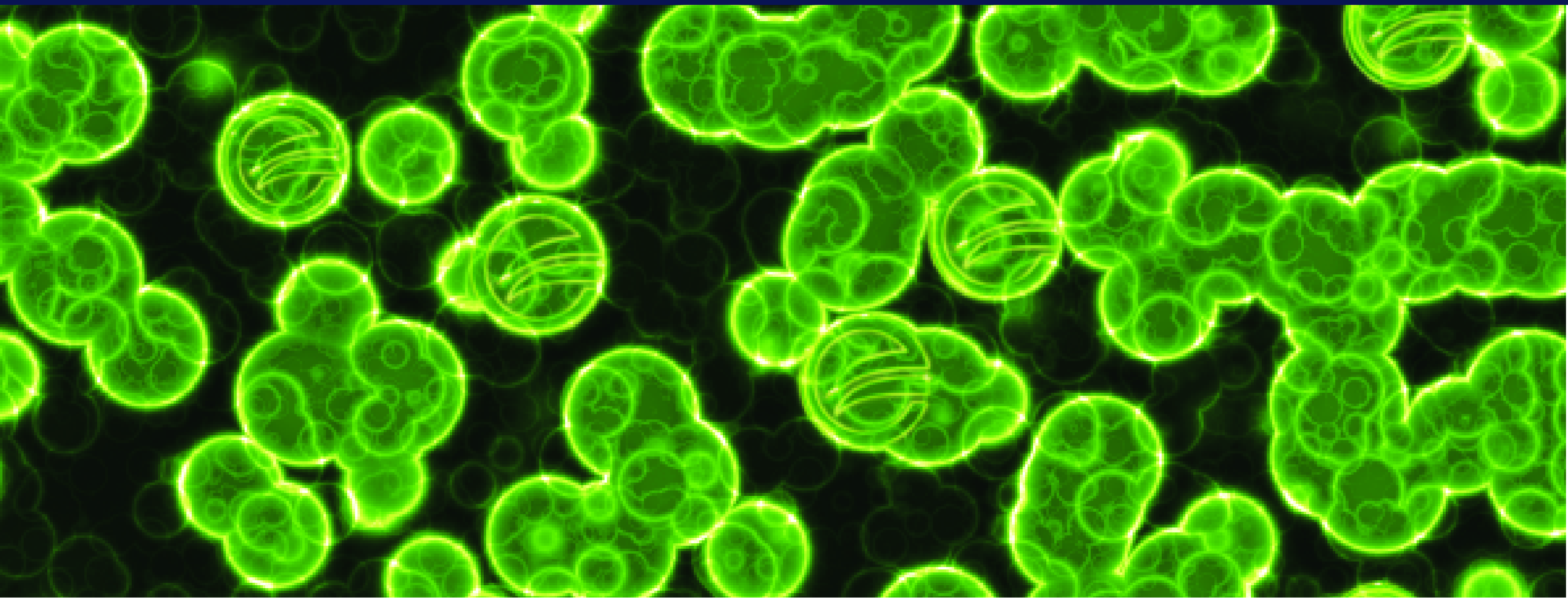

Microfinance Goes Mainstream

Microfinance is starting to become a mainstream asset class. Performance has been good and stable. However, due to the increasing prices of food and energy, there is a danger that the pay-back ratio will deteriorate. Daniel Dax, Secretary to the Board of LuxFlag, sheds some light on this new asset class.

Microfinance is defined as the supply of loans, savings, insurance, transfer services, and other financial products to poor and low-income clients excluded from the traditional banking system. Typically, microfinance includes providing financial services to micro-entrepreneurs to set up a business. Microfinance investment vehicles (MIV) are investment vehicles raising funds from social, commercial, private, or institutional investors in order to invest them in microfinance assets. In general, microfinance institutions in which microfinance investment vehicles invest will have an average loan size of less than EUR 5,000. microfinance institutions refer to all types of formal and semi-formal institutions that offer microfinance services and devote a major part of their resources to provide microfinance services and/or whose client base consists 50% or more of impoverished people and the micro-enterprises owned by them.

Current microfinance market
The microfinance market continues to develop well, with microfinance investment vehicles strongly increasing in number and size during the first half year of 2008 to reach EUR 5.5 billion. The microfinance market is projected to grow strongly throughout 2008. Over 93 microfinance investment vehicles exist, using widely varying legal structures (source: CGAP, February 2008), of which more than 50% are regulated investment vehicles.

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Compared to the one-off or periodical financial aid that may be offered by public development agencies and banking institutions, the capital raised through microfinance investment vehicles provides regular financing possibilities that may constantly be adapted to suit the investment policy of the microfinance funds.

