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# Microfinance and Socially Responsible Investment in Latin America

## Workshop Report

Guatemala City, Guatemala

September 02, 2003

Co-sponsored and hosted by

The Inter-American Development Bank  
Enterprising Solutions Global Consulting, LLC

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## Executive Summary

This report is based primarily on the proceedings of the *Microfinance and Socially Responsible Investment Workshop*, held September 2, 2003, in Guatemala City. The workshop was designed to provide a common forum for socially responsible investors (SRIs), microfinance institutions (MFIs), MFI specialty funds, MFI support organizations and donors. It gathered leading representatives of these groups to discuss the current and future role of social investment in Latin American microfinance. This report synthesizes the workshop presentations, plenary discussions and working group reports, adding background information and references where appropriate. It is intended both for social investors and for MFI practitioners and investors.

**Organization of the report:** Part One summarizes microfinance in Latin America and social investment in the U.S. Part Two assesses the potential for greater flows of social investment to Latin American MFIs, highlighting both the opportunities and the challenges ahead.

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Latin American microfinance has blossomed into a \$1.5 billion industry with an expected annual growth rate of 20%.<sup>1</sup> This profitable industry produces competitive returns and has positive social impact, but needs more access to capital to fuel its expansion. Socially responsible investors, meanwhile -- or those investors who seek both social and financial returns -- represent a sizable and growing segment of the finance industry and currently control over \$2.7 trillion in assets worldwide and \$2.3 trillion in the U.S. alone. These two sectors, Latin American microfinance and U.S. socially responsible investment (SRI), have much to gain from increasing the ties between them. But even though greater flows of SRI to MFIs would serve the interests of both sides, there are obstacles impeding further development in this direction. The Guatemala City workshop focused on identifying these obstacles and discussing steps and strategies to overcome them.

Faced with rising demand, MFIs are seeking cost-effective and diversified funding sources. Local savings may serve as one important source of funds -- a sizeable and relatively inexpensive source. But growing MFIs now often

need the kind of additional volume and diversity of funding that private capital markets can offer. Unfortunately, the non-profit background of many MFIs can make it challenging to establish credibility with conventional commercial investors.

Access to financing is becoming a significant constraint to greater scale and market penetration. It is not just greater volume that is needed, but also different types of capital: for example, start-up equity for new ventures, portfolio capital for unregulated, high-growth institutions, or equity and long-term debt for institutions striving to meet capital adequacy and growth imperatives, as they transform into regulated commercial entities. By some estimates, leading MFIs in Latin America alone will demand over \$230 million in portfolio capital and \$20 million to \$50 million in new equity in 2003 alone.

Meanwhile, for the SRI sector -- which has outperformed the broader financial market, actually continuing to expand despite the recent global contraction<sup>2</sup> -- microfinance is a compelling investment proposition for both social and financial reasons. On the social side, MFIs have significant positive impact by providing low-income clients with opportunities to improve their basic living conditions. This means MFIs represent an investment-diversification opportunity that is consistent with the social interests of SRIs' clients. At the same time, since SRI is not "soft" capital, the financial performance of MFIs is important. Social investors operate within the same financial regulatory system as conventional investors and face the same cost and competitive constraints. This means that, in addition to measurable social impact, social investors require measurable, competitive, risk-adjusted rates of return. Leading Latin American MFIs have been profitable in each of the past five years. While there are no asset-class benchmarks for comparison, these leading Latin American MFIs as a group perform as well as many commercial banks, publicly traded securities and emerging market mutual funds and often perform even better.<sup>3</sup> Moreover, there is evidence of significant potential for SRI interest in expanding into emerging markets, which in turn

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<sup>2</sup> U.S. SRI mutual funds have experienced net inflows of over 3% while the average across all funds has been a 9.5% contraction. For more SRI performance information see: Social Investment Forum Press Release, July 30, 2002 at: <http://www.socialinvest.org/Areas/News/020730.htm>

<sup>3</sup> Supported by "Tough Enough: Microfinance defies recession in Latin America," *Microenterprise Americas Magazine*, IADB, 2001: <http://www.iadb.org/sds/mic/micamericas/eng/1/tough-4.pdf> ]

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<sup>1</sup> Jansson, Tor, "Financing Microfinance", September, 2003, available from the Inter-American Development Bank, Washington, D.C.

could bode well for SRI involvement in microfinance. The results of a poll of U.S. social investors, conducted in 2002 by Enterprising Solutions, suggested that social investor demand for “high-impact” social investments in emerging markets (including in MFIs) could lie between \$3 billion and \$5 billion, of which approximately 30% could be allocated to Latin America.<sup>4</sup>

Efforts to attract U.S. SRI could pay off in several ways for MFIs. For one, social investors have the added social incentive to work with the complexities of investment in emerging markets and in microfinance. More importantly, SRI has credibility among mainstream investors. Because of SRI’s ability to produce competitive financial returns and its demonstrated leadership in community development investments (primarily in the U.S., but in emerging markets as well), SRI has the potential to attract conventional investors to “unconventional” investments.

The Guatemala City workshop identified a range of social investors likely to be interested in MFI investments. Key conclusions were:

- The more likely investors include high net worth individuals and faith-based institutions.
- Interest from institutional money managers and SRI mutual funds is currently muted, given the regulatory constraints they face and the types of MFI investment currently available.
- “Community investor pools,” like those offered by the Calvert Foundation, Christian Brothers Investor Services, MMA Praxis and specialty MFI Investment Funds (such as Blue Orchard and the LACIF family of funds) -- all of which already make MFI investments -- are a good conduit through which to reach the broader social investment community, particularly since they already work within public securities regulatory constraints.

