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Over 2.5 billion people live on less than $2 a day. This level of poverty, though probably impossible for most readers of this article to comprehend fully, is one that concerns us all—as a source of human misfortune, to be sure, but also as a threat to global and regional peace and economic stability, and as a major contributor to the degrading of the environment.

What to do about it? The solution doesn’t appear to be redistribution of wealth and resources. Direct foreign aid programs, for all their good intentions, have a decidedly mixed reputation for helping the intended beneficiaries. On the other hand, most of us know people of very limited means who are willing to work very hard for small rewards in the belief it will lead to something better. What such people would appear to need more than anything is opportunity—opportunity that, as in the case of many businesses, often takes the form of access to capital.

A relatively new set of financial services called “microfinance” now provides what appears to be a sustainable way of supplying that access to capital. Microfinance institutions, or MFIs as they have come to be known, have achieved public recognition mainly for making small loans (sometimes as little as $50) to people considered “unbankable” by the conventional financial sector—and for achieving remarkably high repayment rates on those loans (with top-tier MFIs reporting repayment rates as high as 97%). MFIs also provide other financial products and services, such as insurance and deposits, as well as business training and networking opportunities, designed for the economically active poor.

The growth of MFIs and their client reach in recent years has been extraordinary—so extraordinary that the United Nations declared 2005 the “International Year of Micro-Credit.” And this past December, the 2006 Nobel Peace Prize was awarded to Muhammad Yunus, the founder of Grameen Bank in Bangladesh. Underlying such global recognition of microfinance is the premise, shared by a growing number of observers, that providing financial services to the poor has an important, if not indeed critical, role in fostering small-scale entrepreneurs. Such entrepreneurship in turn has the potential to stimulate local economies within developing nations, giving large numbers of people what amount to stakes in those economies and, in the most successful cases, access to the formal financial sector. What’s more, the MFIs have demonstrated their ability to become highly successful enterprises in their own right, producing returns on equity and assets that often exceed those reported by commercial banks in their local jurisdictions.

In this article, we provide a brief history of microfinance, discuss the ongoing integration of MFIs into the global capital markets (along with recent innovative financings designed to further this process), and close by surveying the challenges that now confront these organizations in becoming sustainable enterprises with social as well as commercial objectives.

**An Entrepreneurial Solution to Poverty**

The beginnings of microfinance have been traced to the early 1970s. In 1971, Opportunity International, a not-for-profit, non-government organization (NGO) with religious roots, began making loans to poor entrepreneurs in Colombia. In 1973, ACCION International, a network of financial institutions with branches in 22 countries, began to issue small loans to what it labelled “micro-enterprises” in Recife, Brazil. Other early success stories came out of Bangladesh and Bolivia, where the repayment histories compiled by MFIs like Grameen Bank and BancoSol demonstrated that the poor were not only creditworthy, but able to leverage small loans and other financial services into thriving enterprises. In fact, many groups of micro-borrowers have achieved higher repayment rates than the average commercial borrowers, enabling some MFIs to report higher returns on equity (from 20-40%) than the largest international banks.

The initial practice of most MFIs was to extend loans to small groups of borrowers who provided a collective, or “joint,” guarantee of repayment. Such group loans had a number of benefits. First of all, the joint guarantee meant that local sources of information and “peer pressure” could be used to address the information and “adverse selec-
As already suggested, microfinance is an essential element in building an inclusive financial sector that supports the full participation of the poor in the promotion of economic growth. The words “microfinance” and “micro-credit” are often used interchangeably in the literature that has grown up around the subject. But, as mentioned earlier, microfinance goes beyond loans and credit by including other financial services.

**What is Microfinance?** In addition to loans, microfinance programs provide economically active poor people with savings and other deposit products, remittances and transfers, payment services, insurance, and potentially any financial product or service a bank can offer to this market. Such programs also offer business training and networking opportunities. Average loan sizes are small, sometimes as little as $50.

