



A QUALITY LABEL
FOR MICROFINANCE FUNDS
IN LUXEMBOURG

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ADA (Appui au Développement Autonome) and ALFI (Association Luxembourgeoise des Fonds d’Investissement) have contributed to this study as advisors.

This document can be downloaded from www.microfinance2005.lu or www.attf.lu.
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Luxembourg Round Table on Microfinance

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CONTEXT AND OBJECTIVES

This study was sponsored by the Ministry of Finance through the “Luxembourg Round Table on Microfinance” set up within the framework of the United Nations year 2005 dedicated to micro-credit.

The work was conducted in parallel with another study aimed at determining the advantages that the Luxembourg Financial Centre can (and could) offer to promoters of investment funds and to investors. The overall objective of the two studies is to enhance Luxembourg as a domicile for microfinance investment funds, bearing in mind that microfinance has considerable development potential in the future.

Within the framework of this context, the study has a double objective. It should provide answers to the following questions:

- What role might a quality label play to strengthen the microfinance investment fund industry?
- How to define, in practical terms, an appropriate methodology to establish a quality label for these funds.

In other words, the study should be relevant both to the promoters/sellers as well as to the buyers of microfinance funds. On the promoter/seller side, it should be demonstrated that the use of a quality label could boost the industry. On the buyer's side, it should reinforce the attractiveness of microfinance funds. The study should also open the way to a more systemic and technical approach in this field.

This study was presented during the Luxembourg Microfinance Week: Capital Markets – European Dialogue – Rural Finance, which was held from October 17th to 19th, 2005 in Luxembourg.

BACKGROUND

The Government of Luxembourg has created a Microfinance Round Table to study ways in which the country can support microfinance in poor countries. Building on Luxembourg's leading position as a domicile for investment funds, one of the measures being considered is to establish Luxembourg as an attractive platform for funds specializing in financing microfinance institutions ("MFIs"). This report examines one aspect of such a policy, the creation of a Microfinance Quality Label. Other papers deal with legal-, and tax measures that could form part of such an initiative.

MicroRate was retained in March 2005 to advise on the creation of a Quality Label for Microfinance Funds (MFFs). At meetings of representatives of the Microfinance Round Table in Luxembourg on May 19 and June 17, 2005 certain principles were agreed to:

- The Label should assure investors that a Microfinance Fund is indeed investing mainly in microfinance ("Truth in labeling").
- MFFs should comply with certain minimum rules of transparency and prudence ("Good housekeeping").
- The rules for the Label should not attempt to establish a tight regulatory framework, rather they should avoid flagrant abuses.
- The Label should make MFFs attractive to investors. It therefore concentrates on quantitative information that matters to investors.
- A subsidy will be needed to administer the Label during a start-up period, but once the number of MFFs, which carry the label has grown sufficiently, fees should cover expenses.

WHY A “QUALITY LABEL”?

Microcredit, and its effectiveness as a tool for fighting poverty is receiving considerable public attention. The heads of government of the Group of Eight (G-8) singled out microfinance as deserving their support. The United Nations declared 2005 to be the “Year of Microfinance”. A world Microcredit Summit will be held in 2006. Innumerable conferences are devoted to the topic, and media attention is focusing on it. With all of this attention, the danger increases, that the term “microfinance” or “microcredit” will be misused to mobilize funds which then are not invested in microfinance institutions (MFIs).

The danger is the greater, because by capital markets standards, the absorptive capacity of MFIs is still small. Identifying suitable MFIs and placing money with them requires significant efforts from MFFs. More money is searching for investment opportunities than the limited number of microfinance institutions can readily absorb. This imbalance is likely to grow as new funds are being launched while existing ones continue to grow rapidly. Two things could happen: under pressure to place more and more money, some Funds will relax their standards. Funds will channel investments to MFIs that are not in a position to use them responsibly and those investments will be placed at prices that do not adequately reflect risks. The other possible development is that Funds, which sell themselves to investors by using the label “microfinance” will in fact place little or none of their money with MFIs.

