Impact investing & the global microfinance sector

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According to the Global Impact Investing Network (GIIN), impact investing is investments made into companies, organisations and funds with the intention to generate measurable social and environmental impact alongside financial return. Among the most dominant parts of the impact investing space is microfinance, which reflects this sector's role in driving financial inclusion, which is among the most commonly targeted social impact themes along with affordable housing.

Microfinance describes the provision of banking services to individuals, households and small businesses at the base of the income pyramid. Microfinance also supports global efforts to increase financial inclusion, which studies show can not only spur economic activity, but, also reduce income inequality (Cull 2012).

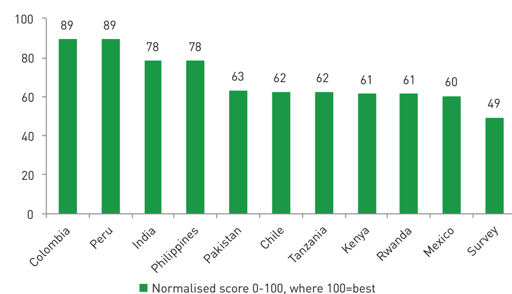
The World Bank defines financial inclusion as the proportion of individuals and firms that use formal financial services. It is therefore different to accessing finance as some people may have access, but, choose not to use financial services. Financial inclusion is therefore an important step in a country's economic and social development. In 2011, the Maya Declaration was launched at the Alliance for Financial Inclusion (AFI) Global Policy Forum in Mexico with signatories committing themselves to make measurable progress to increase financial inclusion.

The significance of financial inclusion was given a further boost in September 2015 when the UN Sustainable Development Goals 2030 were unanimously agreed by the UN Assembly. Of the 17 Sustainable Development Goals (SDGs), ending poverty, ending hunger, gender equality, sustainable, inclusive economic growth and sustainable, inclusive industrialisation all require improved or universal access to financial services as part of the solution to achieve these goals.

Data from the Consultative Group to Assist the Poor (CGAP) estimate the size of the microfinance industry at around USD70bn and serving over 200 million borrowers. Even so, according to the World Bank, there are currently an estimated 2.0 billion working age adults, that is almost half of the total adult population globally, with no access to financial services. Research by McKinsey Global Institute (2016) finds that broadening access to financial services, particularly with digital technologies, could increase the GDP of all emerging economies by 6% by 2025 and potentially more in certain countries. This would represent additional economic growth of USD 3.7 trn equivalent to adding an economy the size of Germany and potentially creating up to 95 million new jobs in emerging economies across all sectors of the economy.

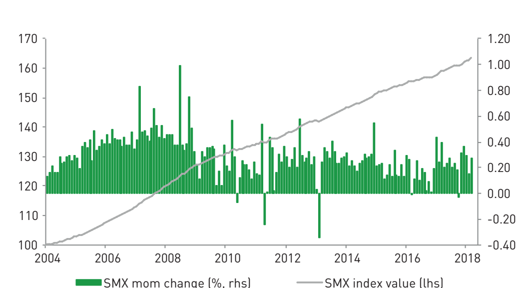
According to the McKinsey report, an estimated 75% of people live in countries where less than 5% of payments are made digitally while only 2% of the global population live in countries where more than 50% of transactions are digital. The heavy reliance on cash creates costs for financial institutions, reducing the number of customers they can profitably serve and making it difficult to assess customers' creditworthiness. However, 80% of adults in emerging economies had mobile phone subscriptions compared to 55% who had a bank account.

Figure 1. **The top 10 countries in terms of an enabling environment for financial inclusion**



Source: EIU Global Microscope 2016 (April-August 2015)

Figure 2. **The performance of the SMX-MIV debt USD index**



Source: EIU Global Microscope 2016 (April-August 2015)

The growth of 'mobile money' or digital financial service is a major opportunity to help address some of the issues surrounding financial inclusion. Digital technologies can cut the cost of providing financial services by 80–90%. Many microfinance institutions are starting to work in this area, but, more could be done. Digital banking services including by microfinance institutions (MFIs) could add 1.6 bn people to the financial system, create USD 4.2 bn of new deposits, reduce loss of government tax revenue by USD 110 bn and lead to USD 2.1 trn of new loans.

