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Investing in microfinance under different institutional configurations[1]**

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A B S T R A C T

The peculiarities of microfinance and prospects of its implementation in the institutional structure of a social and economic system in general and transitional economies systems in particular are considered. Special attention is paid to the problems of investing in microfinance activity under globalization and different institutional configurations.

A R T I C L E I N F O

Keywords:

Microfinance, Institutional Configuration, Investing, Transitional Economies

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1. INTRODUCTION

Microfinance as a specific type of economic institution and a relatively recently emerged and rapidly enlarging sector of financial-economic activity is focused on the needs of small-scale enterprises and individuals (individual entrepreneurs or simply physical entities) in financial resources, without which their effective operation is either impossible or extremely difficult (Yerznkyan, Vardanyan, 2006). There are lots of microfinance organizations everywhere. Such is, for example, the Russian Microfinance Center (RMC), the leading Microfinance think-tank, service provider, and advocate in the Russian Federation. Since its establishment in 2002, the RMC, a not-for-profit fund under Article 118 of the Russian Civil Code, has become the number one provider of microfinance consulting services, research, and training in Russia, as well as

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the sole national-level advocate and resource center for Microfinance Institutions (MFIs). Performance of the RMC as well as other MFIs worldwide, however, is largely depends on the specificity of the social-economic system and its institutional configuration (Yerznkyan, Vardanyan, 2012).

As it is well-known, the dominant sources of financing the large corporations are either equity, as it is practiced in the Anglo-Saxon world (forming a market-based system or model), or debt, which is typical for Germany (and more or less for other European countries) and Japan (where prevails a bank-based system or model of corporate business financing). However, in the case of the small enterprises and individuals, these sources of financing are not available. The reason is quite obvious: the lack of joint-stock form of business enterprise denies opportunities to raise additional funds through the emission of stocks and getting the loans that are unattractive – with regard to their relationally high transactions costs – to banks. The result is a situation of unmet demand for financial products of microscopic scale. One of the possible answers on the expected question who and how can ensure the availability of getting such loans is microfinance.

It should be mentioned that microfinance is nowadays a well-established specific system of financial activity, both in developed and developing countries. In contrast to the traditional banking, microfinance institutions use innovative methods in order to overcome the obstacles faced by people with low incomes, such as lack of security and customer stories. What about microfinance in economies in transition, including Russia, Armenia, former Yugoslavia and so on? What problems, and primarily institutional by nature, impede their growth and development?

The paper is organized as follows. In section we consider the main characteristics of the institutional configurations of a market system. The problems of the globalization and the changing face of the investor we study in section 3. In section 4 and 5 we represent the case and story of microfinance as well as the problems of investing in microfinance. In section 6 we give some concluding remarks.

2.INSTITUTIONAL CONFIGURATIONS OF A MARKET/CAPITALIST SYSTEM

Throughout the history of a market-based business has primarily focused on its economic activity not being preoccupied by goals and aspirations of communities, individuals, environmental concerns, and social objectives. There were exceptions to this, of course, though mostly of a regulatory or a philanthropic nature. A business exists to maximize value for its stockholders, and ‘maximizing stock value’ is best achieved by focusing on maximizing short-term profits which in turn raises the capitalization of a business, thus leading to a greater value of the stocks held by stockholders. This is a simple and powerful paradigm which has always seemed to exist in capitalistic society. The short-term pursuit of profits for stockholders at the expense of all other stakeholders and the narrowing of business perspective have intensified accumulation of enormous wealth. This is particularly true over the last few decades, involving a tiny segment of the world’s population and leading to a widening gap between the rich and the poor. The reckless search for profit for the sake of profit has led to failures and distortions in the modern financial system, epitomized by the Global financial crisis. This kind of pursuit of profit has increased societal costs for the next several generations. The consequence is loss of trust and even questioning of globalization and capitalism itself.

The business as an institution can be attributed to capitalist society. Therefore, before going on to discuss the larger purpose of business as an institution, we first need to understand what capitalism, or market system, is *per se* and which models of capitalism exist in the modern world, In addition we should also consider what are the main drivers of globalization and what is their impact on the world economy?