While the opportunities are many, so too are the challenges. Socially responsible investors are typically uninformed about microfinance and inexperienced in emerging markets. To overcome this knowledge gap, MFIs will need to provide adequate disclosure about their financial performance and social impact. At the same time,

neither the microfinance sector nor the SRI industry is homogeneous, so differing segments of each will have different needs. Perhaps the most daunting challenge will be determining the investment vehicles that best meet the requirements and interests of both SRIs and MFIs. A final challenge will be to redefine the role of donors in light of the evolving needs of the MFI industry.

Creating a bridge between the two industries will require sustained incremental efforts by interested stakeholders. The workshop revealed a high degree of interest among participants to undertake these efforts, despite the evident challenges. The groundwork needed for better linkage between U.S. SRI and Latin American MFIs will include:

- Improved channels of communication between the microfinance sector and the social investment community;
- Increased analysis and awareness-raising about MFI investment opportunities;
- Better understanding of the types of capital that SRI can deliver to MFIs;
- Research and strategy development on how social investors’ influence can be applied to trigger more capital flows (particularly from same-country sources) to MFIs; and
- Clearer definition of the best respective roles for donors and other non-financial actors (such as rating agencies, Microfinance Information eXchange, and so on).

The majority of workshop participants concluded that, notwithstanding the challenges ahead, an ongoing, systematic discussion of these issues would help to better define the available investment options, ultimately leading to more SRI investment in Latin American MFIs.

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<sup>4</sup> See The Potential for Social Investment in Microfinance and Small Enterprise in Developing Countries, Enterprising Solutions, 2003 ([PDF-185Kb](http://esglobal.com/resources.htm)). Available at <http://esglobal.com/resources.htm>

## Part One

# Summary of Latin American Microfinance, Socially Responsible Investment and the Current Status of SRI in MFIs

## Latin American Microfinance

### Financial Performance and Sector Development

The microfinance industry in Latin America has matured over the past two decades from a grass-roots NGO movement into a \$1.5 billion industry, with a growing number of microfinance institutions (MFIs) having become regulated financial institutions that compete head-to-head with commercial banks, for clients as well as capital. Its dramatic growth has been fueled not only by the size of its target market – low-income populations, traditionally underserved by financial institutions – but also by its profitability.

While all MFIs, by definition, provide financial services to the poor, the industry is not homogenous. It is composed of both regulated and non-regulated financial institutions, including commercial banks and finance companies as well as NGOs, cooperatives and quasi-banking institutions.<sup>5</sup> These various MFIs differ in size, corporate structure, capital structure and target market.

The magnitude of growth occurring over the past five years in the market for microfinance is reflected in data on a group of MFIs tracked by MicroRate, an MFI rating agency. This group, the “MicroRate 31,” is a selected group of Latin American MFIs with characteristics that reflect broader industry trends. In 2002, the collective client base of the MicroRate 31 had grown to 790,000 clients, an increase of 250% from four years earlier. Importantly, for the industry as a whole, client growth has not come at the expense of portfolio quality: the Portfolio At Risk (PAR) of MFIs

throughout Latin America is lower than that of most commercial banks.<sup>6</sup>

In addition to growth and portfolio quality, the industry’s efficiency and productivity have improved. Operating expense ratios are, on average, dropping. Only a few years ago, an operating expense ratio of 25% was considered very good. But by 2001, the average for the MicroRate 32 (an additional MFI was added to the original 31) was 19.9%. The very best MFIs are now approaching 10% in this measure of efficiency.<sup>7</sup> In terms of profitability, MicroRate data suggests that MFIs are not only profitable, but several appear to be more profitable, based on Return on Equity (ROE), than many domestic and international commercial banks, including Citibank. Since 2000, the MicroRate 31 ROE has averaged 19%.<sup>8</sup> Return on Assets, another key measure of performance, is 4.2%, far above that of most commercial banks. Funding sources for MFIs are diverse, with the bulk of funding for

#### Figure One Presentations at the 2003 Guatemala City Workshop

“The Anatomy and Performance of Micro-finance Institutions,” Damian von Stauffenberg, MicroRate.

“The Social Impact of Microfinance,” Carlos Labarthe, Financiera Compart-amos.

“Trends and Patterns in the Finance of Microfinance,” Marc de Sousa-Shields, Enterprising Solutions.

“What is Socially Responsible Investing?” Frank Coleman, Christian Brothers Investment Services.

“Challenges and Opportunities in Bridging Socially Responsible Investment and Microfinance,” Michael Lent, Progressive Asset Management.

Workshop Summary, Shari Barenbach, Calvert Foundation

<sup>5</sup> Regulatory authorities in Bolivia, Brazil, Peru and El Salvador have created a new class of financial institution to address the specific operational characteristics and supervisory needs of microfinance institutions. (See Jansson, Tor, “Microfinance: From Village to Wall Street”, Inter-American Development Bank, November 2001).

<sup>6</sup> While PAR is an instructive measure of portfolio quality, certain caveats are in order. While the industry PAR has remained low, individual MFIs, such as BancoSol in Bolivia, have experienced increasing PAR’s, particularly as competition has intensified. Conversely, institutions with low PAR’s may be benefiting from lack of competition in niche markets such as remote rural areas. Also, a low PAR may not include loan write-offs, while a high PAR may be balanced by high loan provisioning. (See Microfinance Institutions Technical Guide, Third Edition, published by MicroRate and the InterAmerican Development Bank, available at [www.microrate.com](http://www.microrate.com)).

