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Social performance of the MIVs: What are the lessons learnt from the SRI experience?

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Preliminary comments

This report was written under the supervision of Professor Marc Labie, co-director of the Center for European Research in Microfinance. The author would like to thank the Association of the Luxembourg Fund Industry for funding and supporting this research, in particular Thomas Seale, Jean-Luc Neyens, and Laetitia Hamon. The author would also like to thank LuxFlag for their help in contacting the participants to the study.

This document is based on a series of interviews realized between December 2010 and March 2011. The objective of those interviews was to identify the opinion of microfinance fund managers representative of the industry regarding the perception, measures and practices of social performance in MIVs.

The content of this report is the sole responsibility of the author, who wishes to thank the participants to the interviews for their extremely valuable inputs and their availability. The reader must also be informed that for presentation purposes, the opinions have been "summarized" when there was a broad consensus among respondents, and therefore the conclusions don't always reflect the exact answers of every respondent.

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Introduction

The Microfinance Investment Vehicles industry is today at a bottleneck. In the context of a damaged reputation due to recent crises, the whole field of microfinance and especially the investment vehicles, funded by public money and by socially inclined investors, have to demonstrate and justify their commitment to social returns.

In such a context, the main objective of this study is to identify what the MIV industry can learn from the experience of the broader Socially Responsible Investment (SRI) sector in terms of integrating social performance into their core investment processes. Indeed, the SRI sector has a longer track record than MIVs and has demonstrated a positive impact on industry behavior regarding investees' corporate social responsibility (CSR). However, many impediments are limiting fund managers to have a true SRI behavior when making investment decisions. They can be analyzed at three levels: individual, organizational and institutional.

Therefore, relying on a well-known conceptual framework of impediments to SRI (Juravle and Lewis, 2008), this study aims at identifying the impediments to the integration of social performance criteria into MIVs' investment decisions, and is structured around the three categories of impediments: individual, organizational and institutional.

In the remainder of this report, we present the methodology and the sample used in the study, show the main findings, and we finally draw some conclusions.

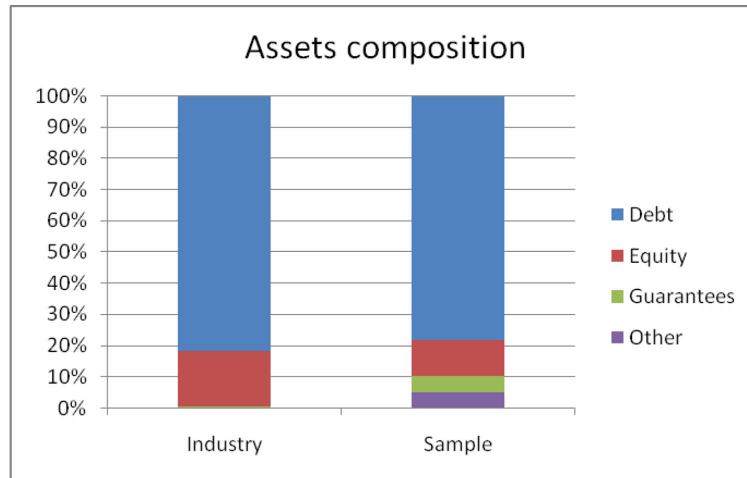
Methodology

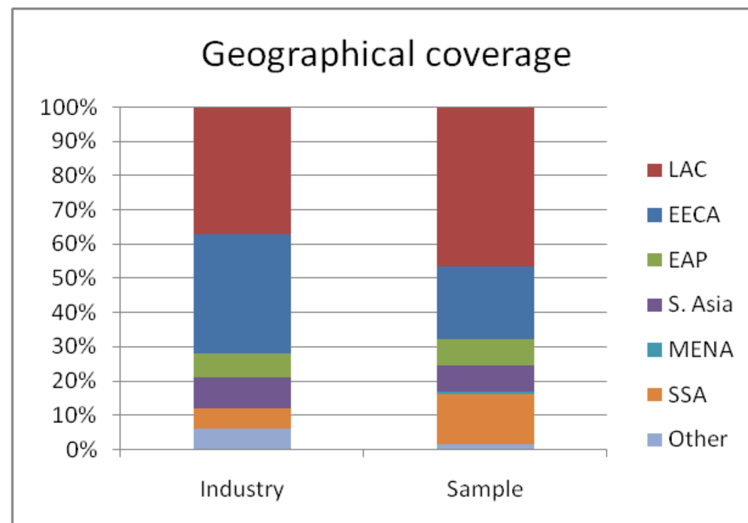
This study is based on semi-structured interviews of 9 microfinance fund managers, representing 19 MIVs altogether. Interviewees were asked their opinion and expectations about social performance according to the previously mentioned research questions, and have been analyzed following the content analysis methodology. All interviews have been conducted by phone, between January and March 2011, and ranged between 45 minutes and an hour.