**Who are the clients?** Because of their low incomes, microfinance clients typically are outside the banking system and at the mercy of money lenders who charge exorbitant rates. As can be seen in Figure 1 (which is based on recent research carried out by the United Nations, with data from the World Bank and the International Labour Organisation), the “informal” financial sector represents a very large part of the economies of developing countries, particularly those in sub-Saharan Africa. The potential market can be seen as comprising the following groups: micro-enterprises, small farmers, low-income salaried employees, day laborers, pensioners, and poor households—all groups that have historically been underserved (if served at all) by banks. In some regions, the vast majority of the clients are women, most of whom are self-employed, often household-based, entrepreneurs who are served by networks like Women’s World Banking and Pro Mujer. In rural areas, they tend to be small farmers or engaged in small-scale activities such as food processing and petty trade. In urban areas, microfinance clients are more diverse and include shopkeepers as well as a broad variety of service providers and artisans.

**What is a Microfinance Institution?** A microfinance institution is an organization that provides financial services to the poor. An MFI can be broadly defined as a credit union, downscaled commercial bank, financial NGO, or credit cooperative. MFIs have been recognized for their low default rates—which have averaged around 3%—and for impressive returns on equity (ROE) that, ranging from 20% to 40%, exceed those reported by most commercial banks. But such numbers almost certainly fail to represent the performance of all (or even most) MFIs since, as one recent study reported, as few as 1% to 3% of all MFIs examined were both financially self-sufficient and had positive net incomes.²

In August 2005, the Microfinance Information Exchange (“the MIX”), a global information source for the microfinance industry, launched a Microfinance Profitability Index (MPI) that uses audited data from 125 MFIs and from the Top 1000 world banks published yearly by The Banker. When comparing the profitability of the 125 MFIs to the largest five and largest ten banks, the MPI indicated that a number of MFIs, especially those in Latin America, have profitability levels that are comparable to if not better than those of the largest global banks.

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² Tulchin (2004). Full citations of all studies mentioned are provided in the References section at the end of the article.
tion” problems that are especially troublesome in lending to newer, smaller enterprises and individuals without collateral. Perhaps equally important, the early reliance on “Self-Help Groups” (SHGs) and “village banking” practices also provided opportunities for group training and education that, along with the joint guarantees, promoted a community of interest and new degree of social cohesion. But over time, and especially in more economically active regions, group lending practices began to prove too restrictive, a barrier to further growth for the most promising micro enterprises. In such cases, loans to SHGs began to give way to loans to individuals and, for those with proven track records, better terms that include longer loan maturities and reduced interest rates.

At present, microfinance is changing from a sector driven mainly by a commitment to a social bottom-line to one more responsive to the demands and interests of private capital and customers. Traditional NGOs dedicated to microfinance have begun to transform themselves into licensed banks and non-bank financial intermediaries to gain access to public funds or small savings deposits. At the same time, some established commercial banks and finance companies have recognized the potential of micro-credit to enhance their product mix and bottom line. Encouraged by the successes of MFIs, many credit unions have begun to reinvent, or at least reinvigorate, themselves and are seeking to regain their leading role as suppliers of a full range of financial services to the poor. Successful entrepreneurs like Bill Gates and eBay founder Pierre Omydiar are actively involved though their foundations in building the scale of such microfinance activities. Even more striking, the world’s largest banks, including Citigroup, Deutsche Bank, Commerzbank, HSBC, ING, ABN Amro, and Morgan Stanley, are entering this “double-bottom line” industry.

Profile of a Nascent Industry
Building a viable microfinance industry and meeting the massive demand of those at the “bottom of the pyramid” poses an exciting yet daunting challenge. According to the Consultative Group to Assist the Poor (CGAP), a consortium of 31 public and private development agencies that aims to expand access to financial services to the poor, there are now as many as 10,000 microfinance institutions worldwide. But less than 1% are considered economically viable, and just 150 to 200 are estimated to be serving the vast majority of clients. These top-tier MFIs, all of which could be described as having taken a “commercial approach,” share a number of other important features:

- A range of products developed specifically for their clientele;
- Ability to operate in competitive environments;
- Consistent maintenance of a portfolio at risk of less than 5% and repayment rates of 97-98% or higher.