<sup>7</sup> The Operating Expense Ratio is calculated as (Operating Expenses/Average Gross Portfolio). Data included an additional MFI (thus, the MicroRate 32 instead of the MicroRate 31). Data was sourced from Performance Indicators for Microfinance Institutions Technical Guide, Third Edition, published by MicroRate and the InterAmerican Development Bank, available at [www.microrate.com](http://www.microrate.com).

<sup>8</sup> See: The Finance of Microfinance 2002, published by MicroRate and the InterAmerican Development Bank. See the MicroRate website at [www.microrate.com](http://www.microrate.com).

the current, leading MFIs coming from savings and other non-donor sources. Donor funds, however, remain critical to smaller institutions and, for small and large MFIs alike, are a primary source of risk capital and technical assistance financing. As the industry evolves, however, so too are its funding needs. The type of funding required by an individual MFI depends on its stage of development as well as its capital structure and strategic direction.

In general:

- (i) Start-up MFIs may need *equity risk-capital* and *low-cost debt* funding.
- (ii) MFIs seeking to transform into regulated financial institutions need to build an adequate capital base and may require *long-term risk share capital*.
- (iii) MFIs seeking to capitalize on the leverage afforded to regulated financial institutions may require *short- and long-term debt, preferably local-currency debt*.
- (iv) MFIs reaching maximum leverage but continuing to grow may require *equity*.

Donor funds are not suited to provide equity capital, nor do donors have available the volume of capital required to support industry growth. Leading Latin American MFI requirements for new debt and equity capital in 2003 have been estimated at over \$230 million.<sup>9</sup> The bulk will come from client savings, and the remainder from a mix of private and public sources, including development banks. Finance from relatively new, private-sector and quasi-private specialized sources like LACIF, Blue Orchard and Calvert Foundation, among others, will play an increasingly important role as they develop. Some believe there will be a shortage of equity capital as more MFIs strive to meet growth expectations and to meet the capitalization requirements of regulated financial institutions.

## Social Impact

The impact of a loan to a microentrepreneur and her or his family and community is multi-faceted. Access to microcredit makes clients less vulnerable to unexpected crises, such as medical or family emergencies. It can be highly effective in generating positive business results, since microenterprises typically have high margins and use their credit with particular efficiency. When it is targeted to women clients, as is sometimes purposefully done, microcredit generates revenues that are more likely to be used for health, education and food needs. Microentrepreneurs' stated purpose is to generate economic activity. And microcredit gives low-income people the chance to build their asset bases. These opportunities in turn can lead to client empowerment and community development. There are various concerns that micro credit increases family indebtedness or that it does not break the cycle of poverty. While this is true, the fact that many clients repay and take on repeat loans indicates the value of microcredit services.

Figure Two

### Compartamos Social and Financial Impact Potential of MFIs

Created in 1990 as an NGO program, Compartamos is a regulated financial institution providing financial services to women in rural Mexico. Compartamos also exemplifies the way a microfinance institution's profitability can enable it to reach the poor in ever-greater numbers. Given its penetration in rural areas, its high percentage of women clients (98%), and its low average loan size, among other key measures, Compartamos is a recognized industry leader in client impact.

Although it is difficult to isolate the specific impact of an MFI on a client's life or community, there are various quantitative and qualitative tools, including client surveys and focus groups specifically designed for the microfinance industry, that measure the impact of an

MFI, over a period of years, on clients' standard of living (access to food, health, shelter or education, for example), empowerment and community involvement.<sup>10</sup> Though compelling, current research on microfinance impact remains unable to assert the strengths of these observations, leaving industry growth and repeat borrowing as the main and a positive indicator of social impact.

Many MFIs -- including Compartamos, ProMujer and Women's World Bank affiliates in Colombia, to name only a few -- are, in their very existence and success, excellent proof that social and financial objectives are not mutually exclusive. Serving women in the poorest rural areas of Mexico, Compartamos has grown rapidly to over 130,000 clients while achieving a return on equity (ROE) of over 50% in 2002. The success of Compartamos has attracted

<sup>9</sup> See: Tor Jansson's *Financing MFIs*, published by the InterAmerican Development Bank, available at <http://www.microfinancegateway.org>.

<sup>10</sup> See, for example: USAID Assessing the Impact of Microenterprise Services projects at <http://www.mip.org/componen/aims/publications.htm>.

commercial investors: in addition to funding from Dexia, the International Finance Corporation of the World Bank Group, and domestic commercial banks, in 2002, Compartamos placed a \$15 million A+ bond with Mexican investors.

Average loan size is considered one key measure (inversely) of an MFI's commitment to poverty. Since larger loans tend to go to more well-off clients, a low average loan size implies that an MFI is reaching the poor.<sup>11</sup> Data from the MicroRate 31 suggest that, over the past five years, the industry has resisted "mission creep", or the temptation to drive up average and/or median loan size in order to improve operating efficiency.<sup>12</sup> Still, though this may be true of the industry as a whole, at the single-institution level, increased competition and changing strategic objectives may cause some MFIs to target a larger loan-size market segment.

## Socially Responsible Investment

Socially responsible investment -- also known as ethical investment, mission-based investment, values investment, social investment or in some cases faith-based investment -- is investment that incorporates social and/or environmental criteria into investment decisions.

<sup>11</sup> What constitutes a low average loan size varies by country. In Mexico, less than \$500 is low. In Ecuador, less than \$250 is considered low.

