

The International Finance Corporation (IFC) has been supporting the development of microfinance since the 1990s. In this article, André Laude shows how donors can influence governance in the sector (as IFC does). Indeed, these institutions are in a good position to ensure a balance is maintained between profitability levels and the social mission of microfinance organizations.

The role of development finance institutions in good governance for microfinance

Development finance institutions, via their involvement in the sector, give microfinance greater access to private financing. They also play a decisive role in the governance of microfinance institutions (MFIs) by helping to build a coherent shareholding, sitting on supervisory boards, and providing tools for internal governance processes. They also contribute to ensuring there is a balance between the social mission and the level of profitability. Moreover, they must be able to withdraw from the MFI's shareholding at the right moment.

By André Laude, Chief Investment Officer for microfinance investments at the International Finance Corporation

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As Head of investments of the "Global Financial Markets" Department at the International Finance Corporation (IFC), André Laude is in charge of the specific support provided to the microfinance sector. Prior to holding this position, he worked for IFC in the financial sector in Southern Europe and the Middle East, after over fifteen years' experience of financial markets in Wall Street, London, Mexico and Casablanca.

The International Finance Corporation (IFC) – like all development finance institutions – must strike the right balance between development needs and profitability for its investment projects. IFC meets the requirement of a "triple return", i.e. a social, financial and ecological return. No project is exempt from this. The financial dimension is in line with its mission to promote the private sector; IFC supports projects that meet the requirements of a "return on investment" plan, calibrated on the basis of a prior risk analysis.

This framework obviously also applies to microfinance projects. Microfinance is a priority sector for fighting against poverty and must have the capacity to mobilize long-term resources. To achieve this, IFC provides and promotes investments that meet the criteria for financial health and returns, in the same manner as any other project. In doing so, IFC has managed to make microfinance more visible, particularly regarding its role as a socially responsible player. Without the prospect of returns, it would have been impossible to attract investors that are first and foremost commercial¹. The financial profitability of microfinance guarantees a sustainable mobilization of resources from the private sector.

This fact does not reduce the need for social and environmental returns; on the contrary, the more a project is profitable, the more it appears possible to guarantee its social impact. This is in any case

the lesson that can be learned from IFC's creation of "de novo institutions"². These MFIs have been established in countries where there was not yet a response to the demand for financial products for the poor. The "de novo" model requires a MFI to rapidly develop in order to scale up its socio-economic impact nation or regionwide. The only way to deploy agencies, diversify products and mobilize the required commercial financial resources is through its intrinsic profitability.

A prerequisite: gather shareholders with common objectives

The creation of a MFI, its transformation into a financial company, or even the launch of a microfinance investment vehicle require putting together a group of shareholders that share similar objectives. This coherence among shareholders is essential; without it things can veer dangerously off course and give rise to stormy debates within supervisory boards. To meet this essential requirement, IFC willingly plays the role of "go-between" and does not hesitate to prompt or strengthen the necessary affinities. For example, in the 1990s IFC convinced Internationale Projekt Consult (IPC) – as well as KfW Bankengruppe, Commerzbank and many others – to invest alongside it in a holding company which ten years later was to become ProCredit. More recently, it also worked with institutions such as the bank J.P. Morgan and Standard Chartered Bank which today have become convinced by a mission to "create social value".

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A basic consensus among founding shareholders remains one of the best ways to make sure things do not veer off track³. In this respect, it is important to form a coherent and clear majority that ensures the technical partner has control of operations in the field. It is useful to define ... specific “locking mechanisms” in shareholder agreements, especially if they subordinate basic modifications – for example, concerning the statutes, the social object, the mission – to special majority voting. The statutes of a MFI must also be as clear as possible in terms of its social object and mission; all shareholders must also be involved in defining them – even in formulating them – so that they are drafted in a clear, collective and consensual manner. In view of the importance of this stage, IFC for example asks its investment officers and its credit, social and environmental authorities to conduct an in-depth analysis of agreements made between shareholders. If the opinion is unfavorable, the investment is systematically refused or suspended until it is restructured.

What guarantees against abuses and needs for measurements of social and environmental impacts

IFC generally appoints representatives to the supervisory boards of the MFIs it supports, at least when its shareholding is of a strategic nature. These representatives carry out their duties by giving priority to their responsibility as a trustee⁴ of the MFI or investment vehicle. Their role within these boards is almost like that of an “activist” constantly working for a dual social and financial requirement. In practice, it is not unusual for the social mission to be guaranteed by the investor/operator; for example, it can help lower the minimum loan size and consequently make financial services more widely available to the poor. Thanks to its successful business model, ProCredit has often promoted this virtuous circle within the MFI community.

IMF governance must ensure that they accomplish their missions and avoid any derailment. For instance, by separating governance from portfolio management, the MFI can make sure that it does not gradually drift away from its social mission. At IFC, for example, the officer in charge of the portfolio cannot be responsible for project appraisal – and even less for internal governance. The officer can consequently unbiasedly monitor operations and issue independent ratings on the financial situation of the investment, and on its social and environmental performance. These assessments can

be made via a pre-established matrix supplied with quarterly reports on, for example, the increase in the number of borrowers or loans allocated to women, the average loan size and portfolio segmentation, the estimated number of jobs created, the added financial value and the economic return by taxation. Although considerable progress still needs to be made in this area, all projects must at least satisfy a minimum financial and social assessment grid established during the due diligence phase of project processing. These tools aim to assess the stimulating effect credit has on the economy as well as the role MFIs play in improving local production methods. Finally, investment projects can also be subject to an independent ex-post evaluation; at IFC, the Independent Evaluation Group is in charge of this. In this capacity, it makes a global review of the impact of an investment based on a matrix of indicators established during the due diligence phase for new projects.

