Chapter 7

Conclusion

7.1 Summary

This thesis started with the narrative of the founding fathers of socially responsible investment and microfinance: Luther E. Tyson and Muhammad Yunus, respectively. First we considered socially responsible investment in developed countries. In chapter 2 we find that compared to other stocks socially responsible stocks have relatively high prices, as measured by their low book-to-market ratio. Because of overpricing, we would expect that socially responsible stocks have lower risk-adjusted returns. Yet, we find that the risk-adjusted returns of socially responsible and irresponsible stocks are not significantly different. The explanation we offer is that the asset pricing model used to calculate risk-adjusted returns includes a book-to-market factor (Fama & French, 1993), which captures at least part of the overpricing. So in asset pricing models inspired by Fama & French (1993) the trade-off between financial and social performance is at least partly captured by the book-to-market factor.

One lesson from chapter 2 for microfinance is that even in a developed country like the US, with a stock market in which prices reflect the available information, socially responsible investment has an effect on stock prices. Given that there is no public market for microfinance investment to timely reflect the adverse effects of an excess supply of funding, the impact of excess demand is likely to be much bigger in microfinance investment. Although this thesis provides no evidence on this, anecdotal evidence suggests that the consequences of the popularity of microfinance in some regions are severe (Chen et al., 2010). In some countries too much money is chasing too few MFIs, which is aggravated by development banks that
are crowding out commercial funding by supplying cheap loans that could have been provided by MIVs as well. In some countries, excessive funding has created an unhealthy focus on growth, which has lead to overborrowing and credit delinquency crises in Nicaragua, Morocco, Bosnia and Herzegovina and Pakistan (Chen et al., 2010).

The commercialization of microfinance with a move to profit-driven institutions and the possibility of microfinance institutions to attract commercial investment has connected the fields of microfinance and socially responsible investment. Commercialization is one of the most debated issues in microfinance today. For some people, like Rhyne (2009), commercialization is the best hope to serve the millions that are still unbanked today. To other people, like Muhammad Yunus, it represents the moral demise of an ideal to reduce poverty. Some of Yunus’ concerns are warranted, as commercial MFIs are less likely to serve the poorest borrowers. Yet, this also implies that there will always remain opportunities for nonprofit microfinance to serve the poorest of the poor.

Taking the commercialization of microfinance as starting point, we try to answer a number of questions in this thesis that are relevant for socially responsible investors in microfinance. First, why invest in microfinance in the first place? An often-mentioned argument in favor of microfinance investment is its low correlation with other international assets, which could make it an attractive diversification instrument. In chapter 3 we test whether this indeed the case: we test whether adding microfinance to a portfolio of international assets shifts the mean-variance frontier outward. Here we find that investors obtain a significantly more diversified portfolio when they invest in microfinance banks and MFIs from Latin America, which has the most commercialized microfinance sector. By contrast, non-profit organizations like NGOs and microfinance institutions that operate in Africa, where operating costs are very high due to limited infrastructure, do not provide any diversification advantages. This is a striking result, because emerging market investments—to which microfinance investment are often compared—do not provide any diversification benefits (De Roon et al., 2001).

Given that a socially responsible investor decides to invest in microfinance, we ask to what extent investors face a trade-off between risk, return and outreach to the poor. Cull et al. (2009) and Hermes (2011) provide evidence that there is a trade-off between return and outreach. Chapter 4 provides suggestive evidence that there is also a trade-off between risk and outreach. Next, this chapter tries to quantify this trade-off by adapting the mean-variance framework of Markowitz (1958) to include
outreach. The findings in this chapter indicate that the price of increasing outreach is modest for a reasonable degree of outreach. Yet, to obtain very high outreach is quite costly in terms of foregone returns and extra risk.

Compared to studies that investigate the determinants of microfinance performance, risk—which is especially relevant to investors—has received less attention. In the introduction we mentioned that MFIs are susceptible to many types of risk. Chapter 5 and 6 focuses on two of these risks: governance risk and regulatory risk. Governance risk comes from the MFI itself and is due to suboptimal governance arrangements. In chapter 5 we investigate whether powerful CEOs are associated with more MFI risk taking. We show that especially powerful CEOs of NGOs increase an institution’s performance variability. We do not find evidence that powerful CEOs are associated with better than expected performance; instead, they are associated with worse than expected performance. Therefore we conclude that good MFI governance guards against powerful CEOs.