<sup>12</sup> Since it can be misleading to assume that increases in average loan size always mean an institution is working less to help the poor, alternative measures have been used to measure "mission creep." These may include median loan size, or may involve controlling for larger loans.

**Figure Four**  
**Community Investor Pools:**  
**Calvert Community Investment and Others**

Calvert Foundation, an independent non-profit organization, associated with the Calvert mutual funds, is a "Community Investor Pool" that was launched with the goal of making it safe and convenient for individuals and institutions to invest in microfinance overseas as well as community development activity in the US. By paying investors less than a full, risk-adjusted return, Calvert Foundation can absorb the costs of investing in MFIs while bringing affordable rates to its borrowers. Since its inception in 1995, Calvert Foundation has raised more than \$60 million from 1700 investors, with 20% of this available to be lent overseas. When lending abroad, it must manage foreign exchange risk and provide investors full assurances that their principal will be returned with interest.

The oldest and largest Community Investor Pool is Oikocredit of the Netherlands (formerly EDCS). Examples of others with similar approaches include Partners for the Common Good, the Wisconsin Coordinating Committee for Nicaragua and Mennonite Mutual Aid's Community Development Investments.

Once considered a niche industry, worldwide SRI assets today total an estimated \$2.7 trillion, having grown over the last several years despite a weak global economy.<sup>13</sup> Of this, an estimated 1.0%, or \$2.7 billion, is invested in emerging-market SRI, mostly held in large-capital, publicly traded stocks. Approximately \$200 million to \$250 million is invested in MFIs and small enterprises in emerging markets.<sup>14</sup>

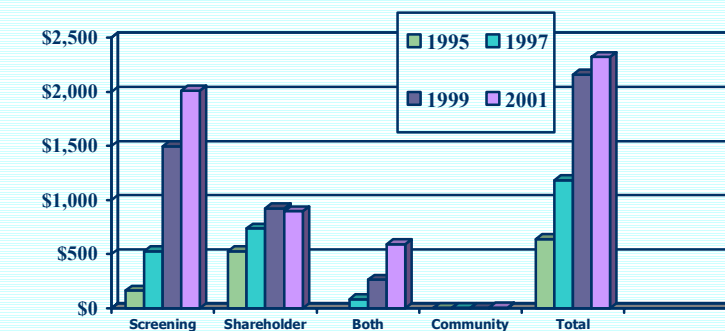
## SRI Strategies

The three basic strategies of SRI are: (i) screening, (ii) shareholder advocacy and (iii) community investment.

Screening refers to the use of social or environmental criteria in investment decisions. With

negative screens, investors may choose to screen out companies with significant business in activities deemed socially or environmentally undesirable. With positive screens, investors choose to invest in companies that advance certain causes (environmental causes could include solar power or organic foods, for example).

**Figure Three**  
**Growth of SRI 1997 to 2002**  
(in USD \$ billions)



From "What is Socially Responsible Investing?" by Frank Coleman, Christian Brothers Investment Services: a presentation made at MFIs and SRI Workshop in Guatemala City, September 03, 2003. Data sourced from the Social Investment Forum, www.socialinvest.org.

<sup>13</sup> For more information on U.S. social investment trends, see the Social Investment Forum website at: [http://www.socialinvest.org/areas/research/Biennial Reports on Trends on Socially Responsible Investing 2001 Trends Report \(PDF format\)](http://www.socialinvest.org/areas/research/Biennial%20Reports%20on%20Trends%20on%20Socially%20Responsible%20Investing%202001%20Trends%20Report%20(PDF%20format).): "Report on Responsible Investing Trends in the U.S. 2001".

<sup>14</sup> Towards Sustainable and Responsible Investment in Emerging Markets: A Review and Inventory of the Social Investment Industry's Activities and Potential in Emerging Markets, Enterprising Solutions and the International Financial Corporation. This report is available in hard copy from the IFC and on the Enterprising Solutions web site at [www.esglobal.com](http://www.esglobal.com).

Shareholder advocacy is the most frequently used SRI strategy and is considered the most potent. In this mode of SRI, shareholders seek to change corporate behavior by directly engaging company management on a particular social or environmental issue.

Community investment, meanwhile, consists of targeted investment in businesses and financial institutions that serve economically disadvantaged people and communities. Community investment vehicles include community development banks, credit unions, and low-income housing projects. Different kinds of community investment offer different kinds of rates of return ranging from insured investments, like certificates of deposit or loan funds, to venture capital funds. The latter may offer rates of return that are competitive, or below-market. Investors can also invest in pooled community funds that offer professionally managed portfolios of community-development-related investments.<sup>15</sup> Examples of the latter include Partners for the Common Good (CBIS), Calvert Community Investments (Calvert) and MMA Community Development Investments (MMA Praxis) -- please see Figure Four. Many social investment advisors and some SRI companies also recommend that their clients allocate a percentage of their portfolio (typically between 1% and 5%) to community investments. Several mutual fund companies, such as Calvert and MMA Praxis, similarly allocate a percentage of mutual fund assets to community investments.

### **Social Versus Financial Return**

There are important differences among the different segments of the SRI industry. Community investors may be more likely to accept below-market rates of return, sometimes, for investments believed to have high, positive social impacts. Generally, however -- and contrary to popular belief -- most socially responsible investors do not wish to forgo financial return for social return. In fact, the SRI industry has grown, in large part, because of a substantial and growing body of research showing that, on average, SRI funds do not under perform conventional funds.<sup>16</sup>

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<sup>15</sup> For more information on community investments at Calvert and MMA Praxis see [www.calvertfoundation.org](http://www.calvertfoundation.org) and [http://www.mmapraxis.com/cdi/page\\_1.html](http://www.mmapraxis.com/cdi/page_1.html).