In its most recent report Microscope 2016, the Economist Intelligence Unit (EIU) assessed the enabling environment for financial inclusion as well as the regulatory and structural framework for MFIs in over 50 countries. The report tracks more than 40 data points for each individual country to assess, among other things, the regulatory and supervisory environment across the financial products and services sector. It ranks countries on a 0-100 scoring system, with 100 representing the best, see Figure 1.

Not surprisingly, it reveals some overlap between those countries that have an enabling environment for financial inclusion and the development and size of a country's microfinance market. The EIU report also reveals an improvement in institutional support for the safe provision of financial services to low income populations through the increased supervision of microfinance activities. While MFIs may not be as rigorously supervised as the banks, the regulatory environment is improving overall, with new codes of conduct coming into play.

One growing issue and opportunity for the microfinance sector is how to support their clients in adapting to the impacts of climate change. As floods, droughts and other disasters become more frequent and intense, MFI clients will likely be negatively impacted. MFIs thus need to be more aware of potential climate impacts in their geographies. In cooperation with governments and development finance institutions, MFIs have an important role to play in supporting training and financial solutions that help clients adapt to and reduce the risk of climate change (Fenton 2016).

THE DIVERSIFICATION PROPERTIES OF THE MICROFINANCE SECTOR

To assess the risk-return characteristics of the microfinance sector we track the Symbiotics Microfinance Index (SMX). The SMX index has become the reference benchmark for microfinance investments. Launched in 2003, the SMX index has included a mixture of fund managers (Blue Orchard, responsibility, Symbiotics, Credit Suisse, Triodos) and MIVs (Dexia, Wallberg). Constituent funds of the SMX index all have the majority of their assets invested in microfinance debt instruments. We find that from a returns perspective the SMX-MIV debt USD index has displayed stable and predictable returns with low volatility.

The performance of returns during the global financial crisis also reveal that the microfinance sector was more resilient to the economic downturn and from the gyrations of global financial markets than more mainstream markets such as bonds and equities. Please refer to figure 2. In addition, since its launch in 2003 the SMX index has only posted negative monthly returns on four occasions, or 2% of the time, and has displayed a relatively rapid recovery phase after such drawdown events, see Figure 2.

In terms of diversification, Figure 3 details the correlation of microfinance returns against benchmark fixed income, equity and commodity indices over different time periods. We find that over the 2007-2017 period the SMX displayed negligible or negative correlations with benchmark fixed income, equity and commodity indices. These strong diversification properties also persisted during periods of extreme financial stress.

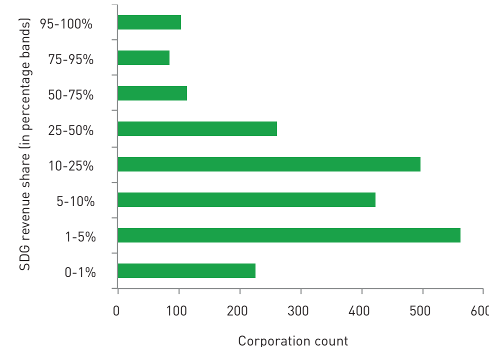
As a result, what started out as a means to address poverty alleviation via NGOs and cooperatives, the past decade has seen microfinance evolve into an important part of any socially responsible investment portfolio. For certain pension funds, investing in microfinance is seen as part of their Corporate Social

Figure 3. **SMX correlation with fixed income, equity and commodities since 2007**

	DB US Treasuries Overall Index	MSCI World Equity Index	MSCI EM Equity Index	S&P GSCI Index
2007-2017	0.09	-0.14	-0.16	-0.03
Pre-crisis*	0.71	-0.28	-0.48	0.48
During crisis	0.22	-0.23	-0.32	-0.05
Post crisis*	-0.16	0.11	0.11	-0.03
Last 36 months	0.26	-0.26	-0.21	-0.28
Last 24 months	0.34	-0.21	-0.16	-0.51
Last 12 months	0.11	-0.09	0.13	-0.65

* Pre-crisis periods ends on 9-Aug-07/BNP Paribas announcement
** Post-crisis period begins on 2-Apr-09 immediately after G20 fiscal expansion
Sources: Symbiotics, Bloomberg Finance LP, DWS (Data as of December 2017)

Figure 4. **The number of companies classified according to their SDG revenue size**



Sources: DWS analysis (March 2018); MSCI ESG Sustainable Impact Metrics database

Responsibility strategy. For others, financial considerations such as portfolio diversification dominate the motivation to be active in the microfinance sector.