However, stemming from the (new) institutional economics vision that various national economies differ due to their institutional setting and constitutional order (North, 1990), it can be argued that there are a variety of types of economic institutions and systems as well as models of capitalism. However, there is no consensus on capitalism and how it should be used as an analytical category. There is a good deal of historical cases over which it is applied, varying in time, geography, politics and culture (Scott, 2005). A number of definitions of capitalism have been suggested by many eminent philosophers and economists from Adam Smith to the present day.

Economists usually put emphasis on the market mechanism, degree of government control over markets (*laissez faire*), and property rights. There is a general agreement that capitalism encourages economic growth. The extent, to which different markets are 'free', as well as the rules determining what may and may not be private property, is a matter of politics and policy. Many states have what are termed 'mixed economies' (Stilwell, 2002).

Capitalism is regarded as an economic system distinguished by certain characteristics whose development is conditioned by yet other elements. The basic characteristics are: (1) private ownership of the means of production, (2) a social class structure of private owners and free wage-earners, which is organized to facilitate expanding accumulation of profit by private owners; and (3) the production of commodities for sale. Conditioning elements are: (a) a certain division of labor; (b) institutional arrangements to insure a dependable supply of wage labor; (c) a degree of social productivity sufficient to permit sustained investment; (d) commercial organization of the market – including banks – whose scope is adequate to the productivity of the community; (e) a political process whereby economic power can become translated into governmental policy; (f) a legal structure that is protective of private property; and (g) a certain toleration – at the least – of new ways of making a living (Weinberg, 2003).

Here are a few remarks about American Capitalism. Since its early years the American economy has undergone many transformations. Historians often call the period between 1870 and the early 1900s the Gilded Age. This was an era of rapid industrialization, *laissez-faire* capitalism, and no income tax. Captains of industry like John D. Rockefeller and Andrew Carnegie made fortunes. Many Americans praised the new class of industrial millionaires and enthusiastically embraced Spencer's 'Social

Darwinism'[2] to justify *laissez-faire,* or unrestricted, capitalism. Spencer based his concept of social evolution on individual competition. Some social Darwinists argue that governments should not interfere with human competition by attempting to regulate the economy or cure social ills such as poverty. Instead, they advocate a *laissez-faire* political economic system which favors competition and self-interest in social and business affairs.

There are three major varieties of capitalism existing in developed countries. The Anglo-Saxon investor capitalism which exists in its most undiluted form in the United States; the social-market capitalism (Rhine Capitalism), epitomized by Germany, which also prevails to some extent in most of the other large countries of continental Western Europe; and the producer-oriented capitalism which provided such an impressive engine of growth for the Japanese economy throughout much of the postwar era.

These three different varieties of capitalism are defined primarily by the nature of the relationships between corporations and their major stakeholders, particularly with employees and their communities on the one hand and stockholders and their agents on the other. Another important factor is the manner in which the interactions among firms and between firms and governments are organized. In Anglo-Saxon style market economies such relationships are generally characterized by formal contracting, arms-length transactions, and market-mediated competition. More organic forms of capitalism, represented in different variants by Germany and Japan, depend much more heavily on non-market relationships, defined by law (formal institutions) or custom (informal norms), to shape the organization of their economies.

There were large differences among the various types of capitalism in the organization of relationships between corporations and those who provided their financing during the early postwar (World War II) decades. In the US, stockholders of large companies were widely dispersed and fragmented: no one entity owned a significant share of the stock. As a result, shareholders tended to be passive owners; the separation of ownership from control had been noted as a defining (Berle, Means, 1932).

