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The Social Impact Of Commercial Microfinance:
Investment that develops entrepreneurs and alleviates poverty

Introduction

Quotes from a champion of the poor like Mahatma Gandhi would seem out of place in research on most investment asset classes. Not so when it comes to commercial microfinance.

> "Whenever you are in doubt … Recall the face of the poorest and weakest man whom you may have seen, and ask yourself if the step you contemplate is going to be of any use to him. Will he gain anything from it? Will it restore him to a control over his life and destiny? True development puts those first that society puts last."
>
> – *Mahatma Gandhi*
>
> (as quoted by the Microcredit Summit Campaign)

It is the social aspect of microfinance that first draws many people to the sector – the use of capital for a greater good. Indeed, microfinance is the one form of socially responsible investment that has a direct impact on the lives of poor people the world over. And as Gandhi so eloquently put it several decades ago, microfinance does for the poor what no amount of charity could ever do – it empowers them to help themselves.

Microfinance institutions in some of the world's poorest countries have an established track record of alleviating poverty and developing entrepreneurs among the poor. Now that commercial microfinance is emerging as an investment opportunity for those with available capital, it's important to remember – and quantify – the social return on investment as well as the financial return on investment.

In this paper, we'll highlight the growing social relevance of commercial microfinance and its impact in developing communities. We'll also compare the "social returns" of microfinance to those of other socially responsible investments, such as Socially Responsible Investing (SRI) funds. And we'll differentiate between the social impact of microfinance from publicly funded sources and that from private, commercial sources. We'll also touch on various methods and theories for how to measure the social aspect of microfinance. Finally, we will close with a discussion of the Double Bottom Line and how it affects the commercialization of microfinance capital funding.

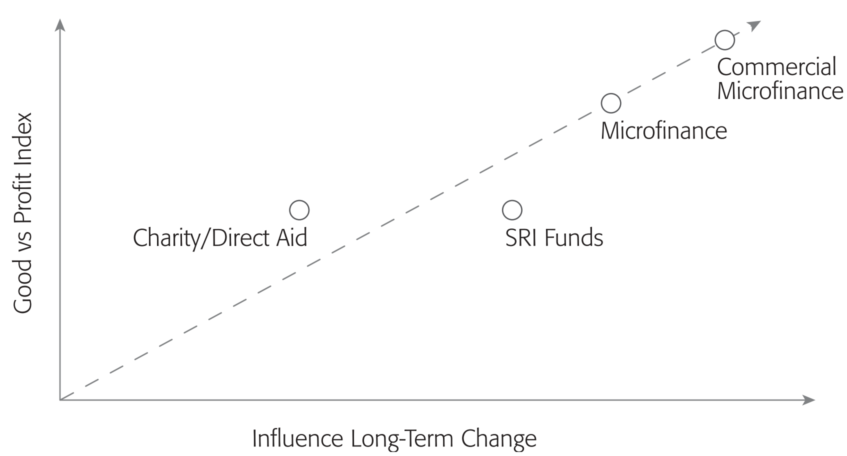
Uses of Socially Responsible Funds

Charity/Direct Aid
Lots of good, no profit, short-term impact

SRI Funds
Strong profit, little good, medium-term impact

Microfinance
Strong combination of good, profit, long-term impact

Commercial Microfinance
Best combination of good, profit, longest lasting effects



Social returns a key goal of Commercial Microfinance

Many of the people now behind the movement for commercial microfinance have experience in more traditional forms of development aid. After working for donor organizations or multi-national bureaucracies, some have come to believe that true development must be sustainable – and that development goal is better served through investment than donations.

"Microfinance is unique among development interventions: it can deliver these social benefits on an ongoing, permanent basis and on a large scale," says a recent *Focus Note* from the World Bank's Consultative Group to Assist the Poor (CGAP). "Many well-managed microfinance institutions throughout the world provide financial services in a sustainable way, free of donor support. Microfinance thus offers the potential for a self-propelling cycle of sustainability and massive growth, while providing a powerful impact on the lives of the poor, even the extremely poor."

