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MICROFINANCE, COMMERCIALISATION AND ETHICS†

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Abstract

This paper discusses the so-called commercial approach to microfinance under economic and ethical aspects. It first shows how microfinance has developed from a purely welfare-oriented activity to a commercially relevant line of banking business. The background of this stunning success is the – almost universal – adoption of the so-called commercial approach to microfinance in the course of the last decade. As the author argues, this commercial approach is the only sound approach to adopt if one wanted microfinance to have any social and developmental impact, and therefore the wide-spread "moralistic" criticism of the commercial approach, which has again and again been expressed in the 1990s, is ill-placed from an economic and an ethical perspective.

However, some recent events in microfinance raise doubts as to whether the commercial approach has not, in a number of cases, gone too far. The evident example for such a development is the Mexican microfinance institution Compartamos, which recently undertook a financially extremely successful IPO. As it seems, some microfinance institutions have by now become so radically commercial that all of those social and development considerations, which have traditionally motivated work in the field of microfinance, seem to have lost their importance.

Thus there is a conflict between commercial and developmental aspirations. However, this conflict is not inevitable. The paper concludes by showing that, and how, a microfinance institution can try to combine using the strengths of the capital market and at the same time maintaining its developmental focus and importance.

JEL Classification: A13, D63, F35, O16

Keywords: Development Finance, Microfinance, Commercialisation, IPO, Business Ethics

I. The Ethical Dimensions of Microfinance

Microfinance is generally understood to mean the provision of small and very small loans and other financial services to relatively poor people and/or to small and very small enterprises, in developing countries and the former socialist countries of Eastern and Central Europe and Asia.

Just 15 years ago, promoting microfinance meant channelling development aid funds in the form of large loans and grants from the industrialised countries to local non-governmental organisations[1] or state-owned banks in developing countries in order to enable them to issue small and very small loans. However, most of the microfinance institutions[2] which received such support were too small to cover their costs and too unprofitable to be able to grow and expand the scope of their activities, and for that reason alone they were unable to achieve any real impact in development terms. In contrast, microfinance has today become an integral part of the financial system of many countries, and in light of the volume of financing involved and its development impact, it is no longer a marginal phenomenon. The main reason for this change is the adoption of what is called the commercial approach to microfinance, one of the topics of this paper.

The awarding of the 2006 Nobel Peace Prize to Professor Muhammad Yunus and the Grameen Bank, the microfinance institution that he founded in the 1970s, had the effect that today microfinance is widely known and regarded as the most humane part of the international financial system, perhaps even the only humane part. The prize was awarded for good reason: Anyone who strives for a fairer distribution of the opportunities for personal and economic development that the access to loans can offer as strongly and effectively as Yunus has done for many years is indeed promoting world peace – because a lack of access to financial services is one of the main reasons why poverty emerges and is perpetuated, and massive and long-term poverty is one of the greatest threats to peace.[3] Thus, there is at least one manifest connection between microfinance and ethics.

The relationship between microfinance and ethics, however, is more complex than the Nobel Peace Prize for the "discovery" of microfinance as a means of combating poverty might suggest. Moreover, there are doubts as to whether microfinance is really a suitable instrument

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1 Referred to hereinafter as NGO (singular) or NGOs (plural)
2 Referred to hereinafter as MFI and MFIs
3 As Yunus noted in his acceptance speech for the Nobel Prize; see Yunus (2006/2008), p. 235.

for combating poverty.[4] Therefore this paper does not to address the role of microfinance for poverty alleviation but rather the tensions that seem to exist between moral standards and economic imperatives in setting up and operating MFIs. The nature of these tensions can most easily be explained by using the example of the Grameen Bank: In spite of its name, the Grameen Bank is first and foremost a social welfare organisation, and as such is highly efficient, truly exemplary, and worthy of a Nobel Peace Prize.[5] However, this does not imply that it is also a model of how MFIs should be organised and operate. Most development finance experts would hesitate to call Grameen an exemplary MFI because, at least up until a few years ago, it was nowhere near being able to cover its costs, and also does not seem to have made any great effort to do so.[6] That it could afford to disregard the business side of its operations in this manner has to do with the unique role that Mohammad Yunus has played on the international "development politics scene" since many years: He has been so well known and respected all over the world – and moreover, is such a good speaker – that he always managed to procure enough funds in the form of donations or subsidies to cover the deficits incurred by the operations of his bank.

There is no objection to be raised against a welfare organisation receiving massive flows of grants from the Western world – as long as this is not deemed exemplary banking for poor people and very small enterprises. For a few welfare institutions a suitable and effective business model can consist in aspiring and achieving great things in development policy and humanitarian terms, publicising these accomplishments and using the publicised successes to attract the ample financial support that is needed to generate the positive effects. For Grameen, this business model was definitely effective. However, it is not suitable for the hundreds and even thousands of MFIs now in existence all over the world, because there could never be enough television appearances, invitations to attend international conferences and meetings with the powerful and prominent of this world, to allow every one of them to generate the same large volume of subsidies which the Grameen Bank has obtained over the course of the years. Therefore, almost all MFIs must find ways to limit their costs and to

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4 See e.g. Morduch (1999b). The scepticism expressed by this author does not imply that microfinance lacks any real value in development or ethical terms. There are a number of other roles or functions of microfinance that are important from a development perspective, and which are also ethically valuable.

5 There is no question that the loans extended by the Grameen Bank make a real difference in the lives of its poor and mainly female customers. Earlier estimates indicated that the subsidies provided by the "international public" for this lending activity until recently, were less than USD 5 per borrower. This figure alone would suggest that a considerable impact is being achieved with rather limited costs. A new study by Makame/Murinde (2008) shows that the cost efficiency of the international support channelled to poor women via the Grameen Bank is even higher and thus the subsidy per borrower is even lower.

6 See e.g. the critique of Grameen's precarious financial situation during the 1990s and its problematic practice of disguising this situation in Morduch (1999a).

cover them through income they generate. They have no choice but to take the commercial side of their operations seriously in order to ensure that they can survive economically and are able to offer their small and very small loans, which are clearly important to the poor people making up their target groups, on a long-term and sustainable basis.

Taking the commercial side of microfinance seriously and ensuring that the institution does not lose money is the core of the so-called commercial approach to microfinance, which the leading practicioners of microfinance and most of their academic observers consider as reasonable in economic terms and, not least for this reason, also as morally sound. Even though its fundamental idea seems to be highly plausible, the commercial approach has been harshly criticised for years; many have asserted, or at least insinuated, that it is an ethically questionable form of development aid.[7]

Up until about three years ago, this was the status of the discussion in the field, in politics and in academia, and the discussion could also end here. It would be interesting enough to analyse the conflict between those who represent a position which appears to meet high ethical standards, but is naïve in economic terms, and most others, who ultimately want to achieve much the same things that Yunus and his supporters do, but who cannot ignore the practical aspects and the difficulties involved and at times are irritated by Yunus's almost invariably moralising speeches about values, good intentions and right-minded thinking.

However, the history of microfinance does not end with this controversy. Trends are now emerging which are even more complicated in ethical terms and, as I see it, also even more interesting: There is currently an increasing number of MFIs which openly state that they are committed to achieving development aims and at the same time embrace the commercial approach. But despite their explicit commitment to development goals and aspirations, their behaviour is almost indistinguishable from that of enterprises seeking solely to maximise profits. The commercial approach, which has always made obvious sense to economists, thus begins to come up against certain boundaries. This paper will end exploring precisely where the boundaries of the commercial approach should be in light of these recent events.

To carry out my analysis of the ethical dimensions of the debate regarding commercial microfinance, I have chosen a "historicising" approach: I briefly reconstruct the development of microfinance and, in doing so, identify what I consider to be the important ethical questions which have emerged at various points in its history. The structure of this paper is a direct result of this approach.

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7 See for instance Hulme/Mosley (1996) and Woller et al. (1999).

II. The Beginnings of Microfinance

1. Starting points and forerunners

Promoting financial systems has long been an important part of Western development aid.[8] This part of development policy was motivated by the assumption – astonishingly, one which long remained a subject of debate – that a better financial system would also lead to more economic growth.[9] However, views as to what constitutes a good financial system and how the financial system of a developing country could be improved, and by outsiders to boot, have changed repeatedly over the course of time. One of these changes led to the emergence of microfinance.