<sup>16</sup> See Towards Sustainable and Responsible Investment in Emerging Markets: A Review and Inventory of the Social Investment Industry's Activities and Potential in Emerging Markets, Enterprising Solutions and the International Finance Corporation (available in hard copy from the International Finance Corporation, or the Enterprising Solutions website at [www.esglobal.com](http://www.esglobal.com)). For a full treatment of return expectations in the emerging market context. For a fuller treatment of SRI performance see literature reviews by: Peter Camejo, The SRI

The SRI industry includes institutional investors, individual investors, mutual funds and asset managers, with risk-return profiles ranging from conservative (low financial returns, low risk and low social impact) to moderate or aggressive (higher returns, risk and impact). (See Figure Five) While a social venture capitalist may seek returns of 15%-20%, an investor in an asset-backed security, with favorable subordination, maturity and rating, may accept a lower return. U.S. social investors must also meet specific legal, regulatory and investment requirements that can impose limits on their ability to place investments.

### **Current Status of SRI in MFIs**

The total estimated worldwide SRI in emerging market MFIs and small business investments is less than \$250 million. Of this, the bulk of current SRI investment in Latin American MFIs is channeled primarily through community investment vehicles. With just over \$7 billion in assets, community investment focuses primarily on U.S. community development and is the smallest segment of the overall U.S. SRI market. For Latin American MFIs, it currently offers dollar-denominated term debt and equity.

Although the community-investment pool of funds is the most accessible for MFIs in the short term, strategically it has less leverage than other forms of SRI would have in attracting conventional investors. The non-conventional nature of community investment and its below-market rates of return make it a poor match for the needs of conventional investors, who require readily understandable investment instruments and competitive return rates. Figures Five and Six show the nature of community-investment SRI instruments and the generalized, inherent levels of risk, return expectations and social impact potential.

Given the heterogenous capital needs of MFIs and the desirability of tapping the broader SRI market, it appears that new instruments are needed, beyond those currently and in addition to those employed by community development investors. Investment vehicles that could facilitate more SRI investment in MFIs include:

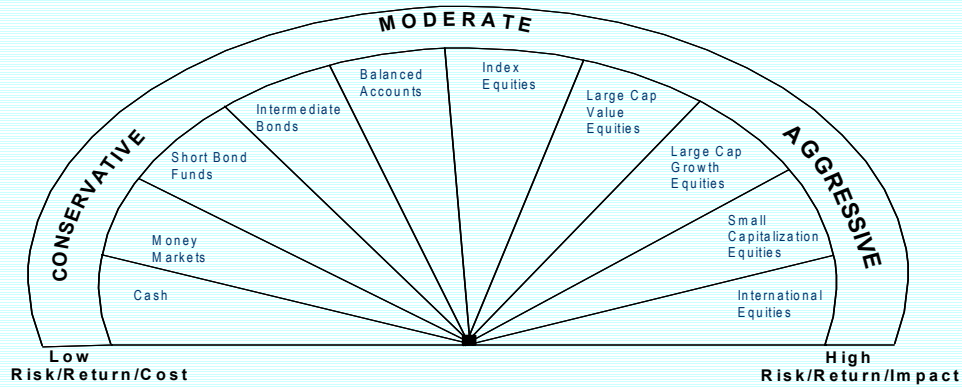
- Specialty MFI funds that offer portfolio diversification, specialization, professional asset management, low minimums, liquidity, daily valuation, currency hedging, social and

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Advantage: Why Socially Responsible Investing Has Outperformed Financially, New Society Publishers, Canada, 2002.

Figure Five

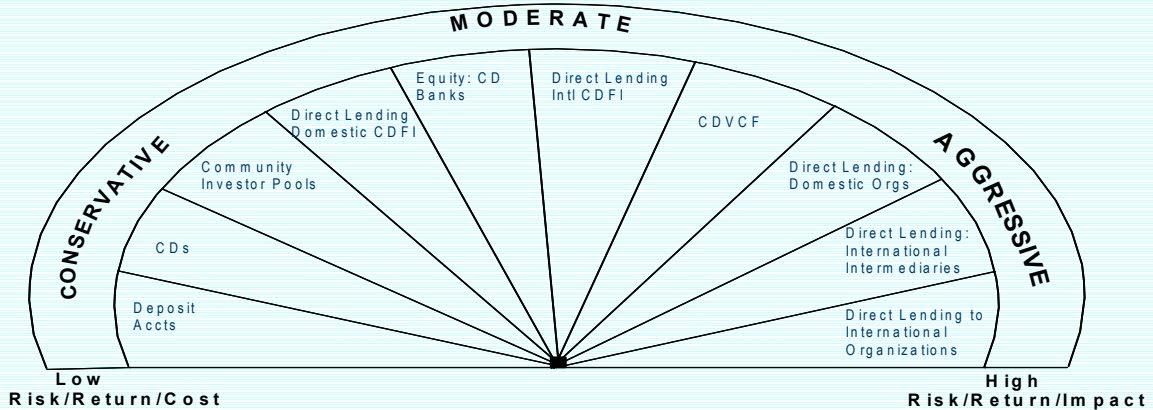
**Risk/Return Paradigm :  
Standard SRI Investments**



From "What is Socially Responsible Investing?" by Frank Coleman, Christian Brothers Investment Services: a presentation made at MFIs and SRI Workshop in Guatemala City, September 03, 2003.