But once one moves beyond these shared characteristics, it also becomes clear that MFIs are a very heterogeneous group of financial service providers. The microfinance market has strong regional differences, which reflect historical circumstances as well as cultural, political, economic and regulatory differences.

According to studies carried out by the MIX, Latin American MFIs have more assets, use greater leverage, and attract more commercial investments than MFIs in other regions. Their loan portfolios are increasingly funded through commercial financing (mainly through savings); and, though their operating expenses are decreasing, they remain high relative to those in other regions.

In the case of Eastern Europe, the youngest region in this industry, although the smallest MFIs continue to be non-governmental organizations (NGOs), the largest have been transforming themselves into commercial institutions. The MFIs in Eastern Europe also rank among the strongest in financial performance (exceeded only by Asian MFIs), which may well reflect the fact that they also provide fewer loans and serve higher-income clients than any other region.

MFIs in Africa tend to have lower levels of profitability, as measured by return on assets (ROA). But when measured by the number of borrowers and savers per staff member, African MFIs can be considered the most productive in the world.

South Asia, seen as the birthplace of modern microfinance, houses the largest MFIs in the world in terms of outreach, numbers of poor people served, and size of loan portfolios. On the other hand, most of these MFIs, especially those in India and Nepal, are relatively young and therefore still heavily dependent on subsidies. In the case of East Asian MFIs, there is a vast diversity of models and levels of development ranging from large-scale, viable commercial models developed by formal financing institutions in Indonesia and Thailand to NGOs with a strong presence in the Philippines and Cambodia. Meanwhile, in China and Vietnam, central government programs and associated NGOs have developed new initiatives for providing the poor with access to finance.

Finally, MFIs in the Middle East/North Africa region are less experienced than their other regional counterparts and rely heavily on equity capital, while Latin American and Asian MFIs have made extensive use of debt financing. Savings have become an important funding vehicle for MFIs in Asia and Africa.

The majority of MFIs continue to be small and have low levels of penetration. Over six out of ten MFIs are serving less than 2,500 clients, while less than 2% of all MFIs serve more than 100,000 people. Such small scale means high costs for delivering services while also limiting access to outside capital. Most commercial (i.e., for-profit) MFIs
The challenge for the future will be to provide sustainable finance in rural regions, where loan processing costs will be even higher than those in cities with dense populations.

**The Prospect of Greater Integration with Capital Markets**

Despite the powerful momentum created around microfinance in the last two decades, the industry is still far from reaching the entire unbanked population. Less than 10% of the 600 million families that are believed to subsist on $2 dollars a day have access to microfinance services, leaving a large level of unmet demand. According to a recent report by McKinsey and Co., the current worldwide loan portfolios of MFIs amount to about $17 billion, with the potential to grow to $250 to $300 billion in the next decade or two. This imbalance between supply and demand appears to be mainly the result of the immaturity of the market. The potential profitability of microfinance has been recognized only recently, and the MFI industry has yet to develop a systematic growth model.

Estimates of MFI annual growth rates range from 15% to 30%, thus suggesting a demand of somewhere between $2.5 billion and $5.0 billion for portfolio capital each year in the immediate future, with $300 million to $400 million in additional equity required to support such lending. But we could see a steep upturn in this demand trajectory if expansion continues at the exponential rates seen recently in larger MFIs. In short, it is clear that microfinance will need significant amounts of financing in the coming years.

MFIs have four options to attract the funds they need for future growth:

**Donors:** Donors have been the main backbone of funding since the early days of the industry, having provided between $500 million and $1 billion annually in grants and soft loans for microfinance in each of the past few years. But the growth of MFIs has recently started to outpace the capacity of such donors; and their contribution to the sector, while continuing to be critical, will need to be complemented by greater participation by the private sector. As this happens, the role of donors will need to change from provider of capital at all levels to provider of more “junior” capital—both in terms of taking more subordinated positions in the capital structure and investing in less mature MFIs.