Microfinance is now such a key part of the strategy of multinational organizations that the United Nations has declared 2005 the International Year of MicroCredit. And microfinance plays a key role in the U.N. Millennium Development Goals, which include the eradication of poverty.

UN Secretary-General Kofi Annan said: "Sustainable access to microfinance helps alleviate poverty by generating income, creating jobs, allowing children to go to school, enabling families to obtain health care, and empowering people to make the choices that best serve their needs. The stark reality is that most poor people in the world still lack access to sustainable financial services, whether it is savings, credit or insurance. The great challenge before us is to address the constraints that exclude people from full participation in the financial sector."

Despite the widespread acceptance of microfinance by aid agencies and others, there is a basic cultural difference between "donors" and "investors" when it comes to money spent on development. Still, much of what attracts donors to microfinance is also what will attract investors – a proven ability to provide social returns, efficient use of capital and the hope that eventually the microfinance institution will be able to stand on its own. Reaching a point where they can pay off investors and continue operating with the need for outside capital only for growth rather than for operating expenses remains a key goal for many MFIs. In the donor world, they refer to that kind of end-user of money as sustainable. In the investor's world, it's simply good profitable business.

There will continue to be a supply, and a demand, of grant and donor money for microfinance. But that pool of money is not large enough to meet the growth needs of the sector.

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>
> *– UN Secretary-General Kofi Annan*

The role of Socially Responsible Investors

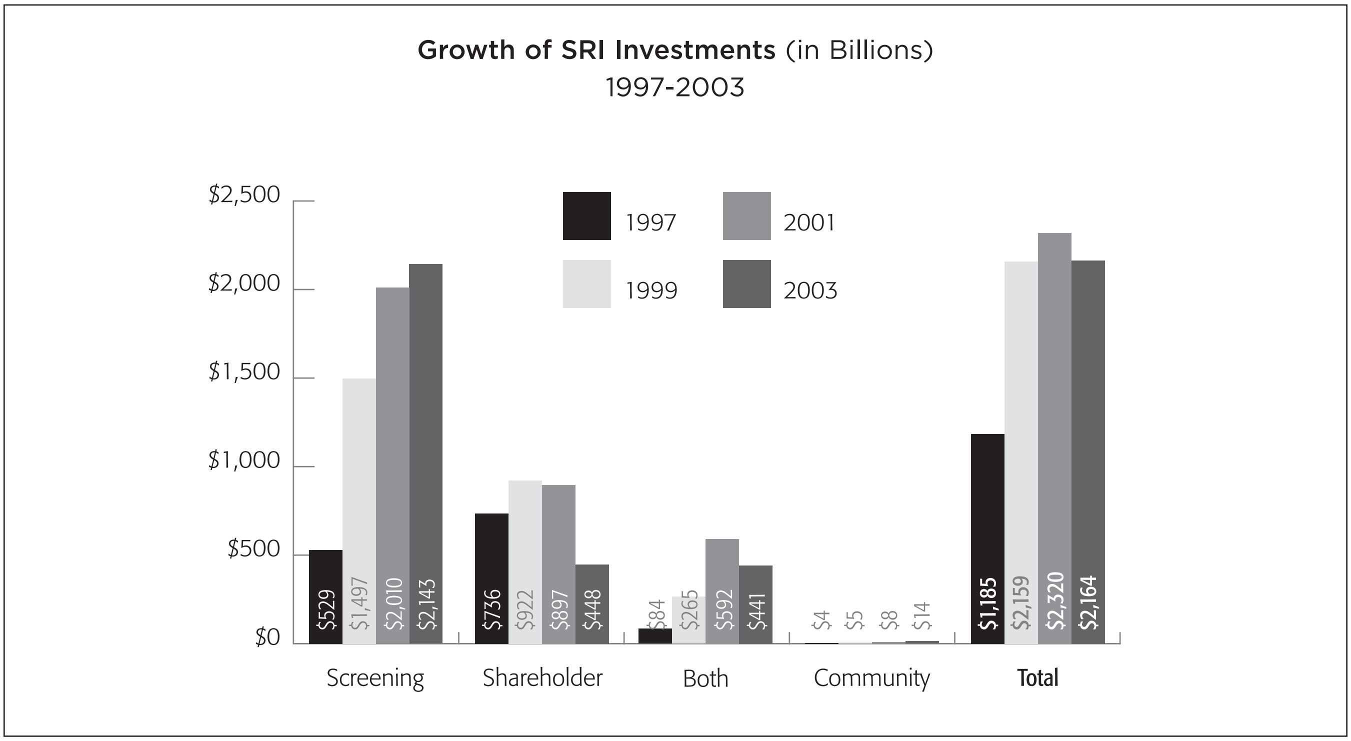
Social impact has always been a goal for some investors, and religious groups, unions and others have long sought to make their investments match their beliefs. But the world of socially responsible investing, or SRI, really got a boost in the 1980s when a stockbroker named Amy Domini realized many of her clients wanted more control over where their money went. By the end of the decade, Domini and two partners had formed their own firm and developed an index that could be used as a benchmark for SRI.