Figure Six

**Risk/Return Paradigm :  
How To Apply to Community Investing?  
A First Attempt.**



From "What is Socially Responsible Investing?" by Frank Coleman, Christian Brothers Investment Services: a presentation made at MFIs and SRI Workshop in Guatemala City, September 03, 2003.

- environmental performance benchmarking and competitive returns. However, until specialty funds achieve significant scale, those with limited distribution capabilities may incur (and pass on to potential investors) significant intermediation costs.
- Global, asset-backed, hard-currency securities in which the bond obligation is collateralized by the future cash flows of an MFI loan portfolio; in other words, the principal and interest payments of MFI clients would pay the principal and interest payments to bondholders. While this vehicle would

be attractive to social investors, it requires coordination and expertise currently beyond the scope and scale of individual MFIs.

- Targeted funds or financial services for qualified high net-worth investors and accredited investors, who are not subject to the same regulatory constraints imposed on mutual funds and retail investments. Such individuals represent sizeable and flexible assets, but competition for these clients is intense.
- SRI mutual funds may also serve as a long-term investment opportunity, but the regulatory requirement that mutual funds' portfolios must be valued on a daily basis represents a key barrier to MFI investment. The U.S. Securities Exchange Commission does allow for up to 15% of a fund's portfolio to be valued less frequently but, in practice, few funds exercise this option.

## Part Two

# The Potential for SRI Financing MFIs in Latin America

### Developed Country SRI Potential and Role

In the wake of recent financial scandals that have plagued both developed and emerging markets, the tenets of socially responsible investment appear to have growing resonance with investors. While the overall universe of funds has contracted, SRI retail mutual funds have experienced positive growth due to asset appreciation as well as new sales. Large institutional investors like pension funds are also increasingly considering the role of social and environmental criteria in their investment decisions as fiduciaries.<sup>17</sup>

Socially responsible investors also have been able to engage conventional investors in a number of movements, from divestment in South Africa to investment in clean air technology, precisely because SRI funds have consistently generated competitive financial returns. In the U.S., SRI has been pivotal in attracting conventional capital to new markets, such as community development investments.

Despite its successes, however, SRI's potential for financing of Latin American MFIs remains unclear. The level of possible demand for emerging-market MFI investment is difficult to estimate due to a lack of rigorous market studies. A 2002 poll of U.S. social investment professionals by Enterprising Solutions suggests there exists the potential demand of \$3 billion to \$5 billion worth of high-impact emerging-market investment, a category includes small-enterprise and microfinance investment.<sup>18</sup> Of this amount, according to the poll, over 30% could be directed toward Latin America. Investment could take many forms: SRI firms could initiate MFI investment funds of their own, or they could limit their exposure and transaction costs by investing in specialized funds. The most likely investors include high net worth individuals,

faith-based institutions and, to a lesser extent (at least in the short-term), SRI fund management companies and mutual funds.

There are also other steps, aside from actual investment, that could be taken by socially responsible investors to support increased private investment in Latin American MFIs. For example, SRIs could initiate shareholder actions or engagements to encourage publicly traded financial institutions, particularly multinational banks, to apply corporate responsibility mandates overseas by investing in MFIs or by providing services to low-income communities. Shareholder advocates have routinely engaged corporations, and with some success, on labor rights, human rights and affordable medicine in developing countries. SRIs could also work to support regulations similar to the U.S. Community Reinvestment Act in emerging markets.

Given the heterogeneity of investors, the role of SRI in microfinance may be different for each SRI firm and contingent upon the types of capital at its disposal. Direct investment in debt instruments issued by MFIs and even some equity investments are possible. But direct investments entail significant transaction and knowledge development costs. For this reason, it is likely that the greatest immediate potential for expanded investment is through investment in specialty funds that intermediate finance to MFIs, such as the LACIF family of funds, or Blue Orchard. The downside to specialty funds, however, is that they represent a "double intermediation" of funds between investors and MFIs, driving up the cost of funds to MFIs and thus driving down the returns to investors.<sup>19</sup>

Some of the major challenges that MFIs face in attracting SRI dollars stem from the highly intricate and stratified nature of the U.S. market, which is characterized by several different investor types (mutual funds, individuals, asset managers, institutional investors) and is governed by distinct regulatory concerns and distribution constraints. SRI investors are best able to purchase

<sup>17</sup> For a full treatment of increased interest in SRI among institutional fund managers, see: Towards Sustainable and Responsible Investment in Emerging Markets: A Review and Inventory of the Social Investment Industry's Activities and Potential in Emerging Markets, Enterprising Solutions and the International Financial Corporation. Available in hard copy from the IFC and the Enterprising Solutions web site at [www.esglobal.com](http://www.esglobal.com).

<sup>18</sup> See: The Potential for Social Investment in Microfinance and Small Enterprise Development in Developing Countries, published by Enterprising Solutions and available at [www.esglobal.com](http://www.esglobal.com).

<sup>19</sup> See Intermediating Capital to MFIs: A Survey of Financial Intermediation to Microfinance Institutions, published by Enterprising Solutions and available at [www.esglobal.com](http://www.esglobal.com).

publicly traded financial instruments, such as stocks or bonds. Yet, few MFIs issue such instruments. Most MFIs are seeking what the markets would call private equity or private debt. In the U.S., private equity and debt are largely held by institutional investors. Regulations conceived to protect the smaller investor, along with distribution channels designed to simplify the purchase of financial products, make it very difficult for individuals or mutual funds to participate in private equity or debt markets. Add to this mix of constraints the foreign exchange risk, the diverse regulatory constraints from MFIs' own domestic financial markets, as well as political risk, and the factors impeding the flow of U.S. SRI dollars to MFIs begin to mount.