3. GLOBALIZATION AND THE CHANGING FACE OF INVESTOR

Economic 'globalization' is a historical process, the result of human innovation and technological progress. It refers to the increasing integration of economies around the world, particularly through the movement of goods, services, and capital across borders. The term sometimes also refers to the movement of people (labor) and knowledge (technology) across international borders. There are also broader cultural, political, and environmental dimensions of globalization. Perhaps more importantly, globalization implies that information and knowledge get dispersed and shared. Innovators can draw on ideas that have been successfully implemented in one jurisdiction and tailor them to suit their own jurisdiction. Just as important, they can avoid the ideas that have a clear track record of failure. It is remarkable that Joseph Stiglitz, a frequent critic of globalization, has nonetheless observed that globalization "has

[2] British philosopher Herbert Spencer applied Darwin's theory of evolution to the development of human society.

reduced the sense of isolation felt in much of the developing world and has given many people in the developing world access to knowledge well beyond the reach of even the wealthiest in any country a century ago” (Stiglitz, 2003, p. 4).

There have been several drivers of globalization over the last several decades. One such driver has been technological advances which have significantly lowered the costs of transportation and communication and dramatically lowered the costs of data processing and information storage. Developments over the last few decades in electronics, in particular the microchip revolution, have materialized electronic mail, the Internet, and the World Wide Web.

A second driver of globalization has been trade liberalization and other forms of economic liberalization which have led to reduced trade protection and to a more liberal world trading system. 1946 General Agreement on Tariffs and Trade (GATT) and later the World Trade Organization (WTO) are prominent examples of trade liberalization policy. Other aspects of liberalization have led to increases in the movement of capital, labor and knowledge across national borders.

A third driver of globalization has been changes in institutions, whereby organizations have a wider reach, due, in part, to technological changes and to the more wide-ranging horizons of their managers, who have been empowered by advances in communications. Thus, corporations which had mainly been focused on a local market have extended their range in terms of markets and production facilities to a national, multinational, international, or even global reach. These changes in industrial structure have led to increases in the power, profits, and productivity of those firms which can choose among many nations for their sources of materials, production facilities, and markets, quickly adjusting to changing market conditions.

A fourth driver for globalization has been the global agreement on ideology. The former division between market economies in the West and socialist economies in the East has been replaced by a near-universal reliance on the market system. This convergence of beliefs in the value of a market economy has led to a world that is no longer divided into market-oriented and socialist economies.

A fifth driver for globalization has been cultural developments, with a move to a globalized and homogenized media, the arts, and popular culture and with the widespread use of the English language for global communication.

Globalization has significant impacts on all economies of the world. Globalization, for example, has produced big gains for the EU in the past. 20% of improvement in EU living standards over the post-war period was due to deeper economic integration at the world level. Globalization is a major source of EU productivity gains through better specialization, economies of scale, technological content of imports, greater competition and the spur to innovation (Globalization…, 2006).

Much has changed, however, since the beginning of the new millennium. The American economy has undergone several economic and political trials during the past decade. The US sub-prime mortgage crisis which has spiraled into "the largest financial shock since the Great Depression" caused global recession. Most recently the economic and structural problems and fiscal difficulties within the Eurozone caused fears about its countries´ sustainable development and raised uncertainty about the future of the Eurozone. These difficulties strengthened forces opposed to globalization, which in the minds of many was equated with investor capitalism and greedy, irresponsible pursuit for short-term profits.

With these trends of globalization in mind, let us now consider the changing face of investor. It is important because of globalization, political changes, as well as recent economic and societal trends, catalyzed societal call for responsible business behavior, which has reached unprecedented momentum during the past few years, particularly after the global financial crisis. The search for meaning beyond profit reflects rising economic thinking of integrating social aspects into mainstream economic models. The economic model based on the parity of people, planet and profit represents the next stage of human development. Responsibility is part of human nature, so it should complement business activities and financial considerations.