The movement got a further push from the corporate and market excesses of the 1990s. Scandals at Enron and other companies put more of a focus on how companies achieved their reported financial results, rather than just the results themselves – or the stock price.

SRI is a growing investment industry. An estimated \$2.16 trillion, or \$1 out of every \$9 in professionally managed accounts in the United States uses some kind of social criteria in investment decisions. SRI is growing about 15 percent a year – or about 40percent faster than the average of all professionally managed investments. There are now numerous SRI funds, some of which are broad-based and attempt to track what is now known as the Domini 400 Social Index, others developed to invest from a particular religious or ethical belief. Many of the funds have developed what they call "screens" to be sure their investment money does not go to a company doing something counter to the fund's beliefs – for instance, tobacco companies, or weapons manufacturers.

But for all the positive influence that socially responsible investment funds have, in the end they are still simply investing money in large multinational corporations. Indeed, one of the shortcomings of many of the funds is they find it easier to weed out companies using so-called negative screens – to avoid 'bad' companies – than to develop positive screens to develop a diversified portfolio of companies doing good things while also providing a solid financial return. Domini says it now makes investment choices for its funds with three basic tools – social and environmental screens, shareholder advocacy (using shareholder status to push companies to do good), and community investing. It is in a variant of the third criteria that some SRI funds are beginning to look at microfinance.

Microfinance is attractive to socially responsible investors because it meets the "positive screen" test. In other words, not only do MFIs not do bad, they have shown they can do much good – and pay a return on investment. Microfinance receives only a tiny amount of the available SRI money, but the interest is growing. Nonetheless, some SRI funds have investment criteria that prevents them from considering international or untested investments, and the long-term nature and limited liquidity of some microfinance investments can also hamper their ability to attract mainstream SRI funds. Still, SRI funds hold enormous potential as an eventual source of funds for commercial microfinance.



Regardless, commercial microfinance is now surfacing as an asset classs in and of itself, and is beginning to grow side by side with SRI funds and to slice off a market share of the investment dollars earmarked toward socially responsible investments, especially from institutional investors such as university endowments, charitable foundations and family trusts.

Measuring Social Impact

The blend of financial and social return on investment in microfinance is one of the key ways it will attract commercial capital. But it also presents difficulties – namely how to measure the social return on investment. How does one first define the social benefits of an investment, and then quantify those results? Measures of financial benefits have become universal and standardized. Those for social benefits have not.