Until the middle of the 1970s, and to some extent thereafter as well, development finance consisted of large-scale capital transfers: Very large loans, so-called credit lines, were issued to state-owned development banks in the developing countries by the development organisations of the industrialised world, such as the World Bank or Germany's Kreditanstalt für Wiederaufbau (KfW). The local development banks, in turn, were supposed to pass these funds on to other state agencies or to large private companies at preferential terms and conditions – which mainly meant at low rates of interest – to finance large-scale projects such as the construction of a steel works or a dam. It was believed, officially at least, that this promotion of so-called "growth poles" would trigger "self-supporting" overall growth which would also lead to an improvement in the economic status of broad segments of the population. In this respect, this policy was indeed intended to achieve development aims, and thus in a certain way could also be seen as being ethically motivated.[10] Given the underlying view of how economic growth is connected to general economic development, there did not seem to be any need to carry out measures to promote poor people or small and very small enterprises, on a separate basis, apart from the large-scale capital transfers.

However, the hoped-for "trickle-down effect" generally failed to emerge. The ethical lesson to be learned from this failure of the first phase of development finance is clear and simple: It is not enough to rely on illusory and poorly substantiated theories as to what the measures in question will achieve and to hope that the initiatives undertaken will somehow simply lead to positive results.[11] In most of the countries in which the traditional form of development

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[8] For an overview of the history of development finance, see Krahnen/Schmidt (1994), Chapter B.

[9] Regarding the theoretical arguments as to why a good financial system stimulates prosperity and growth, see Allen/Gale (2001), and for the empirical evidence supporting this thesis, see Levine (1999 and 2005).

[10] Unofficially, however, this type of development aid frequently, or even primarily, had more to do with promoting the exports of the so-called donor countries.

[11] See also Easterly (2001) for a very sharp critique of this lack of a theoretical basis of this policy.

finance did spur growth, an unintended consequence was that income, wealth and economic opportunity were more unequally distributed than before. In the period after 1968 and the end of the Vietnam War, this effect was not politically acceptable. Social integration was on the agenda – both for the Western countries, which, in the big-scale international politics of the day, wanted to counteract the anti-colonialism and anti-Americanism spreading in the “Third World”, and for the many politically active young people who wanted to create a better world and had discovered development aid as a suitable sphere for working towards this aim.

In 1973, the then president of the World Bank, Robert McNamara renounced development finance as it had been practiced up to that point, namely in the form of capital transfers to large-scale and typically state-controlled projects. In the second phase of development finance, of which his speech marked the starting point, the focus was still on capital transfers from the donor countries to the developing countries; now, however, the funds were intended to go directly to the target groups of the poor and of small and very small enterprises.

But how were the foreign funds to reach the poor target groups? Private banks did not appear to be suitable vehicles for this capital transfer. They were not in fact suitable, nor were they interested in playing this role, because at that time, the governments of almost all of the countries targeted had imposed interest-rate ceilings, which would have prevented any bank from charging cost-covering interest rates on very small loans.

New “channels” were needed to deliver the capital transfers, and two new channels were identified or invented. The first consisted of setting up departments for the extension of small and very small loans within the existing state-owned development banks, or even founding specialised, state-owned “small enterprise banks”. The results were dreadful. The loans were much larger than they should have been, and failed to reach the target groups, and many of the new institutions were extremely inefficient and corrupt.

The other new “channel” consisted of creating new institutions operating on a non-profit basis, or, where such institutions already existed, sponsoring them and using them as vehicles for passing on development aid funds. Many of these institutions had high ethical and development policy standards. One of these institutions was the Grameen Bank. Admittedly, it is almost the only one of its kind which managed, thanks to Yunus’ charismatic leadership, to survive and even to grow. Almost all of the others became, in financial terms, the proverbial bottomless pits. At best, they could have served as fig leaves for the Cold-War-era development policies of the industrialised nations, which otherwise were by no means aimed at meeting human needs; and perhaps their main function was to serve as make-work programmes for legions of left-wing social scientists, who might in this way be prevented from developing and spreading the radical ideas that were popular at that time, and foster their political integration.

However, with only a few exceptions, this second approach to development finance also failed to achieve the desired effect. The politically committed sociologists, political scientists and theologians from Chicago, Berlin or Bogotá who had received the coveted posts in development projects did not have the mindset of bankers, and they could not really relate to the operators of the very small enterprises whom they were supposed to support, given that these individuals were entrepreneurs, in a sense, rather than "revolutionary subjects". Here as well, the ethical lesson is clear: Good intentions alone are not enough to achieve good ends.

2. The beginnings of modern microfinance

A third group of new development projects had better prospects for success. They consisted of externally-financed credit programmes of NGOs which were not shaped and dominated by sociologists and their like from the industrialised countries, but rather by politically liberal men and women, often themselves entrepreneurs, from the established classes of the respective developing countries. The initiators of these programmes were aware of the needs of the micro entrepreneurs of the informal sector, the most important target group addressed by the new policy, and had an understanding of their economic and financial problems.

Towards 1990, the conviction emerged among development finance experts that the combination of small-scale and very small-scale entrepreneurs in the developing countries as the ideal target group, and NGOs operated by local businesspeople as the ideal organisational form for a sponsor organisation, might be the perfect match on the development policy scene. Since the NGOs were at once business-oriented, socially committed, and had as little to do with the state as did their customers, this constellation fit almost perfectly into the political landscape of the time.

Several development aid institutions were quick to jump on the new bandwagon. The Inter-American Development Bank (IDB) set up a large-scale and generous programme for the promotion of credit-granting NGOs. In 1992, a team composed of consultants and researchers was commissioned to carry out an evaluation of this programme. Its task was to analyse the efficiency of those credit-granting NGOs in Latin America which the IDB considered to be the best ones of their kind. IDB provided a list of some 30 NGOs at which the team was supposed to look and which the IDB had supported in the past years. The NGOs analysed could be divided into three groups: The largest group either did not have any micro lending operations or were not willing to be analysed. The second group engaged in micro lending, but placed little priority on efficiency and cost coverage, and instead focused a great deal of attention on providing all forms of support to their customers which they deemed necessary; they were "all-round promoters". The NGOs in the third group, in contrast, saw themselves as cost- and efficiency-oriented and confined themselves to issuing very small loans.

The average size of the loan portfolios of the NGOs that made up the second group was well under USD 1 million. For the average of all NGOs in the second group, the sum of their annual (!) administrative costs and loan losses exceeded the total size of outstanding loans. In other words, the loan portfolios of these NGOS were tiny and their lending-related costs were huge. In spite of their different – declared – business model, the situation at the NGOs of the third group, which claimed that they were committed to running their operations efficiently, was not fundamentally different.[12] With such a high level of costs, these MFIs would also have been unable to survive on their own; they were permanently dependent on subsidies, and any attempt to pass on their costs to their customers in full would have been both economically unfeasible and socially irresponsible and inacceptable.

If microfinance had to be as expensive as it seemed to be at the time, it would not be a suitable instrument either for alleviating poverty or for creating jobs and stimulating growth. Over the long term, the organisations in question could not have created even an illusion of greater social equality. In the form in which it was carried out at the time, microfinance could only be window-dressing. Trying to sell it as ethically responsible – and spending a great deal of money on it which could have been allocated to other, more effective development aid measures – appeared ethically questionable.

These findings inspired the IDB, which had commissioned the survey, and some of the NGOs analysed to begin ensuring that they were really operating on an efficient basis and that they drastically reduced their costs. When he learned about the results of this study, J.D. Von Pischke, one of the leading experts on development finance, suggested a goal which at the time seemed utopian: The sum of administrative and risk costs of good MFIs should not amount to more than 20% of its loan portfolio. At this level, costs would be low enough to be passed on to the customers, thus allowing the MFIs to cover their costs and enabling them to expand the scope of their activities in accordance with their dual goals of sustainability and increasing outreach. Not very long thereafter, a few leading MFIs had made significant progress towards achieving the 20% goal. This was the beginning of modern microfinance.

[12] A summary of the results of this study were published in Schmidt/Zeitinger (1996).