**Savings:** Deposits by public savers is perhaps the most cost-effective way of raising capital, given that it is not only abundant but also cheap in comparison to the costs of external borrowing. But regulation poses challenges since, in order to take in savings, MFIs must be banks or financial institutions properly incorporated as for-profit companies. Local Creditors and Investors: Accessing local financing is particularly important for MFIs not allowed to hold saving deposits. This has been easier for regulated MFIs who have viewed “downscaling” as an opportunity to integrate commercial banks into their activities. Notable among the advantages of local funding are the protection it offers MFIs against foreign exchange risk, and the encouragement it gives MFIs to adopt a commercial approach and so become financially sustainable (if not completely self-sufficient).

**International Investors and Banks:** A 2005 survey by CGAP estimates that less than a quarter of the total MFI funding coming from foreign institutions in recent years is really private capital seeking a market rate of return. Most of the capital has come instead from socially-motivated sources, such as religious organizations, NGOs, and wealthy individual philanthropists. But if the microfinance sector is to provide services to the vast numbers of potential micro-entrepreneurs who currently lack access to finance, it will be necessary to tap more of the supply of commercial capital. In the last few years, there has been increased participation in the microfinance industry by the private sector, signalling the fact that microfinance is a viable commercial business. A CGAP survey conducted in 2003 identified over 225 commercial banks and other formal financial entities engaged in the sector. The entry of these new players has indeed transformed microfinance, weaning many MFIs from their dependency on donors.

As we discuss later, however, scaling microfinance requires much more than funding; it demands changes in regulations, increases in transparency and standardization of financial data, and strengthening of managerial capacities, among others. Nonetheless, funding is one of the main constraints for growth and the capital markets provide an opportunity to integrate microfinance into mainstream capital markets.

**Financial Integration and Commercialization of Microfinance: The Case of FIS**

The growth and funding of MFIs have proceeded in stages. As already noted, most have started out as NGOs funded with grants from private donors. The typical next step has been to attract funding from government agencies as well as private organizations and individuals. And in the last few years, the most successful MFIs have reached a third stage of development: raising outside “commercial” capital to fund their activities.

The first MFIs to tap outside capital either received commercial loans from domestic banks or, in a smaller number of cases, issued bonds in their domestic local capital markets. Some loans made to larger, more profitable MFIs are backing issues of collateralized loan obligations that have

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3. Hence, as a 2004 CGAP survey of over 144 MFIs indicated, funding is their number one constraint to growth.
Unitus, Unitus Equity Fund, and the Dignity Fund

Unitus, Inc., based in Redmond, Washington, uses a venture capital model to identify and partner with the “highest-potential” microfinance institutions in the world. Unitus focuses on bringing microfinance to the 399 million working poor who lack access to formal financial services. Founded in 2000, Unitus provides its microfinance partners with technical assistance and financial support, including loans, grants, and guarantees, to help them increase their capacity and ability to reach even more of the world’s working poor. Through its microfinance acceleration model, Unitus has helped its 13 microfinance partners grow eight times faster than similar institutions. In 2005 Unitus microfinance partners each added an average of 40,000 clients, while comparable microfinance institutions averaged only 5,000. The organization estimates that its portfolio of partners is providing economic and social empowerment to more than 1.3 million micro-entrepreneurs and their families in India, Kenya, Mexico, Argentina, the Philippines, and Indonesia.

The Unitus Equity Fund, L.P. furthers Unitus’s objective of reducing poverty by encouraging the development of a commercial equity market serving the microfinance industry. By backing the world’s most innovative microfinance entrepreneurs, the Fund aims to deliver strong social and economic returns. Since its initial closing in March of 2006, the Fund has raised $14 million from investors, including Omidyar Network, and closed two investments in India and one in Mexico.

The Dignity Fund, L.P. was formed in 2005 to provide debt financing to a select group of rapidly growing MFIs worldwide. The Dignity Fund focuses on “tier 2” MFIs (those with 5,000-100,000 borrowers) identified as having strong management teams, proven track records, and high-growth trajectories, but facing challenges raising financing due to their smaller size and relative youth. A key part of the Dignity Fund’s investment strategy is collaboration with Unitus and other microfinance networks and investment funds that have the capital and technical resources to assist microfinance institutions as they grow. Structured as an investment vehicle for accredited investors, the Dignity Fund is based in San Francisco. To date, the Dignity Fund has provided debt financing and guarantees to MFIs in Mexico, Kazakhstan, Argentina, India, Ecuador, and Peru.

been placed in the international capital markets. Some MFIs have even raised equity from outside investors.

