

## NO LONGER A “NICHE”, LUXFLAG AND THE GROWING DEMAND FOR MICROFINANCE

**Despite some notable progress, the eradication of extreme poverty and hunger is still a major issue that needs to be tackled. Over the last decade microfinance expanded worldwide and has proven to be an essential tool in alleviating poverty. Microfinance Institutions have developed at a fast pace, and while they are becoming more professional, they have also started to look more intensively for foreign funding to finance their activities. Microfinance Investment Vehicles (MIVs) emerged to serve that need and raise capital for microfinance. Investors' enthusiasm for such products has been undeniable and MIVs have seen tremendous growth both in number and assets. However, many MIVs are not yet sufficiently transparent and tools like the LuxFLAG Label are important to reassure investors that the money they invest really goes to microfinance. As other types of funds with a “sustainable development” dimension face similar issues, a label which simplifies investors' selection is also likely to be welcomed. What is more, any initiative encouraging decision-makers to take a more long-term and holistic approach should be supported by those who seek a more responsible financial sector.**

### THE GROWING IMPORTANCE OF MICROFINANCE

According to the World Bank, in 2005 around 1.4 billion people – or one quarter of the population of the developing world – lived on an amount of less than USD 1.25 a day. Although these figures have improved: 25 years earlier there were 1.9 billion people living in poverty (or one half of the world's population), progress was uneven across regions. According to the Bank's August 2008 Policy Research Working Paper<sup>1</sup>: “The poverty rate in East Asia fell from almost 80 percent to under 20 percent over this period. By contrast it stayed at around 50 percent in Sub-Saharan Africa, though with signs of progress since the mid 1990s”<sup>2</sup>. On 25 September 2008 in New York, world leaders, convened by the UN Secretary-General and the President of the UN General Assembly, came together to renew commitments to achieving the Millennium Development Goals (MDG) by 2015 and to set out concrete plans and practical steps for action. The eradication of extreme poverty and hunger<sup>3</sup> was again placed at the top of the World Bank's agenda and microfinance and financial inclusion were recognised as essential tools to alleviate poverty.

Although it started with the development of microcredit in the 1970s in Bangladesh, microfinance has expanded worldwide and now offers a broader range of products, including the supply of loans, savings, insurance, transfer services and other financial products. These specific microfinance services are mainly provided by microfinance institutions (MFIs) which can take various forms from NGOs to specialised microfinance banks and even commercial banks. Their client base consists as to 50% or more of poor and low-income people and the micro-enterprises owned by them. In agricultural and rural areas, they are usually small farmers and others who are engaged in small income-generating activities,

whereas in urban areas, microfinance activities are more diverse and include shopkeepers, service providers, artisans, street vendors, etc. Women make up the majority of clients, men representing 33 percent of all microfinance clients<sup>4</sup>. The average loan size granted to microfinance clients corresponds to less than EUR 5,000 (or EUR 10,000 within Europe).

It is estimated that over 10,000 MFIs exist today<sup>5</sup>. As these MFIs have become gradually more professional, they have streamlined organisational and operational processes and are increasingly looking for foreign funding to finance their activities. Initially Development Financial Institutions (DFIs) and private donors were the primary sources of foreign funding for MFIs, but as they are increasingly turning to international markets, Microfinance Investment Vehicles (MIVs) raising funds from social, commercial, private or institutional investors, have emerged.

### WHEN MICROFINANCE MEETS THE CAPITAL MARKETS: MIVS

According to CGAP, the MIV market has seen tremendous growth both in number and assets over recent years. Assets under management (AUM) reached USD 5.4 billion as of December 2007 (a 78% increase from 2006). Similarly, the number of MIVs has seen tremendous growth (91 MIVs were identified by CGAP in its “2008 MIVs benchmark Study”) but the assets remain highly concentrated in a few microfinance vehicles. These MIVs can use widely varying legal structures from donor funds to regulated mutual funds. Luxembourg appears to have a head start in this niche market as it hosts the majority of the regulated microfinance funds worldwide.