Microfinance investors have been joined by academic research groups and donor organizations in the search for the one metric that will be accepted as the "gold standard" for evaluating social return on investment. Some are trying to adapt business tools like the "balanced scorecard" and cost-benefit analysis to fit the world of microfinance. Others have developed various reporting standards or indexes. Until a single standard emerges, many organizations use proxy measurements to look at social impact, and often microfinance institutions and their backers turn to anecdotal evidence – the words and pictures that tell such a compelling story of the benefits of microfinance to its clients.

Damian von Stauffenberg of MicroRate, a pioneering rating agency for microfinance institutions, says often loan size – especially loan size for returning clients – can be used as a proxy for the social aspects of microfinance. That works in two ways – first, smaller loans generally mean the institution is serving poorer clients, and second, a returning client repaying small loans and taking out slightly larger amounts often indicates the growing wealth of the client – and the success of the program.

In the high-quality MFIs evaluated by MicroRate, von Stauffenberg sees a high percentage of returning clients who have paid off earlier loans. He notes that MicroRate experts also look very closely at the MFI's loan evaluation process, and are especially wary of any consumer lending – that is, money used to simply buy goods and not to develop self-sufficiency.

Until some accepted overall metric is developed that can show the social value created by microfinance institutions, many individual results are possible to see and quantify. They include number of jobs created and increases in individual or community income, relative to loans given. There are also harder-to-quantify long-term benefits, including improvements in health care and number of children receiving education.

The pioneering MFI Grameen Bank in Bangladesh has a list of 10 indicators as proxies for the client benefits from microfinance. They are:

- having a house with a tin roof
- beds for all members of the family
- access to safe drinking water
- access to a sanitary latrine
- all school-age children attending school
- sufficient warm clothing for winter
- mosquito nets
- home vegetable garden
- no food shortages even during the most difficult time of a difficult year
- sufficient earning opportunities for all adult members of the family

Kim Alter of Virtue Ventures noted at the 2003 annual meeting of the Small Enterprise Education and Promotion Network (SEEP) that financial sustainability measures are easier to set and quantify than social objectives, and business objectives can sometimes overwhelm social objectives. Alter also points out that people are simply not accustomed to measuring social impact in business terms, and often the funds and time are not set aside to measure social impact.

Alter and many others who advise MFIs and those who provide the capital suggest that social impact objectives be set early so baseline measurements can be taken and time and financial budgets can be set to measure the changes. For the impossible-to-measure impacts, anecdotes can be a useful substitute for formal measurements.

Anecdotal evidence of the commercial and social success of microfinance is easy to find. The Calvert Foundation, which encourages socially responsible investing in the United States and around the world, cites the story of a woman named Byamma in southern India, who bought a milk cow with a loan of $111, paid it back and contributed $44 to family income with the sale of milk, and then returned for another $111 loan to invest in a sari business that buys in bulk and sells to village women on a weekly payment plan. The Calvert partner involved, Opportunity International, notes that while Byamma's income continues to grow, she has also grown in self-esteem and now advises other women.

But anecdotes only go so far. And they come with a warning you may have heard from an economics, statistics or logic professor at some point – correlation does not prove causality. A village where an MFI is working may be more prosperous than another village without microfinance – but that alone does not show the benefit of the microfinance institution.

And the individual success stories can only take a potential investor so far. As Anton Simanowitz, the program manager for UK-based Imp-Act research group, points out: "Impact assessment is more than just the monitoring of performance outcomes. There are broader and longer term questions relating to the direct and indirect impacts of microfinance services on clients and non-clients, their communities and the local and national economies of the countries in which they live."

(*For an extensive look at emerging and potential measurements for the social impact of microfinance, see Drew Tulchin's paper,* ***Microfinance's Double Bottom Line****, available from the MicroCapital Institute with Ford Foundation funding. Email* ***info@microcapital.org*** *for details on obtaining a copy*)

Private vs. Public Funds

The core reasons for the success of microfinance in alleviating poverty, boosting economic development and developing entrepreneurs is twofold:

1. By requiring that the money be paid back, it creates a system of empowerment and self-reliance that has a sustainable and contagious impact, and which direct aid has failed to produce time after time.
2. It brings loan recipients into the formal financial sector.