As one example of such development, consider the case of FIS Empresa Social S.A. (“FIS”), an Argentine MFI that has gone through each of these three stages. FIS was started in 1999, and in 2001 its members founded and became part of Fundacion El Ceibal, a foundation that carries out social programs in a rural part of northern Argentina. After a number of publicized successes, FIS then began funding its activities with grants from individuals and international and local NGOs. Relying on a proven business model developed and tested in this rural area for four years, FIS had succeeded in making the activity a profitable enterprise by 2003.

The following years saw significant undertakings: professionals were recruited onto the senior management team; new urban branches were opened in the Province of Buenos Aires; and new credit officers were hired and trained. Funding was expanded with commercial loans granted by microfinance networks and local banks, and through the creation of the FIS-Fondo de Inversion Social (FIS-Social Investment Fund), a private debt fund, denominated in local currency, that offers investors an attractive spread over inflation while allowing them to buy or redeem units at any time.6

At the culmination of this process in 2005, FIS was spun off from the foundation and became a for-profit corporation. This transition of FIS from an NGO to a for-profit entity led to a further shift in its sources of funding, from grants to commercial funding. As in the case of large multinationals, FIS’s senior management has devoted increasing amounts of time to consultations with lawyers and tax advisors, meetings with commercial and investment bankers in the U.S. and Europe, and responding to due diligence requirements. Today FIS’s current and contemplated funding includes loans from commercial banks, the FIS-Social Investment Fund, and its new partner Unitus,7 a private organization (see box inset) that provides both capital investment and capacity-building consulting for emerging MFIs. But even under its new charter, FIS remains a social company (“empresa social”), with an implied commitment to the social goals of microfinancing, including reservation of a certain amount of dividends for social causes.

But if FIS represents a relatively advanced stage of development—and for every FIS there are hundreds of MFIs that have yet to “go commercial,” much less seek outside funding—many are well ahead of FIS in terms of financial integration.

6. The Fund’s assets are held in a trust that is regulated by a trust agreement subject to Argentine private trust law. The Fund has an independent Trustee, an independent accounting firm, and an independent Advisory Board.

7. See www.unitus.com
Women’s World Banking: Microfinance and the Capital Markets

Women’s World Banking (WWB) is a leading network of over 50 microfinance institutions that work in more than 30 countries worldwide to expand the economic power and assets of low-income women and their families. Through its affiliates, associates and Global Network for Banking Innovation, the WWB now reaches over 25 million clients in Asia, Latin America, Africa, Eastern Europe, and the Middle East. WWB has been a pioneer in building MFIs’ awareness of the capital markets and in stimulating investors’ interest in microfinance. A milestone was achieved in 2005, when WWB’s Colombian partner, Fundación WWB, issued $52 million in bonds on an unsecured basis and with a AA+ rating from Duff & Phelps. The transaction was groundbreaking for the microfinance sector in that it was the first time an unregulated and non-profit MFI successfully accessed its local capital markets.

In January 2007, Fundación WWB announced plans for a second bond issue for $90 million. The announcement was made during a two-day symposium at Goldman Sachs that was co-hosted by WWB and the Global Markets Institute and that attracted 220 microfinance practitioners and international investors. The event focused on building the capacity of MFIs as potential issuers in the capital markets and on creating linkages between MFIs and international debt and equity investors.

Some MFIs have succeeded in getting their debt issues rated by international rating agencies. And a number of MFIs are even rumored to be seeking to go public through IPOs.

Some MFIs take the view that they should now be viewed as retail banks, while others continue to distinguish themselves as a different business and asset class. We are inclined to the latter view. Although the loans generated by MFIs look much like commercial loans, the operations, marketing approach, and general management of MFIs clearly differ in important respects from those of conventional commercial banks and other lending institutions. And the implication here is that although commercial banks will eventually acquire a good understanding of microfinance—good enough that synergies will likely arise from the merger of both businesses—there is a compelling rationale to let them operate as standalone enterprises, at least for the time being.