Both developments are a potential threat to the reputation of microfinance Funds in general and to Luxembourg as a base for such Funds in particular. The proposed Quality Label will encourage Funds to be transparent. The Label will only be awarded to those Funds, which invest at least half of their assets in microfinance. To receive the Label, Funds will also have to detail the composition of their portfolio and to disclose the ratings received by MFIs they have invested in. This allows investors to form an opinion on the risk profile of such a portfolio.

“TRUTH IN LABELING”: THE QUALITY LABEL SHOULD ONLY GO TO FUNDS THAT ARE INVESTED PREDOMINANTLY IN MICROFINANCE.

To qualify for the Label, a Fund should be at least 50% invested in MFIs.

In principle, all financial intermediaries with an average outstanding loan size of less than €5,000 are considered to be MFIs. Their microcredit portfolio in turn must account for at least 50% of their assets. Consumer loans are not considered to be microcredit.

Comments

This set of proposed rules could be termed the “**Truth in Labeling**” rules. Investors in a Fund bearing the Quality Label must be sure that they get what the name suggests. If a Fund advertises itself as “microfinance” then it should be predominantly oriented towards microfinance.

Definition of Microfinance

But what is “microfinance”? The answer is by no means as straightforward as the proposed €5,000 limit suggests. Loan size by itself does not define microcredit. If size alone is the criterion, then consumer credit is often indistinguishable from microcredit. In fact consumer credit agencies sometimes refer to their product as “microcredit” as they try to benefit from the positive image associated with microloans.

Yet, the two are fundamentally different. In *consumer credit*, the lending decision is primarily based on collateral. Operating expenses of consumer lenders are much lower than those of microlenders, because loan officers merely check whether certain formal requirements (the existence of collateral – usually a salary) are met. Portfolio quality is also lower, since delinquent loans backed by a salary, for instance, are relatively easy to collect and the lender consequently need not worry as much if a loan falls into arrears. The most striking characteristic of consumer lending in developing economies from the viewpoint of a potential investor however, is its tendency to move in cycles, with periods of rapid growth and high profitability often being followed by contraction and even widespread institutional failures.

In *microcredit* by contrast, lending decisions are predominantly based on an appraisal of the borrower’s ability to generate the cash needed to repay a loan. This makes microcredits much more expensive to process than consumer loans. The loan officer must understand the client’s productive activity and both together must construct a simple cash flow projection. It also explains why portfolio quality is such a critical factor in microcredit as compared to consumer lending. If the loan officers judgment of a borrowers ability to generate cash is wrong, then there is little the MFI can fall back on to recover a delinquent loan. Most strikingly, microcredit has not shown the pronounced cycles that afflict consumer credit. At worst, MFIs have slowed their growth, but they have hardly ever contracted. Failures of microcredit institutions are all but unknown to date.

Apart from their very different characteristics, there is a developmental argument for not confusing consumer loans - however small – with microcredit. Microcredit is such a powerful developmental tool, because it is based on the borrowers’ productive potential and not on their existing wealth. Microcredit by definition is for productive purposes. Only a borrower who *produces* enough to be able to repay the loan qualifies. Consumer lenders by contrast rarely ask what the money will be used for. It may or may not be for production. More often than not, it will be for consumption, as the name suggests. A consumer lender does not look to productive potential for repayment, he looks to collateral, mostly in the form of salaries. In developing countries those receiving a salary are no longer poor. Consumer lending typically is not poverty lending. Someone investing in a microfinance Fund should be reasonably assured that the money will not go to finance acquisition of a TV set or a refrigerator, but that it will support someone’s effort to earn a living.

A note of caution, however. In practice, the boundaries between microfinance and other types of lending are fluid. Most microcredit also involves some form of collateral. To make administration of the label simple, it is proposed that lenders be given the benefit of the doubt. Unless average outstanding loan size clearly exceeds the boundaries of “micro” credit, and unless lending decisions are clearly dominated by collateral, lenders should be considered to be MFIs.