III. "New Development Finance" and Commercialisation

1. The classic approaches, their shared features and their critics

The 1990s saw dramatic developments in the field of microfinance, in terms of both concepts and their practical implementation. Thanks to a series of innovations in the credit technology and organisational structure of MFIs, and a greater commitment on the part of various national and international donor organisations, it was possible to reduce the average costs of the best institutions to a level of about 20%. A few MFIs even managed for the first time to cover their costs entirely through current revenues, and thus to become largely independent of the need for subsidies. The first formal bank catering to small and very small enterprises, BancoSol, was created in Bolivia in 1993 by converting a very successful credit-granting NGO into a bank. The NGO had been founded and developed with massive support from the American sponsor ACCION, which was also responsible for its conversion into a bank.[13]

Naturally, there were serious debates regarding the best operational design. Two main "approaches", as they were referred to in the technical jargon, crystallised out of these debates. One is called the *institution-building approach*. As the name makes clear, in this approach, building up viable institutions which can achieve sound performance is seen as very important and is considered to be the key issue. Such MFIs have to have strong incentives to become and remain financially successful and to dedicate themselves over the long term to continuing to serve the target group of "ordinary people".[14]

The main protagonist of the institution-building approach was the Frankfurt-based consulting firm Internationale Projekt Consult (IPC). The other – supposedly different – approach was the *commercial approach,* which has already been mentioned repeatedly. Among experts, it tends to be associated with ACCION. IPC and ACCION are the two organisations which, starting in the early 1980s, have achieved the most in terms of the modernisation of microfinance concepts and practice. Apart from MFIs in Asia, the MFIs created by ACCION and IPC are the most successful ones both in commercial and in development policy terms.

In actual fact, however, there is hardly any contradiction between the commercial approach and the institution-building approach, because if institutions are to be financially viable, they

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[13] This was the first conversion of this kind. The case is presented in detail in Otero/Rhyne (1994).

[14] The theoretical and academic foundation underpinning this approach was the so-called new institutional economics, a branch of economics which was strongly influenced by the academic work of Joseph Stiglitz, at the time chief economist of the World Bank and a later winner of the Nobel Prize in economics. This school of thought emphasises the imperfection of markets, the role played by information-incentive problems, the function of institutions as a means of alleviating these problems and the request that institutions should be designed in such a way that they can effectively and efficiently fulfil this function.

must be commercially oriented, and if they are to achieve the necessary commercial success to have a lasting impact on development, they must have a suitable institutional structure.

It would be a mistake to assume, however, that the views shared by these and other leading practitioners in the field of microfinance, and the dominant role they played in the debates regarding appropriate concepts and policies, also meant that their views were universally accepted. At least at the end of the last century, the representatives and key figures of many MFIs as well as a considerable number of those working in relevant development aid institutions had strong reservations vis-à-vis the commercial approach and the institution-building approach. Some were even openly hostile to them.[15]

It is only possible to make suppositions as to what lay behind these concerns, which could often be felt but were seldom explicitly expressed, and even today have not entirely disappeared. Some of the critics doubtless genuinely rejected the fundamental motivations and ideas involved: In their view, the aim of achieving profits through development aid was morally reprehensible *a priori*; and even covering costs was not considered as an appropriate goal, because the work of the MFIs was so important in social and political terms that the industrialised Western countries were morally obliged to finance their activities and to cover their inevitable deficits and shortfalls. And deficits are indeed inevitable simply because it was and still is expensive to issue very small loans, and it is not deemed compatible with the objective of alleviating poverty to burden poor people with the full cost of the loans.

Other, less radical critics do accept the idea in principle, but consider it unacceptable, for moral and political reasons, to take all the steps which are necessary – or at least, which appeared to be necessary in the 1990s – in order to really achieve full coverage of an MFI's costs. A further argument, for some of the critics, was probably the fear that consistent adherence to the commercial approach could lead to conflicts between the foreign consultants and foreign donor institutions on the one hand, and the individuals in the developing countries who had built up local MFIs on the other. They expected a politically unacceptable paternalistic approach or "excessive intervention" on the part of the foreigners. This criticism of the new approaches to microfinance also appears to be ethically motivated, but as I will

[15] The critical positions of Hulme/Mosley (1996) and Woller et al. (1999) have already been mentioned above. Both teams of authors were the editors of two well-respected journals in this field, the Journal of International Development and Journal of Microfinance, respectively, in the 1990s. Woller and his co-authors explicitly acknowledge their opposition to the commercial approach, which they correctly associate with ACCION. They declare that they "have concerns about the direction in which [the proponents of the commercial approach, and "the institutionalists"] are attempting to push the industry", and they name the Grameen Bank the "most prominent example" of the only type of MFI which they consider appropriate. The authors named here are among the few who have expressed their reservation openly and in such strong terms. Most of the many others who held, and possibly still hold similar views would most probably hesitate to say this openly.

show below, this criticism is not justified on the basis of the presumed facts on which it seems to rest. Thus, its elevation to the status of a moral imperative is not justified either.

2. A simple numerical example

The conflict in the 1990s regarding the ethical value of the commercial approach can be illustrated with an example in figures, comparing two hypothetical, but realistically portrayed MFIs, each of which can be considered a fairly good institution of its kind for that era.

I assume that each of the institutions issues loans with an average amount of USD 1,000 and that both were founded four years earlier, using the same amount of development aid funds. In its fourth year of operations, the commercially oriented MFI-1 has administrative and risk costs which together amount to 15% of its average loan portfolio per year, and thus, including funding costs of about 10%, it has total costs amounting to about 25%. Operators of small and very small businesses are offered loans at terms and conditions which, including the transaction costs for the customers, correspond to an effective interest rate of 30%. MFI-1 is thus covering its costs (it is assumed that it has already been doing so since its third year of operations) and therefore also has the equity that is required for an expansion of its operations. Because it is operating on a cost-covering basis, it also receives the loans it needs for the expansion from development aid organisations which in the meantime have learned to place a priority on cost coverage. Thanks to its better access to funding, MFI-1 has 30,000 borrowers. However, the institution's strict orientation to covering its costs means, among other things, that the management of MFI-1 cannot always afford to be "nice" to borrowers who are in arrears and employees who do not co-operate. It is a commercial enterprise, and considers it important to be seen as such.

MFI-2 rejects the commercial approach on ethical and development-related grounds. Not least for this reason, it also has higher total costs of about 40%, but does not find it acceptable to pass on these costs to its customers. The effective costs of the institution's small and very small loans for the customers are therefore only 20%, which is not sufficient to cover MFI-2's operating costs. Therefore, it is always necessary to find some development aid organisation willing to offset the deficit. This can be managed with a certain amount of effort and skill, but since the organisations which come into question do not approve of the fact that MFI-2 is still failing to cover its full costs even after four years of operations, they cannot be persuaded to provide the additional equity and loan funds that would make it possible not only to maintain, but to expand the institution's activities. This is why MFI-2 has only 10,000 customers.

There are three reasons for MFI-2's higher costs: firstly, the institution's smaller size; secondly, a certain laxity in regard to credit policy and personnel management, which superficially gives the appearance of being a "friendly" approach on the institution's part to its customers and employees; and thirdly, repayment problems and thus higher risk costs. The latter result from the fact that the institution is not covering its costs, that it is known not to be covering its costs, and that some of the borrowers are speculating on the possibility that the MFI may collapse and that they then will get away without paying back their loans at all.

Anyone who is familiar with the typical situation in a developing country will also accept the following assumptions, which make it easy to carry out an first simple comparison of the impact of the two business models: The customers of both of these institutions are taking out loans not out of high spirits or frivolity, but because they really need them for their businesses. Their only alternative is to take out a loan on the informal credit market, where the effective interest rate on small loans is 100% per year.[16]

The ethical problem is now easily demonstrated: MFI-1 can at times be harsh, and it demands higher interest rates from its clients; but at the same time, it provides three times as many customers as MFI-2 with loans which are really attractive for them at interest rates of 30%, or in other words enables 20,000 more individuals to avoid taking out expensive informal loans. MFI-2 is not as rigorous in dealing with its customers (and possibly its employees), and is thus perhaps a friendlier institution, but ultimately it serves far fewer customers.

The monetary value of the costs which the customers of an MFI save by *not* taking out a loan on the informal market can be used as a very simple and rough, but workable, quantitative measure of the impact of its operations. I call this measurement the "benefit balance". In my example, the benefit balances of the two MFIs, and the difference between them, for the fourth year of operations are easy to calculate: This difference (in U.S. dollars) amounts to

$$1{,}000 \times [30{,}000 \times (100\%-30\%)] - 10{,}000 \times (100\%-20\%)] = 21{,}000{,}000 - 8{,}000{,}000 =$$

$$\text{(benefit balance of MFI-1) minus (benefit balance of MFI-2)} = 13 \text{ million } \$.$$

Other benefits offered by the two MFIs can naturally be calculated as well, and it would also make sense to calculate and sum up the net benefits over the course of several years. But for what I am attempting to show, these refined calculations are not necessary. A decision maker who wanted to act strictly in the interest of the officially declared target group, that is, the actual and the potential clients of an MFI, would hardly find it difficult to decide which type

[16] The effective interest rates for very small loans on the informal market are often even much higher than 100%.

of MFI should be supported or created or in some other sense be favoured: MFI-1 creates more benefit than MFI-2 and is therefore preferable both on economic and ethical grounds.