In the meantime, the financial integration of MFIs will continue to be promoted by the microfinance “networks” or “accelerators”—a group that consists of nonprofit organizations like Accion, Opportunity International, WWB, Unitus, and FINCA—that provide funding to member MFIs and help them raise funds in the capital markets, and provide technical assistance.

The Securitization of Microfinance: The BOLD Transaction

Securitization—the repackaging of loans into tradable securities—is likely to be the quickest route for the microfinance industry to gain investor acceptance as an asset class and access to mainstream capital markets. We now discuss a recent example.

BlueOrchard Loans for Development 2006-1 (“BOLD 2006”), a Morgan Stanley-arranged transaction that closed in April 2006 and raised almost $100 million, is a collateralized loan obligation (CLO) backed by unsecured senior loans to 21 MFIs in 13 developing countries in Latin America, Eastern Europe and Asia. The credits funded by the transaction (all with five-year terms and most with “bullet” maturity profiles) were disbursed on the closing date and are being used by the MFIs to make loans to approximately 100,000 micro entrepreneurs.

The largest of its kind to date, and the first to be arranged by a major international investment bank, the BOLD transaction showed that standard securitization techniques can be used to allow the mainstream capital markets to invest in the microfinance industry. The MFIs in the BOLD portfolio were selected by BlueOrchard Finance SA, a Geneva-based asset manager that specializes in microfinance, and that will also function as the “servicer” during the life of the transaction. The MFIs were chosen from a group of some 150 institutions that are generally regarded as the “top tier” of the microfinance pyramid. These top-tier institutions have strong track records, along with a reputation for transparency, so that although most are not rated by agencies the mainstream market would generally recognize, their performance can be readily analyzed. For example, in its six-year history, BlueOrchard has made some 400 loans through the various funds that it manages without a single default. (Ironically, this absence of defaults, which seems to be the case for the industry as a whole, creates some difficulties in establishing a statistical basis for projecting future defaults and expected losses.)

The other key partner in the BOLD transaction was the Dutch development bank FMO, which is half-owned by international debt and equity investors.

8. Albania, Azerbaijan, Bolivia, Bosnia, Cambodia, Colombia, Ecuador, Georgia, Mexico, Mongolia, Nicaragua, Peru, Russia.
by the Netherlands government but seeks a commercial return on its activities. FMO underwrote the junior “B” note (see Table 1) that accounted for some 28% of the value of funds raised by the transaction. FMO’s track record as an experienced investor in MFIs was important in gaining the confidence and participation of the senior investors in the notes.

Reflecting investors’ receptiveness to the offering, the coupon on the three tranches of Class A notes averaged just 78 basis points over the then-prevailing USD five-year swap rate of 5.41%. Holders of the B notes receive all the residual cash flows in the transaction. Providing added assurance to the senior note holders, the transaction also features a reserve account equal to 2% of the outstanding notes that is intended to cover any shortfalls in the payment of interest or principal to senior note holders and is funded by retaining B note cash flows during the first 18 months of the transaction.

In addition to its coupon rate, size, and investment bank provenance, the transaction was notable for a number of new features it introduced to the funding of microfinance institutions. First, although none of the notes was rated—and despite the absence of any of the government guarantees that have accompanied most prior MFI offerings—a listing was obtained (on the Dublin Exchange). This was a major milestone, one that demonstrated the quality of data available on the sector.

Perhaps the key innovations, however, were the local currency content of the lending and the kinds of investors who were sought for and purchased the issue. Some 27% of the portfolio was funded in four different non-USD denominations: Colombian and Mexican pesos, Russian rubles, and Euros. All of these currencies were swapped back to USD, providing both borrowers and note investors with protection from currency movements. This feature of the transaction addressed a fundamental concern among analysts of the microfinance industry about MFIs’ growing dependence on hard currency funding.