Moreover, specialized rating agencies analyzing and delivering a rating to microfinance institutions have emerged, thus ensuring that these microfinance institutions are truly involved in microfinance and are not merely operating as commercially oriented banks or credit institutions. Transparency is also a key factor in the world of microfinance and a microfinance investment vehicle is likely to spark broader interest by giving emphasis to transparency, and more particularly by giving detailed indications as to how the funds' assets are used.

Outlook for the market
The growing volume of the microfinance market is raising further awareness of the role and importance of this investment sector. Microfinance institutions are likely to see further investment in their projects. This will broaden their activities and allow them to reach more microfinance projects on the spot and hence enable them to increase their reach in assisting the poor.

As the microfinance sector steadily grows, both in terms of microfinance investment vehicles and in terms of assets under management, new risks may also arise. These risks are diverse and range from country risk to currency risk. Another risk resides in the fact that it is sometimes difficult to assess whether the funds allocated to microfinance are really invested in microfinance.

Anke Dembowski talks to Daniel Dax, Secretary to the Board of LuxFlag

efm: Will private investors invest more in microfinance?
Dax: Yes, we think that private investors will invest increasingly in microfinance, as awareness of the microfinance market is rising, and investors have responded positively to this niche market. Recent studies confirm that private investors are showing an increasing interest for the microfinance market. They are interested in adding a social and responsible financial component to a financial return. Then the reputation of institutional lead investors may raise the interest of private investors for this market.

efm: As the market becomes more professional, with labelling companies, etc. establishing themselves, does that mean that the fees will go up?
Dax: It is too early to say. The market is still developing, and a more mature market brings with it more competition. Therefore, it is not certain that fees will go up; we expect that more competition and a more professional market will also help to keep fees at reasonable competitive levels.

efm: Will microfinance funds become UCITS compliant?
Dax: In the long term, we would indeed welcome the idea that microfinance funds may come under the UCITS global brand, provided that the structure of the fund could be adapted to UCITS regulation. A step-by-step approach may lead to UCITS compliant microfinance funds. As it is likely that more and more microfinance investment vehicles and microfinance Investment Funds will be set up, there are also additional opportunities with regard to structuring vehicles that may be UCITS compliant, if all other conditions are fulfilled. Finally, the open-minded approach taken with regard to the Eligible Assets Directive (that has been implemented in Luxembourg by a Grand-Ducal regulation of 19 February 2008) might offer other gateways to the UCITS sphere.

efm: Do increasing prices for food and energy mean that the pay-back ratio will deteriorate, and hence, the performance of microfinance funds will go down?
Dax: This is difficult to say, as the consequential effects of the recent phenomena of rising prices are difficult to assess. There may be spillovers that could affect the microfinance market, especially when the credit market gets tightened. On the other hand, if market forces operate efficiently, there may also be further opportunities for the microfinance market to adjust local prices for local good work, products or services, which would ensure that the current high pay-back ratio is not endangered. ■

Mr Daniel Dax was born in 1961 in Luxembourg. Graduated in Law at Université de Droit et des Sciences Politiques in Strasbourg, and absolvent of the 1996 AMP at INSEAD in Fontainebleau. Joined the Association of the Luxembourg Fund Industry as a Director, Legal and Tax, and as a Company Secretary for LuxFLAG in October 2007.

LUXFLAG microfinance

LuxFLAG, which is a Luxembourg based labelling agency created on 20th July 2006, is a cooperation between the private sector, the NGO sector, and the State of the Grand Duchy of Luxembourg. Its founding partners are:

- Appui au Développement Autonome (ADA)
- Association of the Luxembourg Fund Industry (ALFI)
- European Investment Fund (EIF)
- Financial Technology Transfer Agency (ATTF)
- Luxembourg Bankers' Association (ABBL)
- Luxembourg Stock Exchange
- State of the Grand Duchy of Luxembourg

The purpose of LuxFLAG is to grant a Label to investment vehicles that invest in microfinance on the basis of agreed and transparent criteria: the "LuxFLAG Microfinance Label". The activity of LuxFLAG reflects the broad interest that microfinance has elicited in the Luxembourg financial centre. Over half of the regulated and supervised microfinance investment vehicles are domiciled in Luxembourg with a total microfinance portfolio of USD 1.32 billion. On 30 June 2008, microfinance investment vehicles with the LuxFLAG Label held assets under management of USD 1.3 billion, of which more than USD 1 billion were invested in microfinance.

The criteria for the Label
The label reassures investors that the investment vehicle actually invests, directly or indirectly, in the microfinance sector. In order to obtain the LuxFLAG Microfinance Label, the investment vehicle must meet a number of criteria, the principal of which are the following:

- be subject to supervision equivalent to that in EU Member States;
- have a microfinance portfolio corresponding to at least 50% of the MIV's total assets;
- have at least 25% of its microfinance portfolio invested in microfinance institutions rated by a microfinance rating agency recognised by LuxFlag
- have a commercial objective (the Label will not be granted to donor organizations, such as state donor entities or charitable trusts).

Further information: www.luxflag.org