According to Symbiotics<sup>6</sup>, there were 21 MIVs in Luxembourg as of December 2008 with total assets reaching USD 2.29 billion (a 38% increase from previous year) and a microfinance portfolio of USD 1.79 billion

(up 34% from previous year). Since its creation in July 2006, LuxFLAG has granted its Label to seven microfinance investment vehicles (MIVs) domiciled in Luxembourg. As of December 2008, funds labelled by LuxFLAG<sup>7</sup> accounted for 82% of total microfinance fund assets in Luxembourg, a sizeable market share. This demonstrates the increasing interest of institutional and retail investors for responsible investment opportunities. This may also be reinforced by the fact that, due to the financial crisis, investors may want to re-think the allocation of their investments, balancing their decisions between socially responsible and purely profit-motivated investments.

However, many MIVs are not yet transparent. MicroRate, a leading rating agency for microfinance entities highlighted in its 2007 Microfinance Investment Vehicle Survey<sup>8</sup> that "it is often difficult for investors to obtain even the basic information that is taken for granted in more traditional industries. Without access to standardized, comprehensive data, investors find it nearly impossible to make sound decisions". As the number of funds expands, there is a need to assist investors in their choice of investment, especially since the complexity of different structures available and similarity of investment policies make it difficult for potential investors to choose their investment in Microfinance. Furthermore, the current market turmoil has highlighted a strong demand for more transparency and risk-averse investors will in future require better, clearer and more regular reporting and information dissemination.

### A STEP FURTHER TOWARDS TRANSPARENCY: THE LUXFLAG MICROFINANCE LABEL

Providing a concrete tool to reassure investors that the MIV actually invests, directly or indirectly, in the microfinance sector was the key element that led to the creation of the Luxembourg Fund Labelling Agency (LuxFLAG). By awarding a distinctive Label to eligible Microfinance Investment Vehicles, LuxFLAG represents another step towards transparency. The Label facilitates distribution and therefore fund raising, and contributes to the visibility of the relatively young MIV sector. The Label also enhances the image of the MIV, by proving that it is regularly scrutinised by experts and

meets internationally recognised standards in the Microfinance sector. However, the LuxFLAG Microfinance Label is not a guarantee of performance, nor does it constitute a recommendation to invest.

In order to obtain the LuxFLAG Microfinance Label, a fund must comply with a number of criteria set by LuxFLAG. The principal conditions are that the MIV must be subject to supervision equivalent to that in European Union 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<sup>9</sup> and have a commercial objective (meaning that the fund must demonstrate that it seeks a reasonable return on investment and that its objective is therefore to be profitable). The analysis of the candidate funds is delegated to an "Eligibility Committee" composed of board members of LuxFLAG and external microfinance experts. This panel makes recommendations to the board of directors of LuxFLAG, who take the final decision. The Label is then granted for a period of one year, and renewable subject to review for continued fulfilment of the eligibility criteria.

### FROM "DOUBLE" TO "TRIPLE BOTTOM LINE"

To strengthen the quality of its Label, and continue to encourage transparency, LuxFLAG is currently considering adding a social dimension to its Label. Indeed, microfinance investments are characterised by the pursuing of both financial and social objectives commonly referred to as "double bottom line". Microfinance investors are not only looking for pure financial return but they also want to know if their investments have a real social impact. "Socially responsible investors will want to understand the extent to which their investment has helped to achieve development goals, how it has improved the standards of living of the micro-borrowers"<sup>10</sup>. Various tools have been developed over recent years to help microfinance institutions measure and manage the social progress of their clients and adequately report on it. It is now important to collect all MFI data for diffusion at MIV level. Although this requirement is now accepted by the majority of the microfi-

nance industry, the introduction of reporting on social performance raises a range of questions that need to be addressed, particularly in terms of the choice of indicators and the accuracy and reliability of the information disclosed.