The concept of social responsibility in economic relations or the concept of corporate social responsibility (CSR)[3] as a pattern of corporate behavior which requires companies to be guided not by their narrow financial objectives aimed at the profit maximization is not new. In a certain sense, they have existed for many centuries. The same is true of sustainable investing, the history of which stretches over centuries. Religious investors from the Jewish, Christian, and Islamic faiths and many indigenous cultures have long married morals and money, giving careful consideration to the way economic actions affected others around them and shunning investments that violated their traditions' core beliefs. In the American colonies, Quakers and Methodists often refused to make investments that might have benefited the slave trade, for example, and the earliest formalized ethical investment policies avoided so-called 'sin' stocks – companies involved in alcohol, tobacco, or gambling. Indeed, the first fund to incorporate such sin-stock screening was the Pioneer Fund, opened in 1928 and screened since 1950 to meet the needs of Christian investors seeking to avoid involvement in precisely such industries of 'vice'. The Fund continues to exclude the tobacco, alcohol, and gambling industries from its portfolio to this day. Sustainable investing in its present-day form, however, arose in the aftermath of the social and cultural upheaval of the 1960s The rapid growth of the civil-rights, feminist, consumer, and environmentalist movements and protests against the Vietnam War, raised public awareness about a host of social, environmental, and economic problems and corporate responsibility for them. Religious organizations and institutional investors remained very much at the forefront of these concerns about CSR.

There are a number of definitions for the CSR concept. For example, it can be classified as a contribution of the business and civil society to the sustainable development of the economy, and refer to the well-known economic, social and environmental responsibilities of CSR companies (Kakabadse et al., 2005). What is important to underline, that a socially responsible company takes steps in the interests of its stakeholders that are not dictated by direct commercial needs and market requirement (Baron, 2001). Financial or investment social responsibility is primarily addressed by the concept of Sustainable and Responsible Investment (SRI) – a generic term covering any type of investment process that combines investors' financial objectives with their concerns about Environmental, Social and Governance (ESG) issues. The SRI methodology constantly evolves and develops reflecting diversity of various

[3] The idea of CSR is full of contradictions. The reason is not only it does not fit into the traditional notions of a market economy, where private firms maximize profit, governments provide public goods and regulate the private sector, and philanthropy becomes the domain of altruistic individuals rather than 'heartless' legal entities. For some more reasons see: (Yerznkyan, 2012).

investors' approaches and methods in evaluating and integrating the SRI criteria into investment management.

The recent academic research develops further the idea of integrating social, environmental and community goals into mainstream business activities. The concept of Shared Value can be seen as a next stage in this field. Shared value focuses companies on the right kind of profits – profits that create societal benefits rather than diminish them. The concept of shared value can be defined as policies and operating practices which enhance the competitiveness of a company while simultaneously advancing the economic and social conditions in the communities in which it operates. Shared value creation focuses on identifying and expanding the connections between societal and economic progress (Porter, Kramer, 2011).

Impact Investing is a growing area where investors look to both adopt SRI strategies and evaluate their outcomes. The onus is placed on monitoring and measuring the end results of strategies in portfolio construction with the ex-post assessment of SRI strategies as important as the rationale for strategy selection. One important example of Impact Investing is microfinance investing, where the investment strategies are increasingly assessed for social and environmental impacts.

Investments in microfinance represent an area where the goals and objectives of investors are not limited to the utilitarian features of an investment, such as a risk and return characteristics, but rather enriched with new dimensions - ethical, societal and religious values. The microfinance industry, with its history, track record, achievements and setbacks, can be considered as an example of paramount importance for exploring the ways of integrating traditional investment concepts with people's aspirations and concerns about environmental, social and ethical aspects.

4. MICROFINANCE: THE CASE AND THE STORY

Microfinance is described as the provision of a range of financial products and services, including credit, savings, insurance, remittances, entrepreneurial training to poor, low-income people. Traditionally, banks have not considered the poor population to be viable and reliable consumers of banking services. The poor need to have access to finance, especially to credit to set up and run their tiny businesses to escape poverty and to build assets. Microfinance Institutions (MFIs) – providers of formal financial services to this clientele – facilitate access to the financing, filling in the gaps in the supply of financial services. MFIs vary in scope, size, structure, mission and objectives. MFIs may or may not be regulated, depending on their status and the legislation in the particular country. Often the MFIs provide the technical assistance alongside the provision of a range of financial products and services to their clientele. Business models of MFIs differ from the conventional banking model in that microfinance has developed and employs innovative lending techniques to overcome the obstacles which low-income borrowers are facing such as lack of guarantee and absence of client credit history.