Despite this unambiguous result, that the figures in my numerical example illustrate in a realistic way, managers or founders of the second type of MFI and donors who supported such institutions had a better image in the political sphere, because MFI-2 was friendlier to its existing customers and employees. If only an MFI of the second type existed, those people who could not obtain a loan from it because it was unable to grow will never have the opportunity, in such situations, to express their disappointment, because they are not organised in a group and are not even in a position to understand that they are being deprived of important economic opportunities by the political choice of MFI-2 over MFI-1.

The trade-off between somewhat greater advantages for a small number of existing customers on the one hand, and major potential advantages for many more customers on the other, was at the core of the debate about the commercial approach which took place in the 1990s.

3. Upgrading as a form of financial institution building

A related ethical and political dilemma is also encountered in the case of a form of financial institution building that was developed in the 1990s and is referred to as "upgrading".[17] In the first half of the 1990s, some experts came to believe that, at least in the long term, it would make sense to take advantage of the technical and operational benefits offered by the institutional form of a bank.[18] Therefore – according to this view, which was new at the time – as a long-term goal, at least, the really good MFIs should become banks. They would need to have banking licences, which would allow them to offer a wider range of services and to take deposits; they should be supervised by the appropriate national authorities; they should operate on a commercial basis and at the same time be target group-oriented. Deposits are necessary in order to enable a rapid expansion of the credit business, and in most countries only institutions which have an appropriate licence and are subject to supervision by the local supervisory authorities are permitted to engage in deposit-taking. At the same time, most of the representatives of the development aid organisations were still largely convinced of the advantages of working together with local NGOs and their founders and current managers.

The upgrading concept seemed to combine all of these requirements and expectations in an ideal manner. An upgrading project encompasses two phases. However, such a project can

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[17] Authors at ACCION who have written a great deal about this approach use the term "upscaling", but the difference is merely terminological; there is no difference in terms of meaning.

[18] By this time, the state-mandated interest ceilings, which previously would have made the issuance of small and very small loans by a bank impossible *de facto*, had been eliminated almost everywhere.

only begin after a suitable NGO has been found, whose representative(s) and spokesperson(s) are target group-oriented and sufficiently open to the idea of taking on a commercial orientation, and are – or at least appear to be - prepared to carry out far-reaching institutional change. Typically, such an NGO is small at the outset and not very successful in commercial terms and in terms of development impact. Thus, the first phase of development consists of making the existing organisation larger and more efficient through the provision of consultancy, support in acquiring the necessary equipment, and last but not least a substantial volume of loan funds. Once this has been achieved, the second phase of development can begin, in which the now solidly performing NGO is converted into a formal bank.

Both the strengthening of the institution in the first phase and its formalisation in the second phase require a large-scale deployment of competent advisers experienced in institution building, which, as a rule, must be financed by one or more development aid organisations, which also provide the necessary loan funds. There are thus three actors involved in the process of institutional reorganisation: The leaders/founders/managers of the local NGO, the development aid organisations which initiate and finance the process, and the consultants or the consulting firm.

In recent years, there were some cases of successful upgrading. However, there were far fewer success stories than one might imagine, given the high expectations which people had for this new type of project.[19] One reason for this is that there are only relatively few NGOs that would be suitable for a transformation and whose founders/managers/leaders would opt for a transformation. Moreover, the two-phase project design has a fundamental weakness: It fails to create appropriate incentives, and may even give rise to perverse ones. To illustrate this, imagine the hypothetical case of the NGO N, which is relatively small and unsuccessful, but has high ambitions in ethical and development policy terms, and is managed and represented by the person P. P is committed to making a contribution to society or views the management of an NGO as a worthwhile activity and/or as a source of prestige and income. The development aid organisation D would like to carry out an upgrading project with N, and to this end the employee E of organisation D plans to engage the consulting firm C, which has the motivation and the necessary skills and experience to carry out such a project.

Naturally, it is attractive to P that his NGO N, up to now a fairly modest organisation, will be significantly strengthened in the first phase and that others will pay for it. P also sees the formalisation of his organisation as a development which will benefit the many additional

[19] Nair/Von Pischke (2007) give a current overview of the number of successful upgrading projects and also emphasise that this number is lower than had once been anticipated.

customers which the institution will then be able to reach. Therefore, N (represented by P) and D (represented by E) conclude a project agreement, and at the same time a consultancy contract is concluded between D and C. Both agreements describe the two phases of the project and the project goals, and stipulate who is to contribute what to the achievement of these goals at what times.

Let us assume, realistically, that the first phase is so successful that P has unexpectedly become the head of an MFI that attracted attention through its success and soon gains considerably in prestige. Now the second phase is to begin. In the discussions with the banking supervisory authorities that are necessary as a preparation of the transformation of the NGO into a licensed bank, P learns that the supervisory authorities demand a much higher level of qualifications of a bank manager than of the manager of a credit-granting NGO.

P is committed and motivated. However, he does not meet the more stringent requirements for a bank manager and realises that the formalisation and conversion of "his" NGO into a bank would endanger his own position. It would come at a high personal cost for him, all the more so given the success of the first phase of the project, because now he stands to lose not just the power and the influence and the prestige which he had as the manager of the original small, moderately successful NGO, but the much greater power and the much greater prestige which he has in the meantime as the manager of the now stronger, larger and more successful NGO. This being the case, it is understandable that P begins to have second thoughts about the advantages of formalisation and to resist the continuation of the process with the second project phase. Tensions arise with the consultant C, which has a contractual obligation vis-à-vis D to carry out the conversion.

Thanks to the success of the first project phase, N is in the meantime so well regarded, and P thus has such good contacts to politicians in his own country that he finds ways to intervene at the foreign development aid organisation D and to complain that C is not respecting the interests of the local "partner", as represented by P. Complaints of this kind can be expected to have political repercussions and thus have good chances of succeeding. In this situation, employee E rightly expects political and bureaucratic headaches should the upgrading project be continued and the worthy P sidelined in the process. The result is simple: C is let go, and Phase 2 is never carried out. A project agreement was concluded, but the obligations it sets forth are not enforceable in a court of law. Such an agreement is a declaration of intent which becomes meaningless if not both parties wanted to adhere to it. Under the pressure brought to bear by P, D and the employee E have changed their position.

Who benefits from, and who is harmed by, the breaking off of an upgrading project in the manner described above? The beneficiaries of the first phase are the existing customers of the now stronger NGO and the new customers whom it has attracted during this project phase,[20] and, without question, the person P and other local managers. Those who are harmed by the failure to carry out the second phase are the large group of individuals who would only have become customers of the MFI in the course of the further expansion enabled by its conversion into a bank.[21] It is not very surprising that their interests were not protected, given that, here again, they cannot be brought together in an organised form and do not have a spokesperson, and therefore also cannot complain that their situation is not being improved due to P's interest in maintaining his position and E's and D's interest in avoiding political hassles.[22]

In this fictitious case - and in a series of comparable real-life cases - those in power on both sides of the development partnership acted in their own interests and against those of the potential additional customers. The donor institutions' alleged respect for the local partners is in reality a desire to avoid confrontation, or even cronyism between the establishment in the donor country and in the recipient country at the cost of the mass of poor people. Herein clearly lies a serious development policy problem, which is possibly also an ethical problem.

Upgrading projects have a further structural problem: The transformation and formalisation as a licensed bank, requires that the NGO first be converted into a corporation, or that a new corporation be founded. In all cases with which I am acquainted, further shareholders have been required for this in addition to the original NGO, which in many cases becomes an important shareholder. Together, the shareholders are then the owners of an institution which was created primarily with development aid funds and which will also remain strongly dependent on its donors for a fairly long period of time. In light of its purpose, the new MFI should of course succeed in operating with commercial success because otherwise it cannot become a stable institution and achieve growth; however, its task is ultimately to contribute to the country's economic development and to serve the less prosperous members of its society. That gives rise to the question of who has control over the MFI which has been created in this manner, and how – and by whom – the ownership rights should best be distributed. The question can also be formulated as follows: Who is best suited to exercise ownership and

[20] To continue with the figures given in the example presented above: It is the additional 20,000 customers of the NGO once it has adopted a commercial orientation and moved from being MFI-2 to being MFI-1.