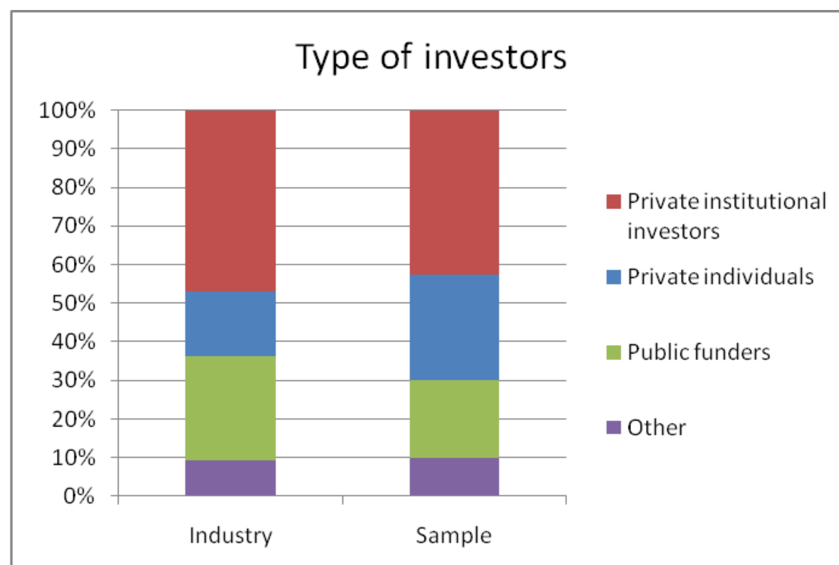
Here is the list of the MIVs represented in the study:

- Advans SA, Sicar
- Alterfin cvba/scrl
- ASN-Novib Fund
- Dexia Micro-Credit Fund, SICAV II
- Dual Return Sicav II – Vision Microfinance sub-fund
- Dual Return Sicav II – Vision Microfinance local currency sub-fund
- Impulse Microfinance Investment Fund
- Incofin cvso
- Luxembourg Microfinance Development Fund Sicav
- NOTS Microfinance Fund
- Oxfam Novib Fund
- ResponsAbility Global Microfinance Fund
- ResponsAbility Mikrofinanz-Fonds
- ResponsAbility Microfinance Leaders Fund
- Rural Impulse Fund I SICAV-FIS
- Rural Impulse Fund II SICAV-FIS
- Triodos Sicav II – Triodos Microfinance Fund
- VDK spaarbank
- Volksvermogen

The sample represents 26% of total MIVs assets, (industry numbers as estimated in the CGAP 2010 MIV Survey Report), and presents similarities with the industry in terms of assets composition, geographical coverage and types of investors:







Key findings

Individual impediments

Firstly, we assessed the perception that fund managers have of microfinance as an investment field, asking if they see microfinance as a social investment *per se* or not. While all fund managers acknowledge the limits of microfinance as a poverty reduction tool by itself, most of them see microfinance as social by nature. Indeed, the poverty alleviating objective is predominant in respondents' discourse; only two answered that microfinance is not social per nature, and that the social side lies in the good policies and business set up by MFIs.

Based on the summary of all answers, we detect most fund managers display positive illusions about microfinance, hence their tendency to simplify the complex reality and to talk only about the noble goals of microfinance without enough stress on the risks that it involves if not done properly (e.g. over-indebtedness). We argue that this "too positive" perception is a major impediment to a formal integration of social performance in investment processes because it supports the idea that all MFIs are social, even those with good financial performance only. It therefore refrains managers to make additional efforts to develop social performance assessment.

We also find that even though all respondents declare being concerned with social performance they provide very different definitions of it, some citing the "old" quantitative indicators only, some being aligned with the latest definition of the Social Performance Task Force, some are mixing social performance with the notion of impact, some others talk about client satisfaction only… This lack of a common view of what social performance entails is also a major impediment at the scale of the sector, because it brings confusion to MFIs with regards to the social standards they should respond to.

On the other hand, risk and uncertainty aversion don't play a major role: all respondents explained that risks in microfinance are high but usually well understood and diversified in portfolios, in particular through country diversification. From the fund managers' point of view, risk aversion and short-termism are not applicable in microfinance and are not an impediment as such to the integration of social criteria in investment processes.

Organizational impediments

The most important question regarding organizational impediments is how social performance criteria are integrated to the core investment decision process. We asked respondents to explain what the first screening criteria for potential investments are, and for most MIVs they are exclusively financial. As for the role of social performance into the final investment decision, no one has given a clear weight for social criteria. The tendency is that the main decision is based on financial risk, and if social performance is good then the investment becomes "very good". However, this absence of a clear and formal integration of social aspects in the investment approach is an important impediment that needs to be tackled if MIVs want to demonstrate their social commitment to investors.

Regarding organization dominant values, respondent were asked about their perception of the relationship between financial and social performance. There was also a broad consensus on this issue: the relationship is perceived negative for small MFIs (because social performance

management is costly) and then positive for well-established MFIs, which have more resources to dedicate to costly policies such a client satisfaction surveys or training programmes for staff.

In the same vein, when asked about the meaning of being "double bottom line" for an MIV, fund managers demonstrated that the objective of simultaneous social and financial returns is rather a belief than an actual practice. They don't have any formal policy regarding the right mix between financial and social objectives; they just believe that social and financial performances are positively correlated for profitable MFIs.