Microfinance plays an important role in the economic development of countries. Through financial inclusion microfinance contributes to economic growth. And of more importance is the fact that microfinance enables growth to be more inclusive, more pro-poor. Microfinance has proved to be a powerful tool, though not a panacea, in combating poverty. Financial inclusion opens new opportunities for entrepreneurially active but 'non-banked' people, strengthens entrepreneurial spirit and empowers the most vulnerable parts of the population, particularly women in developing countries.

Before presenting the microfinance industry's current challenges and opportunities we would like to briefly discuss the idea of microfinance and provide an insight into the historical development of the concept of microfinance and microfinance industry from the past to the present day.

Nearly one half of the world's population lives on $2 a day or less, often unable to meet even their most basic human needs. The majority of these poorest are women and children. Malnutrition, lack of healthcare, substandard housing, and illiteracy result in desperation, disease, and daily suffering. Lacking stable job opportunities, the world's poor are largely self-employed. Their unpredictable day-to-day existence forms a vicious cycle of poverty which leaves little room for hope or opportunity. When proper nutrition or healthcare is out of reach, children grow up at greater risk of contracting life-threatening or disabling diseases. If a family can't afford to educate their children, they have few avenues for a better life than that of their parents. And if a mother can't afford to buy property or livestock, there are few opportunities for her to build assets that will last over time.

What's holding them back? Beyond obvious employment challenges, most people in the developing world - that is, the majority of the world's population - do not have access to formal financial services. According to the Consultative Group to Assist the Poor (CGAP) more than 3 billion poor people worldwide seek access to basic financial services essential to managing their precarious lives. Financial services for the poor cannot solve all the problems caused by poverty. However they can help put resources and power into the hands of the working poor and low-income people themselves, letting them make those everyday decisions and find their own ways to emerge from poverty.

Microfinance offers poor people access to basic financial services such as loans, savings, money transfer services and micro- insurance. People living in poverty, like everyone else, need a diverse range of financial services to run their businesses, build assets, smooth consumption, and manage risks.

Poor people usually address their need for financial services through a variety of financial relationships, mostly informal. Credit is available from informal moneylenders, so called "loan sharks", but usually at a very high cost to borrowers with annual interest rates, often from 300 to 3,000 percent. Under this system, virtually all of a borrower's financial gains are passed directly to the money lender. Individuals are unable to realize the rewards of their own hard work. Savings services are available through a variety of informal relationships like savings clubs, rotating savings and credit associations, and other mutual savings societies. But these tend to be unreliable and somewhat insecure. Traditionally, banks have not considered poor people to be a viable market.

How does microfinance work? The most common microfinance product is a microcredit loan — usually less than $150 (depending on the country and loan cycle; microcredit loans in Mexico, for instance, tend to be larger than in India due to regional economic differences). These small loans are enough for hardworking micro-entrepreneurs, particularly women, to start or expand small businesses such as growing fruit and vegetables, running small shops, or buying wholesale products to sell in a market. Income from these businesses provides better food, housing, healthcare, and education for entire families. Most importantly, additional income benefits children and raises hope for a better future for them.

The global repayment rate for micro-credit loans is higher than 97 percent, which allows MFIs to re-lend these funds to even more clients. By giving the world's poor a hand up, not a handout, microfinance can help break the cycle of poverty in as little as a single generation.

Over the past 10 years or so, microfinance has rapidly evolved and expanded from the relatively narrow field of micro-enterprise credit to the more comprehensive concept of microfinance to the enormous challenge of building inclusive financial systems.

The ideas and aspirations behind microfinance are not new. Small, informal savings and credit groups have operated for centuries across the world, from Ghana to Mexico to India and beyond. In Europe, as early as the 15th century, the Catholic Church founded pawn shops as an alternative to usurious moneylenders. These pawn shops spread throughout the urban areas in Europe throughout the 15th century. Formal credit and savings institutions for the poor have also been around for generations, offering financial services for customers who were traditionally neglected by commercial banks. The Irish Loan Fund system, started in the early 1700s, is an early (and long-lived) example. By the 1840s, this system had about 300 funds throughout Ireland.