[21] To further continue with this example: It would be realistic to think of 200,000 additional customers that an NGO turned into a microfinance bank operating on a national scale can serve, rather than merely the additional 20,000 of a more efficient NGO of type 1 with a local focus.

[22] Similar considerations apply to the group of potential employees who will never receive jobs if the transformation does not materialise.

control? Who would use his rights as an owner to take decisions that fairly balance short- and medium-term financial goals and long-term development aims?

Years ago, a co-author and I put forth the proposition that in upgrading projects the development aid organisations acting as donors should see themselves as owners of the new bank created through the formalisation of the NGO, and that they should act accordingly.[23] They should become "owners" in a legal and economic sense, that is, assume responsibility for the stable continuation of the MFI's operations and its lasting target group orientation. However, this was probably not a good idea. Some development aid organisations did indeed participate in the share capital of the new banks founded with their financial support, but they did not want to, and could not, play the role of active owners. The question thus remained open as to who should be the responsible owners of an MFI. It should not be the original initiators of the local NGO, as the experiences with these individuals had quickly made clear.

4. Greenfield investment as a form of financial institution building

In retrospect it seems that development aid efforts aiming at improving the access of "ordinary people" to financial services could have been carried out more simply, and would have achieved greater success, if it had been recognised early on that there are also direct ways of creating formal microfinance banks, and that the advantages of transforming an existing NGO into a bank and of doing this in co-operation with its local initiators and managers had been overestimated. The direct method consists in simply establishing a new formal bank which is oriented from the start towards offering reasonably priced loans and other financial services for small and very small businesses and other "ordinary people" on a cost-covering basis. This is called "starting from scratch", or "greenfield investments".

This form of financial institution building is feasible, as experience in recent years has shown. It has the potential to create access to the formal financial system for many people who previously did not have such access, and it is a cost-effective and fast way. But naturally, questions arise in connection with this approach as well: Who pays for the creation of these new banks? Who manages and controls them? To whom do they belong? How can it be ensured that they maintain their target group orientation over the long term, and what prevents them from charging their borrowers excessively high interest rates in order to boost profits?

A strategy of creating MFIs through greenfield investments raises many problems. The most difficult and also the most important one is that of finding "strategic owners", because they

[23] See Schmidt/Zeitinger (1998). This proposal was first presented at two major conferences in 1994.

must meet many requirements: They must be investors, and thus need to be reasonably well-funded; they must be prepared to refrain from profit maximisation; they must have a long-term obligation to create a supply of credit for "ordinary people" which will have an impact socially and in terms of economic development; they must have insight into the business policy and financial needs of an MFI; and they must understand that it may well take a considerable amount of time before they can enjoy the financial fruits of their investment. Do patient and socially committed investors of this kind even exist? The immediate answer to this question seems to be No, but as the next section shows, it is possible to create such investors.

IV. Financial Institution Building on the Other Side of the Market: Microfinance Support Organisations and Microfinance Investment Vehicles

1) The starting point: public-private partnerships

The starting point for the following considerations were the insights, which became broadly accepted around the turn of the century, that good MFIs must be banks; that upgrading is rarely the best way to create solidly performing MFIs; that MFIs must have the legal form of corporations and that therefore suitable shareholders must be found; that rapidly growing MFIs need a great deal of equity capital just to meet the applicable capital requirements; and that above all, they need "patient capital" and responsible, socially committed owners. Not all of the investors who meet some of these requirements can be expected to meet the others too. One solution to this problem is the creation of a public-private partnership (PPP).[24]

One group of public organisations that can participate in a PPP are development aid organisations such as those mentioned several times already. They can be expected to have the necessary capital and the commitment and the technical expertise which are necessary for keeping the PPP on track with respect to its financial and social objectives. On the private side, it should be asked which private organisations have proven especially competent as specialists in financial institution building in recent years. The two most important ones have also already been mentioned above, and the will be examined in more detail in this section.

2) ACCION and the ACCION network[25]

Since the earliest days of microfinance, ACCION has been an important, innovative and successful player. ACCION itself is a non-profit organisation based in the USA and with the focus of its activities on Latin America. Over the course of more than 25 years, ACCION has

[24] PPPs in the field of development finance are discussed in part V of Matthäus-Maier/Von Pischke (2005).

[25] Comprehensive information regarding the history and current structure of ACCION and its network can be found on the homepage of ACCION International (http://www.ACCION.org) and in the sources listed there.

built up a large network of "affiliates", i.e. a network of MFIs which were founded, in many cases, at ACCION's initiative and which since then have worked together to a greater or lesser extent with ACCION. In addition, ACCION has participated in setting up other network-like organisations. Among them are several microfinance investment funds, which are more or less closely controlled by ACCION and which acquire stakes in the equity of successful MFIs, many of which are also ACCION affiliates. In addition, ACCION holds stakes directly in some large MFIs within its network.

The Internet presence of ACCION, the investment companies and the MFIs in the ACCION network conveys the impression of a loose co-ordination, i.e. a network. However, in certain key cases, ACCION has also implemented strong and streamlined centralised management. At any rate, the ACCION network is successful as an institution and, in the meantime, in financial terms as well, and is also very successful in development policy terms.

3) IPC and ProCredit – a group of affiliated microfinance institutions[26]

Internationale Projekt Consult GmbH (IPC) is a private consulting firm based in Frankfurt, Germany. It was founded 30 years ago. Its owners and employees have always been primarily committed to pursuing development aims, and they still understand themselves as having such a commitment. IPC engages exclusively in the provision of consultancy services to donor institutions on the establishment and management of MFIs and directly to MFIs. In its early years, IPC had earned a reputation as an expert institution builder – but also as a consulting firm which tried to ensure that only those concepts were implemented that it felt made sense. At times, this business philosophy triggered conflicts which IPC managed to survive.[27] Like ACCION, IPC is a representative of a modern commercial approach to development finance.

In the mid-1990s, IPC was given the opportunity to participate in the equity capital of a new MFI which was to be set up in Bosnia after the fighting in this part of former Yugoslavia had ceased. The firm was glad to accept this offer and later, when this organisational model had proved successful and was to be transferred to other microfinance projects as well, the management of IPC founded an investment company known today as ProCredit Holding AG.[28] ProCredit Holding is now by far the largest equity investment company worldwide holding equity participations in banks that specialise in lending to small and very small

[26] In regard to the following, see also the homepages of IPC (http://www.ipcgmbh.com) and ProCredit Holding (http://procredit-holding.com).

[27] See Schmidt (2005).

[28] The earlier name of the holding company was Internationale Micro Investitionen AG (IMI).

businesses. At the time of writing, it holds majority stakes in 23 micro and small enterprise banks in as many countries in Latin America, South-Eastern Europe and Africa, and thus, taken as a whole, the ProCredit group is itself the largest MFI worldwide. Most of the banks belonging to the ProCredit group were started as greenfield investments.

ProCredit Holding can be considered a PPP in that just over half of the voting equity capital, which currently amounts to about €200 million, is held by IPC and other private organisations, while the remaining voting shares are held by public and/or state-owned development aid organisations, in particular KfW. In addition to the voting capital, there is also a considerable non-voting capital, held mainly by American institutional investors.

IPC and ProCredit Holding together have a total of about 200 permanent staff members[29]; while the 23 ProCredit banks currently employ more than 17,000 men and women. Locally recruited staff members are increasingly taking over senior management positions. The aggregate credit portfolio of all ProCredit banks is currently about EUR 3 billion, and it is growing by about one third every year.[30] The average loan amount in Latin America and Africa has remained around EUR 1,000 for years; in Eastern Europe the figure is EUR 5,000. The average default rate per year, calculated by very rigorous and conservative methods, is less than half of one percent of the total outstanding loan volume. About 80 percent of the loans are financed using local deposits.

In terms of its organisational structure and its business policies, the ProCredit group is not a network, but rather a corporate group. Naturally, the challenges entailed in the difficult business of providing small and very small loans means that the managers of the individual banks must be given considerable autonomy to run their institutions' day-to-day operations; however, the overall strategy is developed in co-operation with, and approved by, the group management in Frankfurt, and compliance with the strategy is strictly monitored. As a result, the image which is presented to customers, the range of clients and services, and the approach of the individual banks are largely uniform.

