized as other types of investments, which could lead to exaggerated perception of default risk.
- Investors do not have any expertise with MFIs and microfinance debt.

The list pinpoints areas of concern mainly from an institutional investor’s perspective. The positive news is that there are not underlying weaknesses in the essentials of the microfinance industry. Rather, most items can be overcome through better communication of the market’s fundamentals and through changes in the way the industry presents itself to investors.

HOW TO GAIN ACCESS
We offer four key recommendations for MFIs seeking to access capital markets. First—and most difficult—an MFI must become profitable and self-sufficient. Otherwise, private investors will be reluctant to risk their capital. Second, get a rating and assessment from an accredited organization. Third, register on the MIX Market. Fourth, network.

For MFIS: BREAKING into the GAME
MFIs traditionally have relied on donors to provide funding for microcredit. Many are not sure how to access capital markets themselves and may not even see a reason to pursue this source of funding.

REASONS TO ACCESS CAPITAL MARKETS
The mere notion of accessing capital markets may be completely foreign to many MFIs. What is the purpose of accessing capital markets? MFIs are currently satisfying only an estimated 10 percent of the demand for microcredit. The full size of the market is roughly US$300 billion, while donors only account for less than US$1 billion per year. Meeting demand will require an ever-increasing influx of cash flows. Private investors via capital markets are the most realistic source for such an immense amount of needed funds.

A secondary reason for MFIs to work towards accessing capital markets is that it will inevitably lead to increased operational efficiency, financial accountability, and transparency. Just to be considered by private investors, an MFI would need to prove itself as a viable organization with competent management and sustainable operations.

Become profitable: For many MFIs, the notion of profitability may be daunting, intimidating, and seemingly out of reach. To effectively access capital markets, however, MFIs must become sustainable organizations that investors can have confidence in. The first step toward profitability is learning the language of business. MFIs must become familiar with basic business terminology to level the playing field with investors. The second step is to incorporate basic business practices (e.g., financial management) into standard operations. A simple Internet search can provide countless sources of information to help MFIs better
manage their organization and work toward profitability. For example, at http://www.managementhelp.org/finance/fp_fnce/fp_fnce.htm, a Web site titled “Basic Guide to Financial Management In For-Profits,” advice is given on basic bookkeeping, budget management, financial statement development, and much more.

There is a risk to focusing on profitability: a theory called mission drift. As the theory goes, as soon as a nonprofit organization begins to focus on sustainability and profitability, they begin to lose sight of the very mission and purpose for which they came into existence. It must be understood, however, that if the long-term goal of microfinance is to help alleviate poverty by providing the poor with access to capital, then billions more dollars need to be raised to meet the massive demand. Becoming profitable and more business-like in order to access capital markets is one of the most promising options for the MFI community to meet its ultimate goal of offering capital to all who need it. MFIs may therefore look at accessing capital markets as central to their mission, not as a detractor from it.

Get a rating: Information about rating and as can be found at http://www.ratingfund.org, the Web site of the Microfinance Rating and Assessment Fund. A formal rating and assessment from a pre-rating organization serves two purposes. First, an assessment can increase the likelihood of an MFI becoming profitable. The rating and assessment will help identify areas of concern and areas of needed improvement. For example, in December 2004, FINCA Mexico received a rating from MicroRate, a microfinance rating agency. The rating included a thirteen-page report detailing the operations, portfolio quality, management and organization, personnel and productivity, operating efficiency, governance and strategic positioning, and financial data. A rating and assessment can provide invaluable information for an MFI that is on the brink of profitability.

Second, for a profitable MFI that is seeking capital market funding, a rating provides investors with needed information to make an estimate of the risk associated with investing in that MFI. Reliable ratings allow investors to benchmark MFIs against each other and make informed investment decisions. Over two hundred MFI rating and assessment reports are posted on the Microfinance Rating and Assessment Fund Web site.

Register on the MIX Market: An MFI can register on the MIX Market through its Web site: http://www.mixmarket.org. According to the Web site, “The MIX Market strives to facilitate exchange and investments flows, promote transparency, and improve reporting standards in the microfinance industry.” By registering, MFIs expose their organization to potential donors and investors.

Network: Although obvious, it should not be underemphasized that one of the best ways to accomplish a goal is to learn from someone who has already accomplished that goal. Numerous MFIs have successfully accessed capital markets. Networking with these organizations is an important opportunity to learn from past failures and successes. The Consultative Group to Assist the Poor (CGAP) regularly posts the Microfinance Capital Markets Update on its Web site. The report lists the recent debt and equity deals between MFIs and investors. Networking with organizations currently in the process of accessing capital markets can also provide MFIs with valuable information.

CONCLUSION

Poverty amidst great prosperity has always existed, in sure because many of the world’s poor were of the same markets that made others wealthy.

microfinance represents a tool that can bring the world’s poverty fully into existing markets. We have suggested a number of reasons and ways that microfinance organizations and investors can work together to bring the benefits and fruits of financial markets to microfinance institutions.

James Copeland teaches development economics at the University of Bath, UK. He has researched and written about microfinance.

Issac H. Smith, Michael A. Broderick, and Richard G. Winsor put their minds together for a field study in early 2006. For an academic course available to MBA and MPA students at Brigham Young University, Smith, Broderick, and Winsor conducted research for the ESR Center. As part of their research they gathered many key players in the field of microfinance together for a focus group—including John Hatch of FINCA, Ellen Vor der Bruegge of Freedom From Hunger, Mushtaque Chowdhury of BRAC, and Louis Pope and Troy Holmberg of Yehu Microfinance. Smith and Broderick earned MBA degrees from Brigham Young University in 2007, and Winsor graduated from Brigham Young University’s MPA program in 2006.

ABOUT THE AUTHORS