This is not to say that MFIs should write off the possible participation of investors who share their mission of creating economic opportunity for every household. There are avenues that offer promise:

- (a) Launch financial instruments that institutional investors can purchase – this is precisely the strategy that Blue Orchard has pursued through portfolio securitization.
- (b) Work through the specialized, non-profit “community investor pools” that have been set up by SRI mutual fund companies and faith-based investors. These investment vehicles were purposefully created outside the conventionally regulated financial markets and designed to lend to NGOs and MFIs that share common social objectives. (The Calvert Foundation is an example: see Figure Four found in Part One).
- (c) Perhaps most promising: appeal to local, domestic SRI investors (social investors who are themselves based in developing countries) through bond offerings. This may be more feasible in larger emerging markets, like Brazil or Mexico, than it currently is in smaller markets like Bolivia or the countries of Central America.

### **Developing Countries Potential and Role**

To date, SRI in developing countries has not advanced as it has in developed countries. Less than 1% of all SRI fund assets worldwide are currently held in emerging market investments. Recent activity, however, suggests that this trend is changing.

Over the last five years, the number of SRI initiatives, particularly publicly available, screened mutual funds and

institutional funds, have grown dramatically in all regions of the developing world. Locally managed SRI retail funds have recently been launched in Korea, Malaysia, Hong Kong and Brazil. Islamic funds, which invest according to *sharia* principles, predominate in the Middle East and have combined assets of over \$3 billion.

South Africa is by far the most dynamic developing-country SRI market. There, some 15 retail and institutional funds that invest in disadvantaged communities, often through unlisted investment. With just over \$1 billion in assets, South Africa represents the largest SRI market among all emerging market countries. Catalyzed in part by government initiatives and in part by key business and civil society leaders, South Africa is an example of how socially motivated funds can be mobilized for community investment in emerging markets.

While not marketed as socially responsible investments, recent bond issues by Compartamos (Mexico) and MiBanco (Peru) were bought primarily by high net worth Mexican individuals and Peruvian domestic pension funds, respectively. These successful debt offerings demonstrate the attractiveness of MFIs to commercial investors and the potential opportunity to attract domestic (developing-country) social investors.

### **Role of Donors and Multilaterals**

The role of donors and their potential support for linking SRI and microfinance cannot be overlooked. Donors have been both the industry's financial lifeline and a favorite target of criticism for continued, widespread subsidies. Clearly, donors subsidize projects that generate a public good; equally clear, these subsidies represent an inefficient allocation of resources and a factor that can inhibit increased commercial funding of MFIs. By providing subsidized capital to institutions that would otherwise be capable of accessing commercial funding, donors can “crowd out” commercial investors and, in doing so, truncate the development of systematic MFI access to commercial capital markets. The irony, of course, is that without donor subsidies, many financing issues facing the industry today would be moot. And their work remains important in several areas of MFI development (in new product development, for example, or in the extension of rural services). These observations notwithstanding, many donors provide subsidized capital to MFIs fully capable of paying market rates, and thus compete with private investors such as Blue Orchard or LACIF for viable investment targets.

The adverse side effects of donor involvement do not obviate the need for donors. Rather, they highlight specific areas where donor intervention would be better suited. Donors continue to play a critical role, albeit an evolving one. For young institutions, donor funding represents a needed source of risk capital. For both young and mature institutions constrained by various technical and managerial limitations, donor-funded technical assistance is still in demand. For mature MFIs transforming into regulated financial institutions, donors may also be a source for much needed equity. For MFIs with multiple funding needs (such as overnight discount credit, bank loans and debt funding), the role of the donor becomes one of market facilitator, supporting greater information flow, educating investors and creating instruments to attract commercial funders by mitigating transaction costs and investment risks. Thus, strategic, non-market-distorting interventions, and sometimes donor seed financing, can in fact serve to “crowd in” private-sector investors.

These judgements were reflected in comments by workshop participants. Many attested to the value of “a multilateral agency that provides a public good, such as information on the financial performance, risk and social performance indicators of MFIs.” It was further recommended that “a private-public partnership [be created] that lets the market create the right vehicle for SRI while public money focuses on such things as: (1) providing market statistics, information, education; (2) reducing transaction costs; (3) risk allocation in terms of risk hedging, guarantees, and subordinated debt; and (4) public policy and local regulation.”

### **Linking SRI and MF: Opportunities**

In summary, greater social investment in microfinance could serve the interests of both social investors and MFIs because:

- **SRI is a sizable, global industry:** Socially responsible investment is a \$2.7 trillion global industry. Given its success in attracting conventional investors to “un-conventional” investments, further SRI entry into microfinance could pave the way for greater commercial investment in general.
- **SRI’s social motivation may supply the will to overcome regulatory challenges:** Regulatory constraints facing SRI are the same as those facing conventional investors. To overcome these barriers

for SRI is to overcome them for conventional investors as well.