In terms of its marketing, BOLD 2006 was the first issue targeted specifically at the mainstream investor universe. Up to this point, as we have seen, investors in microfinance had consisted almost entirely of governments and quasi-governmental organizations such as the international financial institutions (IFC, IADB, EBRD, etc.), along with NGOs or other “socially responsible” investors seeking a less than commercial return while pursuing social goals. Instead of such investors, however, the Class A BOLD notes were deliberately marketed to the type of institutions that routinely participate in asset-backed securities markets—banks, insurers, pension funds, and so on. In a microfinance world often dominated by U.S.-based investors, it was also notable that the vast majority of the issue was sold in Europe, with the U.S. accounting for only 3% of the notes sold.

### Challenges to Microfinance

The entire microfinance industry faces a number of challenges in sustaining the successful growth it has seen over the past few years, and satisfying its potential market—a market that, as already noted, is estimated to grow from some $17 billion at present to $250 to $300 billion over the next decade or two. We will close by briefly highlighting two of these challenges, solutions to which appear to be critical to the future of the industry:

- Human resource capacity; and
- Capital allocation, a more structured approach to which is required if available funding sources are to be used most effectively.

The challenge of human resources arises from the nature of the microfinance model, which is an extremely intensive consumer of such resources, especially in the critical area of credit operations. We have seen from the historical performance of MFIs that, when the model is rigorously applied, the results are impressive both in terms of social outreach and financial return. But the sustainable growth of MFIs—the kind of growth that is achieved without any decrease in the rigor of application of the model—will require a supply of skilled personnel that might be difficult to find even in economies with far higher levels of investment in education and training than will typically be the case. While advances in technology—the use of PDAs for onsite data entry, for example—might allow some improvements in productivity, there will still be no substitute for the intimate knowledge of their customers by loan officers in the field, often among highly dispersed populations with low levels of financial literacy. We believe that focus on this issue is perhaps the key role and challenge for the donors, development networks, and NGOs that provide or fund technical assistance and infrastructure-building capacity to the microfinance industry.

This observation leads to the second key challenge, which is the allocation of capital within microfinance, and the most appropriate roles for the different potential suppliers of such capital, whether equity, debt, or grants. Consider, for example, what happens in a mature market such as the debt financing of small- and medium-sized enterprises in a Western economy. Here we find governments and their

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**Total** $ Eq 99,211,000 Avg USD 5 Y Swaps + 78bp
The BOLD transaction tells us that such deals can be done, but there are a number of obstacles that stand in the way of future issues. Perhaps the greatest challenge is determining how much loss coverage is adequate—a task that involves understanding both the potential for losses by MFIs and the mechanisms for hedging these exposures.

As a new asset class, securities backed by unsecured loans to MFIs force potential investors to assess the expected losses from defaults by the MFIs. Such expected losses can be determined by examining actual losses on microfinance loans over various time periods. What evidence we now have—much of it anecdotal or self-reported, but some compiled by third-party researchers9—suggests that loans to MFIs actually outperform other asset classes in terms of domestic financial and fiscal crises. In addition, both Fitch and Standard and Poor’s have done studies showing relatively low correlations between defaults on emerging countries’ sovereign debt and loans to MFIs in the same country. Why should this be so? Because the micro loan portfolios and funding of MFIs are linked to local rather than international capital markets, the performance of MFIs may be largely insulated from, and even countercyclical to, the performance of the formal capital markets.

What emerges, then, is a picture of low volatility and losses from credit-related defaults. Microfinance institutions backed by large diverse pools of small loans tend to pay their debts on time. But when MFI loans are securitized and placed in cross-border financing transactions, there are other reasons why payments may fail to materialize. One is currency exposure, which arises from the need to convert payments on the microfinance loans into the currencies of the international capital markets. Such exposures can be hedged, however, as happened in the BOLD transaction. Another source of uncertainty in such transactions is political risk, which arises from the possibility of local currency revaluation, political disruption and instability, or fraud. Although these political risks are less susceptible to market solutions, there are a number of government-backed or affiliated institutions that are active in managing (or at least evaluating) such risks in microfinance. These include, for example, the U.S. agency OPIC (which provides political risk insurance) and agencies such as FMO, KfW, and the IFC, which provide credit enhancements of various kinds.