Timely shareholder exit is key to avoid prejudice

Alongside “classic” good governance mechanisms, an arsenal of both legal and “moral” provisions may prove very useful to an institutional investor such as IFC. It will include, for instance, a “right of inspection and objection” for any strategy change. Such mechanisms are efficient for dealing with sudden changes in orientation, or those caused by the sale of shares to a new shareholder (transfer of majority, withdrawal of a strategic partner, etc.). The transfer of a strategic part of the shareholding can be blocked via a pre-emptive right or a “right of first refusal”. Buyback mechanisms are also a deterrent and at the minimum provide a way to exit in case of disagreement with the orientations of the MFI, without this being too detrimental to its growth – a departure that marks the end of the implicit moral support provided by the development organization. These mechanisms also make it possible to keep out investors with ambiguous motives. The vagueness surrounding the definition of certain terms in shareholders agreements de facto gives development institutions considerable worth, the role of a guarantor – or even a power to block. Nevertheless, these agreements must authorize an exit by “mutual consent” when the founders consider that the institutional development mission of an entity has effectively been completed.

However, what happens in the case of a MFI that gradually veers away from its initial objectives or

¹ For example, the European Fund for Southeast Europe (EFSE) – one of the biggest funds operating in the micro-finance sector, and one of the first public-private partnerships of its kind – which provides long-term financing to MFIs in Southeast Europe.

² De novo institutions have been the main instrument by which IFC, thanks to its experience with ProCredit in Eastern Europe, has developed microfinance on the African continent by creating institutions such as MicroCred Madagascar, Advans Cameroun and Ghana, Access Liberia. These institutions combine a strong technical partner and founding institutional shareholders who share the same philosophy for developing financial services for the poorest populations.

³ Lessons learned by ProCredit in the Philippines, or by Access in Mozambique, are good examples of how important coherence among shareholders is. It is core to making the strategy sustainable on both a social and commercial basis. In the case of Mozambique, the “forced” exit of Access led the holding company to ensure it always had majority control within each local establishment.

⁴ Representatives appointed by IFC always act in a personal capacity in order to give priority to the specific interests of the institutions where they are directors, even when this position leads them to take decisions that may be in conflict with the interests of IFC itself.

⁵ For all these reasons, it would appear difficult to recommend to a MFI not to keep its biggest clients and limit the size of the loans it allocates.

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its target market? In the face of such derailments, there are still extremely few fully satisfactory levers – experience also shows that shareholders are not always aware of how serious the situation is. To deal with this possibility, it would seem wise to recommend a minimum level of flexibility in the rotation of directors. A new opinion may indeed prove to be beneficial for both the MFI and investors. By bringing in new players, it is sometimes possible to give new impetus to the “militancy” of a director. But there should not be an excessive focus on the hypothesis of a “gradual loss of control”; during a phase of economic growth, it is normal for a MFI to grow and evolve with its client base and to try to attract an ever-wider public. Marketing tailored to SMEs or certain retail products and a more sophisticated segmentation must be implemented, and this includes helping to look for business beyond the initial area of the MFI’s operations. Indeed, it may well remain true to its original social and environmental mandate and, at the same time, develop related activities (loans to SMEs for example) and look for new clients. Any MFI that reaches a critical size and financial self-sufficiency will then be able to widen

its core business to such activities. It will consequently be able to evolve towards the function of a specialized commercial bank, capable of providing a wider range of products to its clients (documentary credit, treasury management, etc.) insofar as the latter require larger-sized loans and more sophisticated services⁵.

A MFI that develops – especially if it has a bank status – diversifies its activities and reaches a sort of “age of reason”. At this stage, it is time for the development finance institution to withdraw. One might think that the role of the development institution should continue beyond this stage, particularly if the MFI extends its operations to new socially disadvantaged levels. The debate remains open but if a MFI has the capacity to mobilize resources from financial markets by the quality of its financial statements, the aim of the development finance institution may be considered as having been reached. It is then desirable for it to recycle its equity investment and allow its client to bring in carefully selected private institutional investors. This will undoubtedly make the mission more sustainable. ●

ProCredit: a precursory model

The model of ProCredit, an unquestionable precursor in commercial microfinance, drastically changed the situation of a sector which prior to the 1990s was mainly based on solidarity credit. ProCredit improved the technology for loan allocation by analysing and setting parameters for individual microenterprises: financial modeling, analysis of treasury flows, attitude towards debt. This model is built on the postulate of the intrinsic profitability of a microfinance portfolio, based on rapid organic growth and expansion. In this context, it is essential to provide theoretical and practical training in this very specific technology (origination, analysis, validation and close cli-

ent supervision). This initial development phase is the only one to use technical assistance funds that are required to train executives and loan officers – the target remains commercial profitability within two to three years. Finally, this model also aims to reach self-sufficiency in resources by using public savings and payment services, current accounts and transfers. This model has had considerable influence and has been reproduced many times (for example, Advans, MicroCred, Access). In some ways, it has helped adapt the know-how and banking technology of major corporates, so that they are accessible to and serve the needs of the unbanked and/or informal sector of society.