All of the banks of the ProCredit group, apart from the newest institutions founded within the last two years, are operating at a profit. Calculated on the basis of book value, both ProCredit Holding itself and the group as a whole have been earning a return on equity of around 12%

[29] This does not include some 150 employees of the IT subsidiary Quipu GmbH, which was spun off as a separate entity some years ago.

[30] At the end of 2006, the total loan portfolio of the group was thus about six times as large as that of Grameen Bank and about ten times as large as that of the Mexican MFI Compartamos, which will be discussed below.

for several years now. A higher rate of return would probably be possible; however, there has at least in the past been an implicit understanding among the shareholders that a ceiling of 15% for the group's return on equity should apply.[31] If this maximum limit were to be exceeded by a substantial margin and for a longer time span, then the surplus funds would be used instead to expand the branch network – consisting at present of about 500 outlets – in order to create access to loans and other financial services for a greater number of customers, or to lower the prices for banking services or to adopt other measures that would benefit clients and at the same time strengthen the market position of the local ProCredit banks.

The senior management of the group ensures that the individual ProCredit banks, despite their successful performance and their almost rigid orientation towards achieving predefined revenue goals, consistently focus on small and very small enterprises as the most important target group they serve. Although ProCredit is in essence a private-sector corporate group, the purpose of the company has been defined in terms of development aims from the start.

4) Conclusion and assessment: The commercial approach as a sustainable basis?

Networks like ACCION and microfinance groups like ProCredit implement the ideas behind the commercial and the institution-building approaches in a way that I find positive and impressive. At both organisations, the aim of achieving a genuine impact in social and development terms, set some 30 years ago, is still operative today. With just one reservation, which will be discussed below, both organisations appear to have developed, tested and expanded models for institution building which can be copied and are thus, in a very literal sense of the word, exemplary. Both models have indeed already inspired a series of imitators.

Both organisations see themselves as responsible for the commercial and developmental success of the local MFIs which were created with their support and with which they affiliated. They thus represent the desired type of responsible owner of MFIs.

Interested members of the general public have recognised in the meantime that commercial microfinance is an attractive approach, both in development and in financial terms. This is partly why the Nobel Prize to Mohammad Yunus and the Grameen Bank – who, as noted above, explicitly distance themselves from the commercial approach – was "the right prize at

[31] At least this was the situation during the first five years of the existence of ProCredit Holding, the time for which I have reliable relevant information due to my role in the supervisory board. However, the 15% limit seemed so hard to achieve in the first place that there was, at that time, little interest in defining precisely what return and capital figures this understanding really meant. I am not aware of this informal agreement having been abolished ever since, nor does it seem to have been made more precise.

the wrong time".[32] It has long since ceased to be a matter of demonstrating that lending to poor people is possible and has a positive impact; rather, today it is necessary to demonstrate how it can be organised in an effective manner, and this is not possible without recognising the significance of the commercial approach.

At this point, it is once more appropriate to take a look at the ethical aspects of microfinance. In my assessment, the commercial approach to microfinance as it was originally presented 10 or 15 years ago can be seen as a straight-forward application of an ethical concept developed by Max Weber called the ethics of responsibility (*Verantwortungsethik*). In a simplified form, it can essentially be put as follows: Only those actions can be deemed ethically good which can be expected, on the basis of careful analysis and planning, to have positive effects. The opposite position, according to Max Weber - and a position that goes back at least as far as to Immanuel Kant - is that of the ethics of conviction (*Gesinnungsethik*). Briefly put, it states that an action can only be assessed on the basis of the ethical principles which it is intended to implement. While the background of microfinance in the spirit of the commercial approach is Weber's ethics of responsibility, Yunus's views and the approach he takes, and presumably the views held and the actions taken by many other critics of the commercial approach, are closer to an ethics of conviction – closer to it, at any rate, than to an ethics of responsibility. For an economist, Max Weber's own position, that of the ethics of responsibility, seems clearly more appealing.

However, the ethical positions ascribed to the two competing camps in the world of microfinance and the assessment of their respective ethical backgrounds may not be as straight-forward and simple as the last paragraph suggests. Some of the more recent developments in commercial microfinance, which I will discuss in the next section, lead me to wonder whether the effects-oriented ethics of responsibility might not be somewhat too naïve, given that it is not possible to predict the effects of one's own actions as well as some people seem to believe and as would be necessary; and whether ethical principles and even rules and "right-minded thinking" might not be more important in the realm of microfinance than I, and possibly also man others, previously believed was the case. In order to go into this question, in the section below I will focus in particular – and thus in a somewhat one-sided manner – on the negative effects which the success of commercial microfinance has triggered in recent years.

[32] This was the title of a critical assessment of the awarding of the Noble Peace Price to Yunus and the Grameen Bank in the influential German weekly DIE ZEIT on Oct., 26, 2006.

V. Current Developments

1. Microfinance as an attractive assets class

Until a short time ago, the implementation of microfinance remained, with good reason, the exclusive domain of experts, optimists and do-gooders. This applied in particular to financial investments in microfinance equity, whether directly in individual MFIs or in funds which in turn invest in MFIs. All of this seems to have changed just a few weeks ago. Two important institutions have recently published analyses which appear to demonstrate, with no room for doubt, that microfinance is a very attractive investment category for all investors, thus including those oriented solely towards high returns and increasing share prices.

One of these analyses is from DB-Research, the economic research division of Deutsche Bank. Its author states that in the meantime, there is a considerable number of MFIs which are operating on a profitable basis that these MFIs already lack equity capital, that they are growing strongly, and that for that reason alone, they will soon need much more equity capital than they currently have. He concludes, accordingly, that investors should acquire equity stakes in MFIs or microfinance investment vehicles of all kinds now, while it is still possible to do so at very favourable terms and conditions, and that soon, when “the market” has learned that this is really an attractive “asset class”, they will be able to rake in solid profits.[33]

Only a few days after DB-Research, CGAP issued a report on the same topic.[34] Since Reille and Foster, the authors of the CGAP study, are acknowledged experts in the field, I would have expected less over-optimism from them, but there is little difference between the tenor of their article and that of the report published by Deutsche Bank.

In my opinion, this publically expressed anticipation of a triumphant breakthrough of commercialised microfinance is noticeably overconfident. Those making such statements are ignoring how difficult it is to create solid and efficient MFIs and to ensure that they are profitable. Moreover, I fear that the high expectations regarding the return on an investment in MFIs, which I consider to be exaggerated, will have a negative impact on activities in the microfinance sector: Expectations cannot easily be scaled back once they have been raised.

2. The Compartamos IPO and the “ugly side of microlending”

Despite the above-mentioned reservation, it is impossible to overlook the fact that the commercialisation of microfinance is advancing with rapid strides. A distinction must be

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[33] See Deutsche Bank-Research (2007).

[34] See Reille/Forster (2008). CGAP is an organisation affiliated with the World Bank and tasked with promoting microfinance in general and putting it on a more professional footing.

made here between two meanings of the term "commercialisation". One is the previously exclusive use of the term, in which it referred to the commercial organisation and management of MFIs. The second meaning refers to the fact that purely commercial agents such as private commercial banks might increasingly be engaging in business operations with poor people and small and very small enterprises, i.e. that commercial players are penetrating the microfinance market. At present, commercialisation in both senses of the term is taking place. The indisputable success of microfinance in its commercially oriented form laid the foundation for this.

One sign of the increasing degree of commercialisation is that MFIs are issuing shares to the general public and at the same time introducing their shares on a stock exchange for trading. In this way, they attempt to attract private, wholly or primarily profit-oriented investors. Successfully launching shares on the stock exchange – "going public" or making an "initial public offering" (IPO), in financial terminology – can be seen as proof that microfinance has reached a high degree of maturity, since an IPO can only succeed if the institution is able to convince new and anonymous investors that their investment will pay off. Connected with the IPO is thus an obligation which the MFI in question and its management undertake to ensure that the shareholders receive the returns which they expect, give or take the odd fluctuation.

In recent months, four MFIs have gone public, two located in Asia, one in Africa and one in Mexico.[35] In the following, I will discuss only the IPO of the Mexican MFI Compartamos, since it serves to highlight the relevance of the ethical questions brought up in the last section.

In early 2007, 30 per cent of the then existing shares in Compartamos, a former NGO which had been converted into a joint stock corporation in 2000, were sold to American and Mexican private and institutional investors, and the Compartamos shares were listed for trading on the Mexico City stock exchange. Since no new shares were created in the course of Compartamos', the MFI did not receive new funds.