One of the obstacles for the pension fund investment community has been market size and the relatively small allocations to the sector from a portfolio perspective, typically under 1%. For some pension funds such a small allocation limits the impact from an overall portfolio diversification perspective. However, we would expect as the microfinance sector grows and capacity constraints ease that this will help to increase the sector's appeal from a portfolio allocation perspective.

According to the GIIN and other industry surveys, institutional investors expect sustainable/impact investments to constitute 5% of their total portfolio in the next 10 years with microfinance representing an important part of these investments. However, investors may be wary of the macro and FX risk around their microfinance investments, since these typically sit in EM or frontier markets.

Encouragingly the microfinance regulatory environment has improved over recent years with greater efficiency and transparency for private sector investors. Indeed we find that more than two-thirds of developing and emerging markets have microfinance regulatory agents, in addition to some dedicated credit bureaus for MFIs.

Furthermore, participants in the microfinance industry have rallied around a code of client protection known as the Smart Campaign, promoting an emphasis on the end client and on responsible finance. This better regulatory environment might also help to explain the growth of institutional investors, which not only constitute the majority of MIV investors, but, are also the fastest growing segment among the various investment groups. Even so, the relatively small size of the microfinance sector is a constraining factor for portfolio allocation although we would expect these constraints should ease as the microfinance sector matures.

FROM PRIVATE TO PUBLIC MARKETS

Up until now most impact investing activity has focused on private equity and debt funds such as China clean tech, US renewables or microfinance in emerging markets. But these investment opportunities can lack sufficient size for large institutions. Given the ambitions of many investors to scale-up their allocations to impact investing, attention has turned to the fixed income and listed equity space for a solution.

To meet this demand, our ESG research and investment work is being extended to identify the corporations that have products and services aligned directly to specific UN SDGs. Signed by all 193 member states of the UN in 2015, the SDGs set aspirations and targets for economic development, social inclusion and environmental sustainability. The Business and Sustainable Development Commission estimates the SDGs could be a key driver of economic growth and unlock opportunities worth up to $12tn per annum by 2030, or more than a tenth of global output. In addition, almost 400m jobs could be created across the food and agriculture, cities, energy and materials and health and well-being sectors.

For listed equities and corporate bonds, DWS now includes MSCI's ESG Sustainable Impact Metrics data into its broad ESG dataset. These measure the extent to which the products and services of specific companies support one or more of the SDGs. Our analysis reveals that only 300 corporations have a considerable SDG impact – that is, where sales supporting the goals are in excess of 50 per cent of their total revenues. In contrast, around 70 per cent of all globally listed companies, have a SDG revenue share of less than 10 per cent. When the SDG revenue hurdle is lowered to a quarter of sales around 560 corporations are captured. These corporations are typically concentrated in the alternative energy, energy efficiency and healthcare sectors.

CONCLUSION

We expect the microfinance sector will enjoy increasing attention by global investors in the years ahead. The sector has not only demonstrated its strong diversification properties versus traditional asset classes, but the asset class promotes many of the UN SDGs. Indeed with more investors now coalescing their investment activities around the SDGs we believe the microfinance sector will be a natural beneficiary.

This is already underway as we are witnessing the growing reach of the microfinance sector. Not only has the range of financial services expanded to include not just microcredit, but also the provision of savings instruments, mobile payment systems and micro-insurance. The variety of funding counterparties has also increased, with institutional investors now the fastest growing segment of the investor universe. The microfinance sector is also benefiting from a more transparent regulatory environment, which we expect will facilitate further private sector involvement.

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