The cut-off for average loan size is therefore set deliberately high at €5,000. Today, none of the MFIs rated by *MicroRate* has an outstanding average loan size of more than €2,500 and the great majority remain below €1,000. Average outstanding loan size, although unable to distinguish between microcredit and collateral-based lending has the advantage that it is easy to verify: it is calculated by simply dividing the outstanding gross loan portfolio by the number of loans. Even though a MFI with an average loan size of €5,000 could have made some loans of €100,000 or even of €500,000, ease of verification seems more important than making sure that MFIs, which also make larger loans are rigorously excluded.

While the €5,000 limit is generous in most of the developing world, it may be less so in Central- and Eastern Europe. It may be necessary to allow exceptions for countries with comparatively high per-capita income. On the other hand, loans that exceed €5,000 are likely to be backed by formal collateral and the lending decision may no longer take the borrower’s ability to generate cash flow into account.

To assure investors that their money will end up where they think it is going, the Label should only be awarded to Microfinance Funds, which are directly or indirectly, *at least 50% invested in microfinance*. Guarantees should be counted as exposure to microfinance. If a Fund has extended guarantees to MFIs, then the 50% cut-off should be calculated as 50% of the sum of a MFF’s assets plus guarantees. Similarly, investing through other MFF Funds should be counted as microfinance investment in proportion to the assets the second Fund has invested in microfinance. For example, if Fund “A” lends €100,000 to Fund “B” which in turn has 45% of its assets invested in microfinance as defined here, then Fund “A” would be considered to have invested €45,000 in microfinance.

To sum up, the basic principle governing the “Truth in Labeling” aspect of the Quality Label is that directly or indirectly, at least half of a Fund’s assets are invested in MFIs. “MFIs” in turn are defined as institutions with an average outstanding loan size of less than €5,000; the majority of their assets must consist of microcredits, as opposed to consumer loans. Under this definition, large banks that run microfinance programs on the side, don’t qualify as MFIs. This is deliberate. Money being fungible, it would in practice be impossible to assure investors, that funds channeled to such banks actually financed microcredits. For Funds eager to obtain the quality Label, and hard-pressed to find investment opportunities in genuine MFIs, the temptation would be irresistible to place their money with banks instead.

Usually, new Funds will not be able to meet the 50% rule, because they have not had sufficient time to build up a portfolio. It was considered to allow an exception to the rule for Funds that have been in existence for less than 3 years. But exceptions make a Quality Label less intuitively understandable for investors. Also, as a practical matter, exceptions complicate administration of such a Label. On balance, it is preferable if the Label is awarded to Funds not when they express their intention to invest in microfinance, but after they have done so.

“GOOD HOUSEKEEPING”: THE LABEL SHOULD SINGLE OUT FUNDS THAT FULFILL MINIMUM CONDITIONS OF TRANSPARENCY AND GOOD GOVERNANCE.

Portfolio Composition: to qualify, microfinance Funds must publish the name and location of MFIs they have invested in, the amount and type of the investment (equity, loan, guarantee), its term and currency. Where available, the rating awarded to a MFI and the name of the rater should be published. No fewer than 75% of the MFIs in which a Fund invests should carry a rating.

Main investment policies: to qualify, MFFs must publish their investment policies. The Label could be withheld, if investments are overly concentrated in one company or country.

Management and Governance: to qualify, Funds must publish their management structure and the names of key managers, as well as their qualifications. Likewise, they must explain the functions of their governing bodies such as investment committees and boards, the names of their members and their qualifications.

Fee structure: A Fund's fees and administrative expenses must be disclosed. Investors should know the all-in cost of running a Fund.

Comments

Investors should be able to check, where a Fund has presently invested its assets. The names of MFIs in the portfolio and their location should therefore be published. Information on investment amount, type and term gives a rough indication of the risk profile of the portfolio. This is supplemented by the requirement to publish the ratings of MFIs (see below). Where a Fund invests in MFIs indirectly through other funds, it should publish the same information (names of MFIs, location, type and amount of investment, term) for the funds it has invested in.