In the 1800s, Europe saw the emergence of larger and more formal savings and credit institutions which focused primarily on the rural and urban poor. The financial cooperative was developed in Germany. The concept of the financial cooperative was developed by Friedrich Wilhelm Raiffeisen and his supporters in Germany. From 1865, the cooperative movement expanded rapidly within Germany and other countries in Europe, North America, and eventually developing countries.

Many of today's financial cooperatives in Africa, Latin America, and Asia find their roots in this European movement. Another early example is the Indonesian People's Credit Banks (BPRs) that opened in 1895 and became the largest microfinance system in Indonesia, with close to 9,000 branches.

Between the 1950s and 1970s, governments and donors focused on providing agricultural credit to small and marginalized farmers in hopes of raising productivity and incomes. These efforts to expand access to agricultural credit used state-owned development finance institutions, or farmers' cooperatives in some cases, to make loans to customers at below-market interest rates. These subsidized schemes were rarely successful. Rural development banks were unable to cover their costs with subsidized interest rates. Customers had poor repayment discipline, because they saw their loans as gifts from the government. Consequently, these institutions' capital base eroded and, in some cases, disappeared. Worst of all, these funds did not always reach the poor. Instead, they often ended up in the hands of more influential and better-off farmers.

Meanwhile, the 1970s saw the birth of micro-credit. Programs in Bangladesh, Brazil, and a few other countries began lending to poor women entrepreneurs. Early micro-enterprise credit was based on solidarity group lending in which every member of a group guaranteed the repayment of all members. Examples of early pioneers include Grameen Bank in Bangladesh, which started out as an experiment by Prof. Muhammad Yunus; ACCION International, which began in Latin America and then spread to the United States and Africa; and the Self-Employed Women's association Bank in India, which is a bank owned by a women's trade union. These institutions continue to thrive today and have inspired countless others to replicate their success.

In the 1980s, micro-credit programs throughout the world improved on the original methodologies and defied conventional wisdom about financing for the poor. Firstly, well-managed programs showed that poor people, especially women, paid their loans more reliably than better-off people with loans from commercial banks. Secondly, they demonstrated that poor people are willing and able to pay interest rates which allow microfinance institutions (MFIs) to cover their costs. MFIs that cover their costs can become viable businesses that attract deposits, commercial loans, and investment capital. They can reach huge numbers of poor clients without being limited by a scarce and uncertain supply of subsidized funds from governments and donor agencies. Bank Rakayat Indonesia (BRI) is a dramatic example of what can happen when MFIs focus on collecting loans and covering costs. BRI's village-level branch system now serves more than 30 million low-income savers and borrowers.

In the early 1990s, the term 'microfinance' rather than 'micro-credit' began to be used to refer to a range of financial services for the poor, including credit, savings, insurance, and money transfers.

Two main models of credit that have evolved and are used for financing microfinance are group lending and individual lending. The group lending methodology is based on solidarity pattern when the credit risk of a single borrower is proportionately distributed on all members of the group. As the practice shows this group lending models works the best in case of relatively small amounts of micro-credit. In individual lending model the financing of a micro-borrower is based on a thorough examination of the cash flow of borrower.

To reach ever larger numbers of poor clients, MFIs and their networks increasingly began to pursue a strategy of commercialization, thus transforming themselves into for-profit corporations which could attract more capital and become more permanent features of the financial system. An emphasis on creating and growing strong institutions (as opposed to channeling credit to specific groups) is a core element of this recent history.

The period of fast growth in the past years later changed into a phase of "cooling down" aggressive lending from many MFIs in different countries. The global financial crisis also brought in credit risk and liquidity constraints to the microfinance sector in recent years. The clients of MFIs – micro-borrowers- suffered from rising costs of food in addition to painful macroeconomic adjustments in some countries. This lowered micro-entrepreneurs' repayment capacity, which negatively impacted the delinquency of loans. In spite of this the bad loans levels at MFIs globally stayed within manageable limits and were far below the levels at commercial banks in developing and emerging countries. In spite of some deterioration in portfolio quality of the microfinance institutions, the financial and operational indicators on average remained at acceptable levels. During this time many MFIs reviewed their business plans, diversified their funding sources and improved efficiency levels. Microfinance is evolving and our expectation of it has to evolve as well.