These same two reasons are also at the core of why commercial microfinance – profit-driven loans from private sources – can be more successful at achieving social objectives than money from public, taxpayer sources. To draw a correlation on a more macroeconomic level of global finance, it has long been argued that the use of public funds from the likes of the World Bank and International Monetary Fund to bail out ailing governments in the developing world is counterproductive, because by acting as a "lender of last resort," the multinational institutions are creating an atmosphere that encourages moratoriums on debt payments and sometimes outright default of loan principal and interest.

The same thing can happen in microfinance. MFIs that are supported by public monies have less of an incentive to be vigilant about paying back the loans, as they know that in the end the lender of last resort – be in the World Bank or a local aid institution – will absorb any non-performing loans. Consequently, those publicly funded lenders also have a tendency to be less vigilant about selecting profitable MFIs and monitoring their progress. Often, the attitude is if one MFI doesn't work out, they can always move on to another.

Commercially funded microfinance has built-in efficiencies along the value chain.

Commercially funded microfinance, on the other hand, has built-in efficiencies along the value chain. Because investors expect to be paid back, commercially backed microfinance funds pay close scrutiny to the MFIs they select to receive loans, and monitor them more closely. And that profit-driven attitude is translated to the MFIs when they select clients for loans and monitor loan repayment schedules. Finally, the loan recipients themselves are empowered with a sense of responsibility and obligation for repaying the loans. Add to that the added responsibilities that peer-lending groups imply, and the incentives for loan repayment can be quite strong. As a result, making efficient use of that capital becomes paramount. And that has a direct result on raising the financial and social level of both the loan recipient, those around him or her, and the community at large.

Also, there are indications that the best-run, most profitable MFIs are more efficient about introducing additional financial products into the community – from mortgages and home equity loans to savings and checking accounts, insurance and even credit cards. All of this brings people who were once below the poverty line into the formal financial sector, and can go a long way toward poverty alleviation and economic development.

Conclusion: The Double Bottom Line

A study by Barbara MkNelly and Chris Dunford for the organization Freedom from Hunger found that MFI clients in Ghana increased their incomes by $36, compared to $18 for non-clients. An assessment by BRAC in Bangladesh found that clients who stayed in the program for four years increased assets by 112 percent, and spent 28 percent more on family well-being. Those figures may not mean much to someone living in the West. But to the poor in Ghana and Bangladesh, it is a huge social impact.

Study after study has shown similar results. As CGAP's focus note concludes: "No single intervention can defeat poverty. Poor people need employment, schooling, and health care … Access to financial services forms a fundamental basis on which many of the other essential interventions depend. Financial services thus reduce poverty and its affects in multiple, concrete ways. And the beauty of microfinance is that, as programs approach financial sustainability, they can reach far beyond the limits of scarce donor resources."

The New York Times recently went along on a visit to MFIs in India and Bangladesh by Vinod Khosla, a partner at the Silicon Valley venture capital firm Kleiner Perkins. He said he was "completely blown away" by the stories of the women the MFIs were helping, and he pledged to spend both his time and money supporting microcredit initiatives.

Khosla calls microfinance "one of the most important economic phenomenon in the world in the last fifty years" – and he notes that in addition to providing amazing social impact, many of the programs he visited were highly profitable.

The clear social impact combined with a reasonable expectation of a financial return provide the double bottom line that is the "story" that will sell commercial microfinance in the capital markets. More work needs to be done on a standard measurement to quantify the social impact – which may keep capital flowing slower than it otherwise would to the sector – but in the long run its hard for investors who seek to do good to ignore the stories of thousands of small lenders and their millions of clients.

About the MicroCapital Institute

The MicroCapital Institute is a non-profit organization supported entirely through private donations. Our mission is to educate financial professionals on the emerging asset class of microfinance.

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