In order to draw up reporting standards on social performance in microfinance, several initiatives are currently being developed, notably by the CGAP which is in the process of including in its MIVs disclosure guidelines, which originally only covered financial aspects, a social performance section. To develop these social reporting guidelines on microfinance, stakeholders such as the CGAP initiated their process taking as a starting point the 3-pillar approach of sustainable development, namely environment, social and governance (ESG) aspects. The initiatives already in place for socially responsible investments (SRIs), such as the UN Principles for Responsible Investments (UNPRI) and the Eurosif transparency guidelines for SRI retail funds, are being adapted to be more suitable to the microfinance industry. Some elements of the Global Reporting Initiative (GRI)<sup>11</sup>, may also be used to define the content of the report (materiality, stakeholder inclusiveness, sustainability context, and completeness); its quality (balance, comparability, accuracy, timeliness, reliability, and clarity); and to set report boundaries.

### MIVS AND SRIS: TWO SIDES OF THE SAME COIN

As investors' interest in both microfinance investments and SRIs grow in parallel, LuxFLAG believes that it also can play a role for SRI and thematic funds, where a label which simplifies investors' selection is also likely to be welcomed. This belief was reinforced at the ALFI "Sustainable and Responsible Investments" conference held on 15 January 2009 in Luxembourg, where the Minister for Development Cooperation and Humanitarian Affairs of Luxembourg, underlined the government's active involvement in a wide spectrum of projects in the field of sustainable development and advocated a potential extension of LuxFLAG's activities to Sustainable and Responsible Investments, "the great strides made by microfinance should be extended to all of the fields covered under SRI. The scope of the LuxFLAG Label could thus be enlarged"<sup>12</sup>.

Furthermore, on 6 March 2009, the Government Council of Luxembourg gave its approval to a preliminary project on a "national plan on sustainable development" with a specific focus on sustainable finance, the eradication of poverty and the promotion of a sustainable development on a global level. In line with the above declarations, the creation of a quality label for funds that pursue sustainable investments is a clear step forward in the development of this niche market in Luxembourg.

In these particularly uncertain times the LuxFLAG Label is a powerful tool for decision-makers who wish to take a more long-term and holistic vision of environmental, social and governance issues in their invest-

ment policy and decision-making processes, with a view to creating a more responsible finance sector. ■

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<sup>1</sup> Policy Research Working Paper, The World Bank Development Research Group, August 2008, Shaohua Chen and Martin Ravallion

<sup>2</sup> <http://web.worldbank.org>

<sup>3</sup> [www.un.org/millenniumgoals](http://www.un.org/millenniumgoals)

<sup>4</sup> Source: The Consultative Group to Assist the Poor, CGAP, [www.cgap.org](http://www.cgap.org).

<sup>5</sup> Microcredit Summit Campaign Report 2006

<sup>6</sup> [www.symbiotics.ch](http://www.symbiotics.ch)

<sup>7</sup> [www.luxflag.org](http://www.luxflag.org)

<sup>8</sup> 2007 Microfinance Investment Vehicle Survey, MicroRate Inc., August 2008

<sup>9</sup> A non-exhaustive list of the microfinance rating agencies recognised by LuxFLAG can be found in the Microfinance Rating Outlook report 2008, ADA

<sup>10</sup> Lynn Martin, director, investor relations of BlueOrchard Microfinance Investment Managers, BlueNews, special edition – social performance report, January 2009

<sup>11</sup> The Global Reporting Initiative (GRI) is a large multi-stakeholder network of thousands of experts, in dozens of countries worldwide. This framework sets out the principles and indicators that organisations can use to measure and report their economic, environmental, and social performance.

[www.globalreporting.org](http://www.globalreporting.org)

<sup>12</sup> Introductory speech of HE Minister Jean-Louis Schiltz, Minister for Development Cooperation and Humanitarian Affairs of Luxembourg, on the occasion of the ALFI "Sustainable and Responsible Investments" conference held on 15.