5. INVESTING IN MICROFINANCE

It should be mentioned that microfinance is currently not only a phenomenon existing in developing countries (where microfinance has proved to be an effective tool both in poverty reduction through the support of income generating activities mostly in the poorest countries) but is also an important component of a broader micro-, small and medium-size enterprises segment which is a basis for development and growth of the middle-class in more developed countries. Microfinance exists and should also be considered by policymakers as a viable tool in advanced countries, especially in light of economic difficulties currently persistent in Europe and the U.S. Microfinance can serve as an effective economic tool for mitigating social issues such as high unemployment, integration difficulties for migrants and for cultivating entrepreneurial spirit and unleashing creative potential within socially vulnerable segments of population in developed countries.

To sustain the growth of microfinance services MFIs are employing strategies to diversify their funding sources by using a growing range of financial instruments, in order to optimize their capital structure, aligning this with interests of various local and international investors.

Mainstreaming of microfinance, its increased access to capital markets and a wide range of financial instruments available in the market pose both opportunities and threats to MFIs and their investors. Awareness of risks, including counterparty, country, foreign exchange, reputational risks and specifics of risk mitigation in microfinance are crucial for investing in microfinance.

And we need to remember that commercial microfinance is a business activity based on economic efficiency and not an activity based on donation and aid. Microfinance is a vivid case of social entrepreneurship.

With increasing demand for microfinance services and the entrance of various public and private actors in the field, microfinance has evolved to become a financial services market with a size of more than US$ 250 billion. Today microfinance serves the needs of around 150 million micro- and small enterprises. MFIs worldwide have accumulated assets of US$ 50 to 60 billion and about US$ 25 billion in deposits. The World Bank estimates that there will still be 1 billion people living below US$ 1.25 per day in 2015, which means that there will be a need for microfinance for many years to come.

During the last decade with the emerging of numerous specialized microfinance investment funds microfinance has transformed to become a recognized asset class. This was a major transformation not only in the minds of MFIs but also in bankers and asset managers' perceptions about the industry.

According to Consultative Group to Assist the Poor (CGAP) and the Microfinance Information Exchange (MIX) foreign investment in microfinance r, including both debt and equity, reached US$13 billion as of the end of 2010. The growth has been driven by both public institutions and private and institutional investors. More than half of all cross-border investment in microfinance is provided through financial intermediaries. Various Microfinance Investment Vehicles (MIVs) have grown in number, scale, and product offering. MicroRate (a rating agency specialized in microfinance) has estimated the total assets of MIVs as of December 31, 2010 to be US$ 7 billion.

MIVs raise funds from public, institutional and private investors to finance MFIs worldwide. MIVs can take the form of collective investment schemes or other dedicated investment vehicles. MIVs provide financing to MFIs through both debt and equity investments.

Why is microfinance suitable for responsible investors? Microfinance asset class provides investors with an opportunity to participate in stimulating economic growth and improving living conditions by providing credit to low-income households and entrepreneurs in emerging and frontier markets (EFM). Investing in microfinance provides investors with a solid financial return in addition to strong social and ethical impact.

Investing in microfinance can generate strong financial returns for investors, while providing diversification from today's highly interdependent global markets. In addition, EFM often exhibit higher and more stable economic growth projections than advanced markets. Moreover, investing in microfinance which addresses the elementary needs of people – food, healthcare and education – is a partial guarantee of independence from market speculation.

Three characteristics of microfinance are particularly attractive for institutional investors: the social value of microfinance, its perceived attractive risk-adjusted returns, and its potential de-correlation from other asset classes.

Several academic studies have demonstrated that microfinance investment returns are apparently not correlated to mainstream investment indices (see for example: Krauss, Walter, 2008).