Regarding the social performance indicators used by MIVs, most of them still integrate output indicators in their reporting to investors: total borrowers, gender, average loan size… Although all interviewees are aware that these indicators don't reflect real social performance, they recognize that at the same time they are very easy to aggregate for reporting to investors, who are fully satisfied with it.

While in SRI, the screening role is played by CSR rating agencies, the use of social ratings remains limited in microfinance, and most MIVs use in-house assessment tools to evaluate an MFI. Social audits (such as the CERISE's SPI) are perceived as important for MFIs to position themselves towards their stakeholders, but are considered as biased for assessment purposes if done internally by the MFIs. MIVs also stress the importance of ratings because they are made by an external body. However, respondents feel the need to complement the ratings (when available and not outdated) by their own due diligence process.

Finally, regarding fund managers performance review and incentives, very few mention social aspects in their performance assessment, but they also mention very few incentives related to volume of profit objectives. Many respondents have a fixed salary and team incentives.

Institutional impediments

With respect to the institutional environment of MIVs, a very important element is the absence of a microfinance-specific regulation in Luxembourg and Switzerland (the two main countries where MIVs are incorporated). No obligation at all for funds to report on social performance to their investors makes a major impediment to its integration in investment decisions. In European and US SRI, regulation has been a major driver of industry development by setting mandatory disclosure requirements.

As a result, reporting to investors and investments follow-up in microfinance are mostly based on output indicators (average loan, women percentage, total borrowers…), but on the other hand, investors are said by fund managers to be satisfied and not asking for more information on social performance.

Regarding fiduciary duty and duties of prudence, most respondents explained that investors are risk averse, but profit requirements remain quite limited, with no minimum return expected or at least not a higher return than industry benchmarks.

Another element relates to the professional skills in the MIV industry. Some explained that most fund managers have a mainstream investment banking background, and not enough expertise in social aspects. Many respondents also explained that the industry would benefit

having a better risk management, especially after the over-indebtedness crisis that happened recently in India. Taken together, this lack of expertise in social aspects and the respondents' big concern about risk management skills make a considerable impediment to the integration of social performance as a main decision criterion.

Finally, all respondents acknowledged the current herd behavior happening in the sector, with most MIVs focusing on the same small number of mature and profitable MFIs. This is a strong selection bias and a major impediment to really consider social performance when making investment decisions.

Discussion and conclusion

The microfinance investment vehicles industry is today at a bottleneck. In a context of a damaged reputation of microfinance, the whole field of microfinance and especially the investment vehicles, funded by public money and by socially inclined investors, have to demonstrate and justify their commitment to social returns.

The main objective of this study was to identify what the MIV industry can learn from the experience of the broader SRI sector, in terms of integrating social performance into their core investment processes. Indeed, the SRI sector has a longer track record than MIVs and has demonstrated a positive impact on industry behavior regarding investees' corporate social responsibility. However, many impediments are limiting fund managers to have a true SRI behavior when investing, and can be analyzed at three levels: individual, organizational and institutional.

We used a qualitative methodology to identify the main impediments to the integration of social performance as a decision criterion in microfinance, using the Juravle and Lewis (2008) framework. The overall finding is that while social performance is recognized by respondents to be an important topic for the industry, fund managers still don't give a strong role to social criteria in investment decisions. We argue that this is linked to a number of major impediments such as the tendency to believe that microfinance is social per se, the lack of standardization in social tools and also a loose regulation regarding social reporting.

The belief of fund managers that microfinance is social per se has to be nuanced by their perception of the relationship between financial and social performance of MFIs. Indeed, as long as they continue to think that there is a trade-off for small MFIs regarding social performance, they will tend to continue focusing on big MFIs according to their financial performance. However, the SRI literature has largely documented a positive relationship for all types of companies, meaning that caring about social aspects always pays back (in the long run) in terms of financial performance. We think that MIVs still have to make that observation in microfinance to be able to change their behavior.

The lack of standardization in social tools is an important issue that the broader SRI sector also faces. Nevertheless, the literature shows an overall positive impact of SRI on corporate CSR practices, even if the methodologies of CSR rating agencies are questioned. The MIV industry relies very little on external bodies to make the assessment of their potential investments, because they don't trust self-reported MFI social performance, and because

microfinance ratings still don't aggregate financial and social performance in one single assessment at the moment. If the microfinance rating agencies can manage to harmonize their methodologies and social indicators used, they could play a greater role in the future of microfinance.

The loose regulation is also a major impediment. Indeed, there is no obligation in terms of social reporting in microfinance, when it has been a major driver or European and US SRI development, thanks to the setting of mandatory CSR disclosure requirements for SRI funds.

As a conclusion, the impediments that have been identified in this study should help industry practitioners and scholars think of a way to make microfinance investments change from a negative screening approach (which seems to be currently the case: aiming at a good financial performance « under a social constraint ») to a true positive approach, with social performance criteria at the heart of the screening process because after all, what socially responsible investments need in the first place, is to actually be socially responsible…