In financial terms, the IPO was highly successful. The issue price was 13 times higher the book value of a Compartmos share, [36] which corresponds to an extremely high price-earnings

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[35] These four cases are compared and analysed in Lieberman et al. (2007). The first case, in Asia, was the IPO of BRAC, a large "pure" MFI in Bangladesh. The second case in Asia is BRI and, as a part of it, UNIT-DESA. BRI is a long-established and very large state-owned bank in Indonesia, which had been partially privatised a few years ago. UNIT-DESA is the microfinance arm of BRI; it is separate in organisational terms, though not in terms of legal status. UNIT-DESA is roughly as old as the Grameen Bank and, measured by almost all conceivable criteria, more successful, see Robinson (2001) and Yaron (1992). This may be the reason why this MFI is much less well known, even among specialists, than the Grameen Bank: For years, DESA has not had any reason to seek to become well-known, because, unlike the Grameen Bank, it is not dependent on being able to attract subsidies. The case from Africa concerns a much smaller, specialised MFI from Kenya.

ratio.[37] Assessed at the offering price, Compartamos was thus worth about USD 1.5 billion, and this although Compartamos is not a very large MFI.[38] Despite the high share issue price, the share issue was oversubscribed by a factor of 13; and after the issue, the price rose once again, by about 50%.

Among those who sold shares in the course of the IPO were the non-profit organisation ACCION and the development finance institution IFC, as well as several private shareholders drawn from among the founders and managers of Compartamos. They had bought their shares at the then nominal value when Compartamos was converted from an NGO into a joint stock corporation in 2000.

The investment in Compartamos shares was very lucrative for the first subscribers in 2000, because Compartamos was unusually profitable. From 2000 up to and including 2006, i.e. over a period of seven years, this MFI earned, year for year, a return of more than 50% on the book value of the equity capital. The annual return on the investment for the investors who had acquired shares in 2000 and sold them in the framework of the IPO was about 100%, or twice as high again. As unbelievable as it might sound, the value of their investment had doubled in each of the seven years.

The financial aspects of this IPO give rise to questions and concerns. The concerns do not have to do with the fact that shares in an MFI became publically available and were sold to a broad range of investors, however, nor with the fact that the IPO was extremely profitable for the investors. Both occurrences should in fact be seen as welcome, as they had the effect of serving as advertising for microfinance as an “asset class” and thus making it easier for others to access the capital market as a source of equity capital.

There is cause for concern, however, in what made the shares so valuable, namely the high profits earned by Compartamos almost exactly as from the point at which this organisation was converted from an NGO into a joint stock corporation. Once it became a corporation, it could be expected to have the goal of earning a profit, and presumably as high a profit as possible, connected with the highest possible increase in value for its shareholders in the run-

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[36] All of the figures given here are taken from the carefully conducted assessment of the Compartamos IPO by Richard Rosenberg, a CGAP staff member; see Rosenberg (2007). The equally extensive documentation of the IPO provided by ACCION (see ACCION (2007)) arrives at very different conclusions than does Rosenberg, but provides no reason to doubt his figures.

[37] The price-earnings ratio of the Compartamos shares at the time of the IPO was close to 25. Generally, price to book ratios of listed banks are in the range of 1 to 4, and their price-earnings ratios lie between 10 and 20, depending on the type of bank and its outlook. For IPOs, the figures are typically even lower.

[38] The credit portfolio of Compartamos at the end of 2006, i.e. the end of the year that preceded the IPO, was only slightly more than half as large as that of the Grameen Bank and only one-eights the size of that of the ProCredit group. However, Compartamos seems to grow fast than that of the other two organisations.

up to the IPO – which perhaps was already being envisaged at that point. The unusually high offering price can possibly be explained as an expression of the new shareholders' expectation that this stunning profitability would also be maintained over the coming years. Looked at from the other side, namely that of Compartamos' initial owners and its managers, the share issue at such an atypically high offering price could be interpreted as a promise on their part that the institution would strive to maintain the equally unusual level of profits in the future as well, and as an indication that it expected to be able to do so.

This naturally gives rise to the question of how Compartamos was able to earn such extremely high profits over the last seven years. It was not due to low costs, since Compartamos's costs, at around 30% of the portfolio volume, are unusually high for an MFI of this type. It also did not have to do with the type of funding which the institution was obtaining; Compartamos was not financing its operations by means of cheap deposits from customers or large "soft loans" from development aid organisations, but rather largely by means of profit retention and of loans from other banks, and through the issuance of bonds on the capital markets.

The high level of profit was generated by the institution's high level of revenues, which came about in an unusual manner: In the mid-1990s, Mexico experienced a short phase of extremely high inflation. The rate of inflation shot up to about 100%. As every well-managed MFI should, Compartamos promptly adjusted the interest rates on its loans to ensure that the inflation-adjusted or "real" interest rates remained positive. However, the inflation rate fell very quickly to its normal level of less than 10% – but Compartamos retained its high interest rates, rather than reducing them correspondingly as the rate of inflation declined. This is the reason for the extremely high profits which the institution has earned in recent years, and it gives rise to the suspicion that this pricing policy was chosen with an eye to the planned IPO.

Real interest rates of almost 100% would constitute a political and ethical problem at any financial institution. They are all the more problematic at an institution which presents itself as a development-oriented MFI. The high interest rates bring about a massive transfer of wealth from the customers to the owners of the MFI. It is possible to vary the figures in the numerical example presented in section III.2. above and thus arrive at a rough estimate as to the extent of the transfer of wealth which took place at the customers' cost. Now the basis of comparison are, however, not the interest rates prevailing in the informal market, which are very high in Mexico just as elsewhere, but rather the rate of interest which an efficient MFI must charge in order to cover its costs. The rough estimate yields a transfer of wealth of USD

100 million per year for the time between 2000 and 2007.[39] This appears to be a flagrant exploitation of the customers, which in any event seems to constitute an ethical problem!

The exorbitantly high interest rates at Compartamos probably also had an impact in terms of the type of borrower which the organisation attracts. At the interest rates set, it is highly unlikely that small businesspeople are taking out Compartamos loans for business purposes; the loans are simply too expensive. Those who take out loans from Compartamos despite the high interest rates are either so uneducated and poorly informed or in such desperate need of funds that they would be more in need of protection by a responsible MFI, and not exploitation. There may not be any legal obligation compelling Compartamos to protect its clients, but after all, since ACCION and IFC became shareholders in 2000, this organisation has had co-owners who, according to their own understanding of themselves and the way in which they present themselves to others, are committed to a development-oriented and ethical mission. As recently as 2002, the then president and CEO of ACCION, Michael Chu, and his successor Maria Otero, explained in a co-authored article on the governance and ownership of commercially oriented MFIs with the legal form of joint stock corporations, why non-profit microfinance support organisations such as ACCION and development aid organisations like IFC should acquire stakes in the equity capital of such MFIs. According to Otero and Chu, it is because as important shareholders, the organisations would have the opportunity to monitor and influence the MFI's activities from the standpoint of development impact and ethics. They would be able to prevent the "unethical" behaviour in which the commercialised MFIs might be tempted to engage as they sought to earn a profit, and ensure that they did not neglect their development mission.[40] This control function does not seem to have worked in the case of the Compartamos stake, possibly because the expected super profit has simply eliminated the incentive to carry out this honourable control function in the first place.

The development of commercial microfinance in Mexico gives grounds for concern for other reasons as well. As the American business magazine *Business Week* reported several times over the past year, once under the title which I have taken over here, "the ugly side of microlending",[41] several large international banks have recently begun engaging in

[39] To arrive at this figure, I assume that the Compartamos loan portfolio has averaged USD 200 million over the years and that, because of the very small size of the loans granted by Compartamos, the necessary costs of its lending operations may have been 40% of the loan portfolio (that is, two times as high as the 20% that would correspond to "best practice" for MFIs in general), while the effective interest rates charged by Compartamos (according to Rosenberg) were at 90% *per annum*. 200 million times (90% - 40%) yields 100 million.

[40] See Otero/Chu (2002), p. 231. This argument can be found in a book that concerns, and welcomes, commercialisation in both of the above-mentioned senses of the term.

