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Making a little go a long way

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Even the wealthiest are jumping on the bandwagon of microfinance – the business of making tiny loans to entrepreneurs in developing countries. Charitable foundations, in particular, have seen the appeal and over the last year both Bill Gates and Pierre Omidyar, founder of Ebay, have made big micro-credit investments.

Has the time come for microcredit to take its place as a serious asset class for high net worth investors, or should it remain a matter of philanthropy?

Microcredit or, as it is now being called, inclusive finance, involves making small loans to impoverished individuals – mostly women – who can lift themselves out of poverty by developing their businesses. It dates back 40 years and began as a form of charity, providing loans through donations by governments, the United Nations or aid agencies.

The effort to turn micro-finance into a mature asset class with access to global markets dates back almost 10 years. At a New York conference in 1998, Muhammad Yunus, who founded the Grameen Bank in Bangladesh, laid out a manifesto for securitising micro-loans, and allowing the sector to tap international capital markets. The concept may in the last 12 months have finally taken a hold, thanks in large part to energetic financial engineering.

The biggest issuer to date is the Mexican microfinancier Compartamos (“Let’s share” in Spanish), which has made a total of five issuances through Citigroup since July 2002, raising a total of 700m pesos (or about \$67m). The last two, public debt placements worth \$50m, had the distinction of being the first investment grade bonds in microfinance, thanks to a 34 per cent guarantee from the World Bank’s International Finance Corporation. The tranche released in October last year was three times oversubscribed – one of the clearest signs that the sector is maturing.

Underlying performance also suggests the sector is coming of age. John Tucker, deputy director of inclusive finance at the UN’s Capital Development Fund, says: “The sector has demonstrated profitability. The first country to do that was Bolivia in the mid-1990s. An NGO (non-government organisation) doing microlending converted to a commercial bank, Banco Sol, and it became one of the most profitable banks in the country. That made people realise that poor women could provide the basis for a profitable business.”

Banco Sol is also trying to take advantage of another growing trend – remittances from migrant labourers. Latin America received \$55bn in remittances last year, with more than \$20bn going to Mexico alone.

Microfinance International, led by Atsumasa Tochisako, a former Latin America official with Tokyo-Mitsubishi bank, this month announced a tie-up with Banco Sol and a money-transfer company, with the idea of channelling remittances to microcredit. It has also signed deals with HSBC and others to explore possibilities in Mexico and central America. Mr Tochisako raised his first \$6m from wealthy Japanese investors but is now aiming for institutional funding.

With all these efforts bearing fruit, it is easy to see why capital philanthropists such as Mr Gates and Mr Omidyar have been attracted by the “double bottom line” of profit and social good.

Reliable data is hard to come by but it appears about \$500m is currently out in the form of microloans, with an average loan size of about \$340. Citigroup and Deutsche Bank both have microlending operations on their own account and have made issues open to big investors.

But the greatest interest comes from imaginative foundations. Many charitable endowments like the idea that their foundation’s portfolio can further their goals, and not just the income that is distributed to good causes.

Investing in the sector is still somewhat of an adventure. There is no central clearing house aimed at investors. And there is also a lack of any standardised method of investing or template for raising bonds, although there are signs that the industry is moving in that direction.

The microfinance funds open to investors do not themselves make loans but pass the money on to banks, lending co-operatives or credit unions in developing countries. These then make the loans at very high rates of interest and often at a profit to themselves. In effect, the investor lends the money to the fund (receiving a promissory note in exchange); the fund lends it to the microfinance institution (MFI) and the MFI lends it to the individual.

One of the largest microfinance funds, Accion, offers three ways of investing. A minimum \$250,000 in Accion Investments, which makes equity investments in microlenders, expects to return 8 to 10 per cent, according to the company. For retail investors, a minimum \$2,000 investment in the Accion Global Bridge Fund, which lends to MFIs around the world, has varying returns, and the USA Loan fund, which also requires a minimum of \$2,000, lends within the US and offers returns of up to 2.25 per cent.

Retail investors on a budget might prefer the Community Investment Notes offered by the Calvert Foundation (which is associated with, but run separately from, the Calvert mutual funds). The notes invest mostly in US projects (which have much higher loan amounts) but about 25 per cent goes to microfinance. They are easily bought through most broker-dealers.

Shari Berenbach, the executive director of the Calvert Foundation, says it is considering lifting the micro-finance proportion to 50 per cent, partly because of demand.

The minimum investment is \$1,000, and gives investors the option of getting a return on their capital (of up to 3 per cent, depending on the term of the note) or of donating returns to the fund.

Returns tend to be slightly lower than for other types of investments but risk is not high. Poor rural women are better credit risks than many companies, so default rates are low. Accion reports a historical repayment rate of 97 per cent – which would be almost unimaginably high for a US credit card portfolio, for example. No Accion or Calvert investor has lost money to date.

But the sample size remains so low that this is not necessarily reassuring. John Tucker makes the point that there are still too few investable lenders for the weight of money coming into the industry. Many microlenders do not yet offer the transparency, consistency of policies, appropriate audits, and so on, that are needed for them to be seen as investable. There have also been some cases of lenders inflating possible return rates and minimising the risk of defaults.

The Microfinance Information Exchange (www.mixmarket.org), which rates microlenders, is a good place for would-be investors to start. It lists more than 600 microfinance institutions, and 74 funds. Returns vary greatly, and institutions with large amounts tend to get offered better rates.

Alan Snoddy, senior vice-president of investments at the Episcopal Church Pension Fund, says the rate of return offered was a key reason for the \$8bn fund's first investment in microlending last November. It committed \$15m to Deutsche Bank's Global Microfinance consortium, which raised a total of \$75m from investors by offering both debt and equity tranches. The debt component returns Libor plus 1.25 per cent (the London Interbank Offered Rate, the most widely used benchmark for short-term interest rates, is at present about 4.9 per cent for one year).

"Our investments have to be made for returns, not social reasons," says Mr Snoddy. "That said, we are a church fund and we were requested to look at community benefit investments. When this [consortium offer] came through, it was one of few that were attractive on a risk/return basis as well as from a social standpoint."

Additional reporting by Richard Lapper