In chapter 6, we investigate the effect of debt enforcement institutions on MFI risk. Typically, MFIs do not use debt enforcement institutions, because their loan sizes are too small and borrowers have no collateral. Surprisingly, we find that weak debt enforcement institutions reduce MFI risk. The explanation we offer is that microfinance has a competitive advantage vis-à-vis formal finance when debt enforcement institutions are weak, because it does not require collateral. The larger market for microfinance implies more diversification opportunities. Consistently, we find that weak contract enforcement is associated with less risk. Like Ahlin et al. (2010), we also find that weak contract enforcement leads to lower loan-size growth. So even though the pool of borrowers becomes bigger, weak debt enforcement limits MFIs’ growth prospects.

7.2 Implications and limitations

Chapter 3 implies that there is scope for investors to use microfinance to better diversify their portfolio. Yet, for investors that are only interested in financial returns, only the more commercial MFIs are attractive. For investors also interested in the social returns, there are much more possibilities to invest in microfinance, because also the large number of non-governmental organizations and credit unions could be attractive investments. Still, chapter 4 shows that also these investors face a trade-off, because to invest in MFIs that serve the poorest they have to accept relatively large increases in risk and large drops in returns.
An important drawback of the methods used in chapter 3 and 4 is that they were not originally designed to be used on book data. MFIs are not actively traded and therefore have no market returns. Therefore, we had to rely on book data to conduct the spanning tests and form optimal portfolios. The book data from the MixMarket dataset could suffer from sample selection bias, as it mostly represents the better performing tier 1 and tier 2 MFIs.\(^1\) Also the time span is relatively short and the number of MFIs used in forming optimal risk-return-outreach portfolios in chapter 4 is too small to be representative of the world’s microfinance sector. Finally, the recent financial crisis has had effects on the real economy in developing countries. As a result funding has declined and repayment rates have deteriorated. Yet, the analyses in chapter 3 do not include the years of the financial crisis.

Both the financial crisis and microfinance repayment crises have put risk high on the agenda of researchers and policy makers. In the introduction we introduced many types of risk that are relevant to microfinance. Most of these risks have received little attention in the literature, but instead of a general analysis of all these risks, we focus on two specific risks. Like we discuss in chapter 5, especially in a sector like microfinance in which nonprofit institutions are often not regulated, good governance is of the essence. In addition, due to the dual objectives of microfinance there is much more leeway for directors to decide what they think is best. If this happens to harm the MFI financially, it is easy to argue that this decision improves social impact. Therefore, donors should be wary against directors that are too powerful and press for good governance with sufficient checks and balances.

Still, weak regulation in developing countries also offers opportunities for microfinance. We discuss in chapter 6 that with repayment rates as high as in microfinance and debt contracts that have no collateral, microfinance has much less need for an efficiently functioning court system. As long as proper institutions are not in place, microfinance could be a valuable first step in developing the financial sector in developing countries. Donors and social investors might therefore want to target their microfinance funding towards MFIs in countries with the least institutional development.

In any case, they should not target their funds to countries and regions where microfinance is already well developed, because overfunding could result in poor customers lending from multiple borrowers and ending up highly indebted. Des-

\(^1\)Tier 1 includes mature, well-known, financially regulated MFIs. Tier 2 includes less well-known MFIs that are near profitability and candidates for conversion to for-profit status. Tier 3 includes mostly NGOs approaching profitability and tier 4 includes unprofitable start-up MFIs.
pite adverse effects of microfinance growing too fast in some regions, the popularity of microfinance among socially responsible investors has meant that millions of extra poor have access to financial services today. Without investors such growth would not have been possible. To some extent, firms in developed countries are concerned with socially responsible investment because the extra demand for their shares lowers their cost of capital. Given that in chapter 2 we find that the effect of socially responsible investment on prices and risk-adjusted returns in developed countries is fairly limited, microfinance investment looks like a more appealing instrument to push for social change.

Overall, microfinance appears to be attractive for investors, but there are several caveats. First, only the most profitable MFIs are attractive investments. Second, investors face a trade-off between financial returns and outreach to the poor. If they want MFIs to target poorer people, they have to give up financial returns. Third, MFIs are subject to many risks, on most of which there is little research. Although this thesis makes a start with investigating the determinants of microfinance risk, the impact of many other sources of risk still has to be identified.