- **SRI’s social motivation may yield added patience and a long-term approach:** Given their social interests, socially responsible investors are more willing to listen to the “story” of microfinance. This willingness can translate into more will to work on overcoming initial information asymmetries, in order to facilitate investment. Also, since socially responsible investors typically invest for the long run, they can provide the kind of long-term funding needed by maturing MFIs.
- **SRI has community development experience:** SRI already makes similar investments domestically. U.S. investment in community development banks, loan funds and venture funds totals an estimated \$7 billion. Given their experience with investments of this type, socially responsible investors may be predisposed to subsidize, initially, some of the due diligence and transaction costs associated with investment in Latin American MFIs.
- **Latin American MFIs are profitable and growing:** The microfinance market in Latin America alone is projected to grow by 20% per year. [Leading Latin American MFIs have posted, on average, a positive return on equity in each of the past five years. By investing in Latin American MFIs, U.S. socially responsible investors can have social impact while achieving competitive rates of return.
- **Latin American MFIs are maturing:** With the microfinance industry maturing and becoming increasingly diverse, and with the emergence in the industry of regulated financial institutions marshaling high-caliber financial and managerial expertise, there is a growing and more visible pool of qualified investment opportunities from which SRIs can select.
- **Latin American MFIs have strong, positive social impact:** Since MFIs provide financial services and empowerment opportunities to low-income populations, SRIs can improve their outreach by investing in MFIs, ultimately helping more families meet basic living needs.
- **Diversification:** SRIs can serve their own interest in diversifying their portfolios by investing in MFIs, thus achieving diversification while furthering both

financial and social objectives. Conversely, for MFIs, although the prerequisites for attracting SRI involve their own set of challenges, SRI represents an alternative to local commercial investors who may not have the capacity to meet MFI needs.

### Linking SRI and MF: Challenges

Though the opportunities are promising, the challenges to be overcome if SRI is to expand its interests in microfinance:

- **Communication:** Primary challenges cited by workshop participants were the communication gap between SRI and MFI communities, in terms of defining and creating measurements of social impact, and the need to better market MF investment opportunities to the SRI community.
- **Information flow and transparency:** Investors perceive MFIs as having insufficient standards of disclosure and transparency. To enable investors to conduct adequate due diligence, MFIs will need to offer consistent, standardized and full disclosure of operations, financial statements and management.
- **Transaction costs:** The costs associated with non-traditional investments can be high. Due diligence, transfer, and custodial costs for placing international capital in MFI debt investment is estimated at 3.2% to 5.4% of the amount invested, whereas the comparable figure is less than 1% for conventional investments. With average investment sizes of less than \$1 million, this fixed cost can be prohibitive.<sup>20</sup> Such cost constraints are compounded by the fact that investment opportunities are scattered across the region.
- **Social impact measurement:** To secure SRI funding, MFIs will need to produce quantifiable evidence of the social impact of their operations. Standardized measurements will need to capture impact without in themselves becoming an undue cost (for either the MFI or the social investor) to collect and disseminate.

- **Commercial investor education about microfinance:** In most investment circles, microfinance is either a foreign concept or, in any case, lacks credibility as a profitable investment. This is compounded by a general lack of adequate emerging-market experience, among SRIs and conventional investors alike. Country intelligence, industry-wide statistics and rating capabilities need to be improved if commercial investors are to be systematically educated on the financial viability of MFIs.
- **Role of the donor:** As mentioned above, donors offering subsidized funding to sustainable MFIs risk “crowding out” commercial funders. Instead, donors could improve access to commercial capital by supporting the creation of facilities or instruments that help improve information flow, reduce transaction cost and mitigate risk.
- **Optimal investment vehicles:** The various needs of different MFIs and SRIs must be balanced to determine the mix of investment vehicles best suited to mitigate transaction risks and costs, meet the regulatory requirements of socially responsible investors and serve the capital requirements of MFIs.

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<sup>20</sup> See: Private Capital for Microfinance: How to Turn the Facet On, in Microenterprise Development Review, August 2002, Vol 5. No.1, published by the InterAmerican Development Bank.

## Conclusions

Given the diversity of challenges and players involved, there is no single solution for linking U.S. SRI and Latin American microfinance. A combination of complementary approaches will be needed to overcome the various obstacles. The Guatemala City Workshop helped create a sharpened focus on these obstacles, as evidenced by a shift in participants' perceptions over the course of the workshop: when asked prior to the workshop for their impressions of the potential for SRI to place funds in Latin American microfinance, there was unanimous agreement on a large potential; but responding to the same question after the workshop, approximately half of the participants had significantly downgraded their expectations, due mainly to the regulatory complexity and transaction costs of pooling and distributing SRI capital to MFIs.

It is significant, however, that even in their post-workshop responses, participants unanimously maintained interest in SRI and MFI investment. There remained a willingness on both sides, SRI and MFI, to consider a future together. This is important in and of itself: a key first step to overcoming the existing information barriers and the regulatory, financial and logistical challenges to realizing a sustainable SRI-MFI partnership. Though final conclusions were not drawn at the workshop on the precise

prerequisites for a strengthened partnership, several key, needed ingredients were identified:

- Improved channels of communication between the microfinance sector and the social investment community;
- Increased analysis and awareness-raising about MFI investment opportunities;
- Better understanding of the types of capital that SRI can deliver to MFIs;
- Research and strategy development on how social investors' influence can be applied to trigger more capital flows (particularly from same-country sources) to MFIs; and
- Clearer definition of the best respective roles for donors and other non-financial actors (such as rating agencies, Microfinance Information eXchange (MIX), and so on).

There was near consensus among participants that systematic and ongoing discussion of these issues will help define investment options and industry roles and ultimately lead to more SRI investment in Latin American MFIs.

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