Still another challenge confronting the securitization of MFIs is the need to obtain credit ratings, which will be essential if mainstream capital markets are to be tapped in size. To date, MFIs have typically been rated by specialist rating agencies. While the technical competence of these agencies is generally not in doubt, they tend to be small and unknown to the mainstream capital markets, and their ratings (which have been designed mainly to meet the requirements of donors rather than creditors) tend to focus on operational performance and not credit quality. As far as bank investors are concerned, moreover, Basel II rules now require that only recognized agencies be used, of which there are currently only four. Finally, there has been no consistent approach among microfinance fund managers to require MFI ratings as a condition of their funding; some, like BlueOrchard, demand ratings while others do not. Since ratings are a significant cost for MFIs, especially smaller ones, these different approaches have at times become a source of competition between funders (and, for obvious reasons, not a healthy form of competition for the long-term interests of the sector).

In recent months, large, global, Basel II-recognized agencies have shown signs of serious interest in microfinance. This interest should result, over time, in a significant number of larger MFIs obtaining at least one credit rating. (For smaller MFIs, however, the issue of cost will likely become more problematic, possibly resulting in the unintended consequence of a further widening in the gap between the top tier and those below, yet with greater pressures of funding concentration on this top tier.)

As regards structured finance based on microfinance assets, as well as the lack of MFI ratings to date, there has been a problem with an often significant mismatch between MFI quality and country quality—that is, excellent MFIs in countries with a low, or no, sovereign rating. As a consequence, “country ceilings” have significantly limited the benefits that might otherwise come from a structured approach, such as diversification and subordination. For these reasons, as well as others, there has been no rating of a structured finance vehicle so far by a major agency. Here again, however, we believe that progress is being made in understanding the dynamics underlying the microfinance sector, and in developing appropriate new methodologies and approaches to rating it on a portfolio basis, with the result that we expect rated issues to start to emerge in the near future.

agents (the equivalents in this market of players such as the IFC, EBRD or development agencies in the microfinance market) having very specific and targeted roles in addressing areas where markets often “fail” — notably, the financing of startups without collateral, or businesses in depressed areas or industrial sectors seen as higher-risk but strategically important. The funding of expanding businesses may also attract some very targeted support (especially sectoral), but the funding of mature, profitable businesses will typically be left entirely to the commercial sector.

This stratification of the market has yet to take place in the microfinance sector. Indeed, despite the recent proliferation of funding sources, there is still considerable disagreement within the industry about fundamentals such as the proper “mission” of the funders of MFIs. Should it be purely commercial (with related benefits of improved living and educational standards following as a consequence) or should it reflect the social objectives of an MFI in terms of, say, health and education improvements, while making allowance for the inevitable dilution of financial returns? This leads to some confusion and blurring of roles. On the equity side of the funding of MFIs, for example, there are many examples of institutions where investors have widely differing motivations, from NGOs with primarily social missions to profit-driven private equity, in some cases with a venture capital-like approach to performance and growth.10 On the debt side, despite fairly transparent data showing the financial strength of the top tier MFIs and the absence of any widespread market failure in their funding, non-commercial players are actually acting as competitors to commercial players in providing funding to these institutions, with the effect that the market for this kind of debt in being distorted.

The microfinance industry is in such an early state that it is still possible to see the tectonic plates shifting. It is therefore not surprising that there are many uncertainties about strategy, and some fuzziness over the parts that various parties should play. For microfinance to flourish as an asset class, however, the leading participants in the market—issuers, investors, and intermediaries—must engage in a debate over the optimal allocation of scarce funding resources. In so doing, we can hope to move closer to something like a consensus about how much and what kind of support should come from private versus publicly subsidized capital, and where it is most appropriately allocated in the market. Only then will we see the full potential of this vital development tool for the 21st century.

10. It is also worth noting how fragmented the latter group is. A recent count suggested there are now more than 60 microfinance investment funds, most with portfolios of a few, or at most a few tens of, millions—a size that would probably not be viable in a fully commercial market.

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