Funds should reveal their investment policy guidelines as to maximum exposure in one institution or country. The Label will only be awarded to MFF that have policies which assure reasonable portfolio diversification. “Reasonable” in this case means that no more than 10% of the portfolio is invested in one company. Unless Funds specialize in one country or one region, and clearly advertise that fact in their promotional materials, portfolios should also be geographically diversified. It is proposed not to set maximum country exposures, but to require disclosure of geographic diversification. The Fund's auditors should certify that policies are being followed.

Measuring the adequacy of Fund management and of governance in particular, involves judgments that are hard to quantify. The Label should therefore only be conditioned on broad rules. For instance if a Fund does not have access to relevant microfinance experience, this would be a reason for withholding the Label. Similarly, “governance” should assure that a body with the necessary qualifications has oversight over management and that investment policies are set prudently. Beyond that, the body awarding the Label should not attempt to judge how well a board or advisory committee is doing its job.

Ratings of MFIs

To promote transparency MFIs, in which Funds invest should have obtained a current performance rating from a rating agency with microfinance know-how. “Performance Ratings” show how well an MFI compares with industry performance standards and whether the MFI applies its microfinance methodology effectively or not. Also, Performance Ratings will disclose, to what extent an MFI’s portfolio contains microloans or whether the institution is in reality a consumer lending agency posing as an MFI. All ratings – whether specialized Performance Ratings or conventional credit ratings – will analyze a MFIs financial position, portfolio quality and creditworthiness.

It is proposed that at least 75% of a Fund’s microfinance portfolio should be invested in companies that carry a current Rating. Through its web-site, a Fund should make ratings of MFIs it has invested in available to the public. Ratings would be accepted from qualified microfinance rating agencies. A working group should be set up to establish eligibility rules for raters. Among those, rules to prevent conflicts of interest would figure prominently. Luxembourg is well positioned for this role, since ADA, a Luxembourg NGO specializing in microfinance, is the administrator of the “Microfinance Rating Fund” established by CGAP and the EU.

ADMINISTRATION

The Quality Label will be awarded by “Ethicalux”, which will review whether an applicant meets the requirements.

Comments

The Label would be awarded for a limited time only. It is proposed that the label would expire after two years, unless it is renewed. Validity of the label could be reduced to one year, once Ethicalux has built up sufficient capacity to handle the additional workload.

If Ethicalux were to analyze the performance of microfinance Funds itself, and if it needed to verify information these Funds submit, the costs would be extraordinarily high. To keep down costs, Ethicalux should therefore rely as much as possible on already available information, when it considers a Fund’s application for the Label. MFI rating agencies, for example, can easily verify whether a given MFI complies with the definitions for microfinance. For the up to 25% of a Fund’s portfolio that consists of investments in unrated MFIs, Fund management would be asked to certify whether these MFIs qualify or not.

One possible way of using existing resources would be to link ADA into the process of administering the label. ADA, a Luxembourg based NGO, has acquired considerable microfinance know how and is highly regarded in the microfinance industry.

Since 2004, ADA and the Argidius Foundation have worked with *MicroRate* to create a *Guide to Microfinance Funds*. The Guide contains a description of each Fund, together with a review of portfolio composition, investment policies, financial performance, management and governance. It thus covers most of the areas Ethicalux will have to consider when it reviews an application. The project has concluded its pilot phase and is ready to be implemented on a wider scale. Ethicalux and *MicroRate* should collaborate in the design of the final version of the Guide, to make sure that it meets the needs of Ethicalux. The Guide will allow Ethicalux to check data submitted by the Funds, against information from an objective source that specializes in the evaluation of those Funds. Since the Guide will be marketed to a large number of investors, the costs to Ethicalux will be comparatively low. Through the Guide, which will be updated annually, Ethicalux will also gain access to wider industry data, which will allow it to place applications into an industry-wide context. The Guide is intended to evolve into Fund ratings, once a long enough track record of microfinance Funds is available.

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