[41] The article, which is available on the internet; first appeared on pp. 38-46 of the Dec. 24, 2007 US edition.

microfinance in Mexico – and unfortunately, it is necessary to add, elsewhere as well. In any event, though "microfinance" is what they call their lending operations, this business has nothing to do with financing small and very small enterprises. Instead, it is plain and simple consumer lending. In general, a certain amount of scepticism is justified as to whether it is ethically defensible to finance consumption on the part of poor people, all the more so when such financing is provided under a misleading label. When the supply of de facto consumer loans is targeted at poor people, as is currently the case in Mexico, it must be considered irresponsible lending,[42] especially if, as in the cases reported by *Business Week* and at Compartamos, it occurs with usurious interest rates. What is going on in Mexico is highly questionable from an ethical standpoint.

3. A hypothetical case of a microfinance IPO and a concluding remark regarding ethics

Although it may not sound like it, I do not want to imply that ACCION had any base motives for investing in Compartamos shares at the point at which it did. Those who took the decision probably believed that they were promoting the kind of microfinance in Mexico which ACCION has long been advocating, namely the financing of small and very small enterprises, and presumably they also expected that the subsequent IPO would have only positive consequences for the field of microfinance as a whole. From the point of view of the ethics of responsibility, this would be an acceptable position. Things turned out differently, however, and the pull of the capital market began to have its effect on Compartamos and also on its shareholders. I credit ACCION and IFC with not having been able to foresee this as a consequence, because IPOs of MFIs are really an innovation of recent years, and almost by definition, the impact of an innovation is always difficult to foresee. But this is exactly the difficulty which an ethics of responsibility entails: Isn't the world of business characterised by innovations, and thus by unpredictability? In a situation of this kind, is it possible to gear one's actions solely towards the consequences which they will have and how one assesses the anticipated consequences? And if not, then what guideline should be used? Are not then general maxims, values and even "right-minded thinking", important after all – as Yunus has always preached, often to the annoyance of those development finance experts in his audience who would have preferred to hear him explain Grameen's figures and business model?

Using the example of an IPO of an MFI, it is possible, I hope, to at least sketch out an answer. I am considering the fictitious case of the MFI X in the country Y. As regards this fictitious

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[42] For a theoretical analysis of "irresponsible lending", see Inderst/Müller (2008), and for a very critical assessment of the blurring of the boundaries between responsible microfinance in the sense of development policy and irresponsible consumer lending, see Zeitinger (2008).

MFI, I assume here that it has in the past consistently followed the commercial approach and has been profitable for a long period of time, and at the same time that it operates on a clearly target group-oriented basis and is very aware of its development policy commitment and that it can be regarded as very successful in both regards. Most importantly, I assume that MFI X also considers undertaking an IPO in the hope of being able to raise new equity.

For an MFI like X the experience with the Compartamos IPO is encouraging on the one hand, because it shows that the capital market is open to first-time issues of MFI shares. On the other hand, the controversy surrounding this IPO creates a certain pressure as well, because it can be feared that social investors, with whom X may have wanted to place a large part of its newly issued shares, would turn away from the field of microfinance entirely, because they no longer trust commercially oriented MFIs to maintain their commitment to development aims once they have submitted themselves to the "dictates of the capital markets". Moreover, the managers and current owners of MFI X might fear that their organisation and possibly they themselves could also change in the way that it appeared to have happened at Compartamos if they went public, or even if they only seriously considered doing so.

My last assumptions are that X already has a legal form in which it has owners and that the owners are a closed group of people who know and communicate with one another and have largely similar development aims and world views. Can they do something to prevent a change of the type which seems to have occurred at Compartamos in the event of an IPO?

There is a positive answer to this question. However, this answer requires a thorough understanding of the problems that have to be solved. What appears to have happened at Compartamos could have been expected in principle, because there, at each point in time the exact thing happened which could have been expected, given the incentives for the participants involved and the options available to them at that point in time. But that this mechanism is effective is also predictable in principle *and as a principle*: The incentives and opportunities that will be encountered at a later point in time can be anticipated and structured in advance. One can try to establish binding commitments *in advance* that will take effect at a *later* point in time if one knew *in advance* that one did not wish to act in accordance with the incentives and opportunities which will arise *later*. However, this is not an easy matter, and it has economic costs.

Thomas Schelling analysed and described this principle of self-commitment years ago in a masterly way.[43] It can be applied directly to the case of the IPO at MFI. *Before* the IPO occurs, the existing owners can create a binding commitment regarding the orientation that their MFI will follow *after* the IPO has happened, by establishing an agreement among themselves to do so. For example, they could agree among themselves that the level of profit earned by their MFI may not exceed a specific limit for any significant length of time. Having such an agreement in place would minimise the incentive to later shift to providing consumer loans, or similar products, in the face of the pressure created by the capital market. However, it is absolutely necessary to make sure that this commitment cannot easily be revised. The present owners of the MFI must give it something like binding constitutional status, or those whom they trust to be best able to withstand the financial temptations which can be anticipated to arise later must be granted the majority of the shares or of the voting rights. Shareholder agreements govern this kind of arrangement. Thus, self-command can be created, and it can be very effective, but it has a price, namely that the composition of the existing group of owners must consist of like-minded partners.

But wouldn't the distribution of voting rights among the owners automatically change once the IPO has taken place? That depends on whether the new shareholders receive voting rights. Non-voting shares exist in almost every legal system. The existing owners of an MFI, who would want to preserve the orientation of their MFI could agree among themselves to issue only non-voting rights in the event of an IPO. That would leave the existing distribution of voting rights intact and would ensure that the agreement to maintain the existing development orientation of MFI X remained in place. This naturally comes at a price, one which may even be very high, because non-voting shares cannot be placed at the same price as voting shares, due to the fact that they lack the value component of conferring an ability to change the policies of the joint-stock corporation to place a greater emphasis on profit-seeking. It might even be feared that non-voting rights could not be placed at all. However, the good lesson of the Compartamos IPO, that is relevant here, is that the capital market seems to have a considerable interest in the shares of MFIs. It can thus be expected that the market would

[43] See Schelling (1960). Schelling received the Nobel Prize in economics in 2005 above all for this work. In a later book (Schelling, 1984, p. 57), he explains his principle of pre-commitment using a memorable example: Odysseus is eager to hear the enchanting song of the Sirens, and yet he knows that, once he has heard the Sirens, i.e. *later*, he will have only one wish, namely to go straight to them. However, he also knows *beforehand* that he and his companions will smash up on the cliffs of the Sirens' island and be killed, and he certainly does not want that *beforehand*. Therefore, he stops up his companions' ears with beeswax, so that they can neither hear the Sirens singing nor his commands, which he rightly anticipates will then be present and certainly be very loud and urgent, and has himself lashed to the mast of the ship, so that he will be unable to steer the ship around. With this self-commitment, he undertakes a binding obligation – in both a literal and a figurative sense – and achieves both: He can hear the bewitching song of the Sirens and yet still survive.

even take up non-voting shares in an MFI with a long-term profit limitation which could only be revised with difficulty.

Under these conditions, MFI X can try, and indeed hope, to maintain its identity and its development orientation, which is important to the owners and has always been the source of the political significance of microfinance, and at the same time take advantage of the capital market. The very recent euphoria about "Microfinance (as) an Emerging Investment Opportunity"[44] allows cautious optimism in regard to MFI X's prospects as well. Thus, an attempt to avoid the pressures created by the capital market, and yet still make use of the capital market, would appear to have good chances for success.

In concluding, I venture to put forth the optimistic proposition that if an MFI does not approach the dangers of the capital market in a blind and naïve manner, then the commercial orientation, which is definitely required for the reasons explained earlier in this paper, need not lead to a situation where the pursues a strategy which will maximise profit at the cost of all ethical and development aims, even when such a (micro-)finance institution wants to draw on the capital market as a source of funding. Only in a model world with full competition in all markets would the pressure of the capital market force participants to maximise profits at the cost of all other goals. But this is not how the real world works, and if it were, then there would be no reason or occasion whatsoever to even think about microfinance issues.

I prefer to leave the question open of whether this idea of a consciously cautious use of the capital market is only another form of the ethics of responsibility, even if one which is subtle and based on economic principles rather than concrete mechanisms, or whether it is closer to an ethics of conviction in seeking to maintain a development orientation at any price and to avoid the pull of the capital market as dangerous in principle and thus a force to be contained. I think it has something of both – and that it is thus somewhat questionable to formulate the two ethical positions as oppositional categories. Today, I would simply rate more highly the role of values, principles of action and even "right-minded thinking" in guiding and motivating the actions of all players than I have previously done in the context of microfinance. Perhaps the microfinance experts should not feel too irritated by Yunus's moralising speeches after all.

[44] This paraphrases the title of the above-mentioned study by DB-Research (2007).

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