Strategies to manage risks of Microfinance Investment Vehicles (MIV)

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Executive Summary

In the last few years, microfinance has become an interesting investment opportunity for the private sector. Since 2004, microfinance investments from institutional and retail investors in developed economies have increased substantially. Even though investment growth rates slowed down in 2009, they have remained positive to date. Investors seek varied combinations of financial and so-called social return. This dual return property is the unique selling preposition of microfinance. The bulk of investment is flowing through different types of Microfinance Investment Vehicles (MIVs). A MIV acts as an intermediary for investors, selects Microfinance Institutions (MFIs) from an international investment universe to build and manage a portfolio, and sells shares to interested investors.

The aim of the paper is to examine the risk situation of MIVs and their risk management strategies, from the first screening of individual investments to the ongoing process of portfolio building and continuous monitoring. As MIVs are a special kind of investment company, we look at how their risk management differs from other companies. The thesis builds, on the one hand, on the literature on investment companies and funds. On the other hand, it reviews the available literature, including the non-academic one, on microfinance investments with regard to their risk situation and risk management. Homepages, surveys, reports and prospects are helpful to gather direct and hidden information about risk profiles and the state-of-the-art risk management strategies. In the end, a list of ten risk management tools is built and it has been observed that the underlying fundamentals are not different from other investment companies. However, the risk management style changes.

We start with analyzing the microfinance industry from an investor's perspective using Porter's five forces. This actually makes us aware of the current issues and arising risks in the microfinance market on different relationship levels. On the one hand, we review the classic features of microfinance. On the other hand, we analyze the changing power relationships between clients and MFIs, MFIs and MIVs and the competition between MFIs and MIVs. We see that high competition between MFIs can cause overheating in some

markets and can be counter-productive. Once, MIVs used to have "unlimited" power. Now, because of the rising competition between them and the limited investment spectrum, tier one MFIs are gaining power. However, this is not everywhere true. MIVs have to adapt to these changes and adjust their risk management priorities quickly. We also deal with the question of whether microfinance is an asset class or not. This helps us to understand the investor structure behind MIVs and detect other industry risks. Microfinance is not a fully independent asset class yet for many reasons. Despite the increasing number of privates, public investors are still very present.

The general justification of investment companies as financial intermediaries, which follows next, perfectly explains the role of MIVs as well. The main duty of investment companies is to overcome transaction costs arising from informational asymmetries. We picture them as delegated monitors, that screen investments, prevent opportunistic behavior and audit or punish companies (in our case MFIs). In simpler words, investment companies are better risk managers as single investors and can achieve higher diversification. Investors have advantages and disadvantages if they invest via intermediators, instead of investing directly. Regarding risk management, investment companies should maintain a specified risk exposure, which depends on the fund's strategy. While asset allocation funds have a very broad investment spectrum, sector funds (like MIVs) are thematically focused and take more risks on purpose. MIVs are actually positioned as risk takers and risk mitigators at the same time. Asset allocation funds can be passively managed as index funds, whereas sector funds need a rather active management style, as observed in the case of MIVs.

In our fourth section, we focus on MIVs. According to risk perspective, MIVs can be categorized in Equity, Fixed Income and Mixed MIVs. While Fixed Income MIVs are broader diversified and more commercial, Equity ones are rather focused, have a clearer social mission and a proactive risk management approach. MFIs' risks definitely affect MIVs in many ways. That is why they are briefly analyzed before going to MIVs' risks. As financial and external risks are more or less known, we pay more attention to the specific risks of the relationship MFI-MIV. These include accountability risk, concentration, competition, fraud, reputation or governance risk. Finally, a list of ten risk management tools, based on information gathered from homepages, reports and sales prospects, is built. First is screening via an institutional appraisal, with or without the help of a rating agency. Then, a list of different diversification strategies while building a portfolio follows. Starting with MFI type diversification, we continue with other diversification decisions such as: debt or equity, public or private, product delivery and investor choice, countries, themes or currencies. Governance is a very important risk control tool as well, especially for Equity MIVs. Last but not least is monitoring on single MFI and portfolio level, which is crucial for MIVs. In order to illustrate all of the previous points and their importance, concrete risk management strategies from 12 different MIVs are summarized in a table. It is clearly observed that the state-of-the-art risk management approach of MIVs is very active compared to other investment companies. There is no right valid formula for risk mitigation. Each MIV has its own risk approach according to its policies, financial and social goals. The investors' structure and investment form reveal a lot about the MIV's investment strategy and risk appetite.

In the end, the question if passive management would be reasonable for MIVs is asked. However, it is strongly recommended that MIVs continue with their active risk management. The industry is not mature for passive management, even if a representative index existed. That is why some ideas on improving the *existing* risk management tools are outlined. MIVs can, for example, use their power to negotiate for better regulation and accountability. They could consider investing in many minority stakes of big top tier MFIs and combine it with majority shares of MFIs in earlier stages to share risk. Innovation in structured products or delivering via internet platforms would attract new investor types and contribute to investor and product diversification. In order for Debt MIVs to be part of governance, voting rights (similar to equity investors) would be necessary. Even though thematic diversification is not popular now, it could gain importance in the near future as an effective way to mitigate reputational risk. Our list of recommendations is not exhaustive by nature. Enough data in the future will enable to conduct empirical analyses to test and compare different strategies or develop new technical risk management tools.