Philanthropic activity, donations and activities of public donors, and development financial institutions cannot alone provide solutions to the challenges our world faces today – private investment is increasingly engaging in the development of an effective route to social and environmental progress. Therefore there is a great need for increased deployment of capital from private investors particularly in the microfinance asset class. In spite of availability of many various dedicated private investors participating currently in microfinance, there is still only limited understanding of the business model of microfinance and the opportunities it can offer among a wider circle of professional investors.

Microfinance asset class, being the most advanced niche in the broader impact investing field, offers a new approach in the way that it reduces the imbalance in the distribution of wealth between the rich and the poor parts of the world. In general the microfinance investments can be seen as an area of respectful business cooperation between the rich and the poor, based not on donation and philanthropy but on economic efficiency and mutual economic interests.

Despite some evidence that in the short run tensions can arise between simultaneously achieving the financial and social goals, in the long run these two objectives do not contradict each other: doing right by all stakeholders is the only long-term sustainable business solution. And this is the essence of the double bottom line in microfinance: a social promise to benefiting clients combined with a financial commitment to operating profitably.

Somewhat affected by the global crisis and some negative events in countries like India, Nicaragua and Bosnia and Herzegovina the microfinance industry still continues to show its resilience to shocks and de-correlation. The damaging effects of financial, energy and food crises globally underlined the important social mission of microfinance institutions in providing sustainable delivery of financial services to millions of people worldwide.

By calling for more transparency on the performance of MFIs to provide the responsible delivery of financial services to the micro-clients, to improve the quality of microfinance products and services, to enhance their client protection and social performance, we should not forget about the need for responsible behavior at the level of all actors, especially at the level of investors. Investors can play an important role in participating in the industry initiatives (such as for example, the Smart Campaign's Client Protection Principles) committed to improve transparency, client protection, customer service and business ethics, responsible pricing and not coercive collection practices. In accelerating commitment of client protection and social performance management by supporting such strategies at the level of MFIs, they can create the right incentives by funding providers who have strong social missions and objectives, and turn down providers with inadequate practices. Investors can also play a role by avoiding investments in saturated markets, contributing to mitigating the risks of potential over-indebtedness. Investors and investment management companies specialized in microfinance can also add great value by innovating: finding new and better ways of making investments in microfinance, developing investment instruments, introducing local currency financing fund products and enhancing risk management solutions for responsible investors.

6. CONCLUSION

The global financial crisis highlighted the need to aim to achieve positive social effects alongside financial return – a shift from a pure profit-maximization paradigm. This also reflects the increasing interest of various investors in making investments in businesses which pursue social, ethical and environmental development objectives in addition to financial goals. Recent regulatory changes in the EU and worldwide in addition to increased exposure to emerging markets will significantly impact the asset management industry in terms of investment decisions and distribution strategies. And the microfinance asset class, due to its transparent, social and investable nature, is an attractive niche for asset managers, advisers and distributors, who strive to offer innovative fund products to satisfy the growing needs of private and institutional investors.

Microfinance has emerged as a leading impact asset class that can provide investors risk-adjusted financial returns combined with solid social impact. The microfinance asset class has its own investment frameworks, risk management, benchmarks and a growing array of dedicated stakeholders. Microfinance investment funds have been recognized to be scalable, financially sustainable and internationally replicable investment structures which can offer investors financial returns as well as social values. Understanding the whole microfinance fund value chain, microfinance fund objectives, structures, policies, as well as investment processes, portfolio and risk management practices are important for microfinance investors to make informed investment decisions.

Microfinance correlates strongly with the goals of inclusive development and creating shared value and has already proved to be one of the most effective techniques to promote sustainable and responsible finance.

After the period of rapid growth in the past and recent set-backs, the microfinance industry is entering a new stage of its development – a stage of more sustainable and responsible growth.

Microfinance academics and practitioners constantly seek ways to develop tools and systems for social performance measurement to clearly demonstrate credibility of microfinance impact, thus increasing efficiencies along the value chain.

A high degree of confidence exists that the stakeholders of microfinance will be capable of addressing the different challenges microfinance currently faces by adopting best practice solutions to mitigate risk of over-indebtedness, to better protect clients and to enhance transparency.

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