

MICROFINANCE REVOLUTION OR FOOTNOTE?

The Future of Microfinance Over the Next Ten years

Ira Lieberman, Paul DiLeo, Todd A. Watkins, and Anna Kanze



**FINANCIAL INCLUSION
EQUITY COUNCIL**



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The authors acknowledge that the views expressed in this paper are their own and may not reflect the views held by individual workshop participants or the views of the sponsors. We accept that any errors in the paper are our own.



PREFACE

Should proponents of microfinance claim victory and go home? This seemingly innocent question has sparked much discussion. For some early supporters of the microcredit movement, mostly donors and development agencies, the fairy dust is gone and most have moved on to other endeavours. In so doing, many have proclaimed that “microfinance is dead.” On the other hand, one need not look far to realize that, quite to the contrary, microfinance is not only very much alive but growing rather nicely. There seems indeed to be a disconnect.

Since its inception more than 40 years ago, the sector has surpassed even the most ambitious milestones its early proponents visualized, far exceeding the original goal of 100 million clients, achieving sustainable large-scale efficiencies, and successfully cracking global capital markets, while largely preserving focus on the bottom of the pyramid.

Nevertheless, many unresolved issues remain, such as:

- Why has product diversification—into areas such as microsavings, insurance, housing, education, and money transfers—not become more important as a source of growth for the sector?
- How are mobile banking and other technical disruptions challenging ways microfinance institutions (MFIs) operate?
- What is being done about concerns that some MFIs, particularly in urban areas, have oversaturated selective markets, over-lending and enabling borrowers to over-borrow without constraint?
- With charismatic founders of MFIs now retiring, the institutional capacity of some large MFIs may be constrained by poor governance practices. How can succession risk be mitigated?
- Academic assessments of microcredit, specifically, have thrown doubt on its poverty alleviation impact. Unrealistic expectations may have been created early on. Whatever the reason for these concerns, how are they being addressed?

Driven by a feeling that a lot could be gained by a comprehensive discussion, a workshop at Lehigh University convened thirty-four leaders from the microfinance community—operators, investors, academics, and analysts and representatives of the broader impact investing and financial inclusion communities. Open discussion sessions revolved around select major themes, each led by a small panel with the active participation of all attendees. The workshop’s goal was to bring varied perspectives to bear on key questions raised by the successes and shortfalls of MFIs and to articulate challenges that lie ahead:

- What has MF accomplished? What can it still accomplish going forward?
- Is MF in decline? Consolidating? Being absorbed? What is its future?
- What are the major issues impacting and shaping the sector globally and regionally?
- What are the successors or alternatives to traditional MF models: financial inclusion, fintech, mobile and agency banking? Can they maintain and build on the social content that inspired MF in the first place?

A secondary objective was to engage the disillusionment and debunking of MF that have dominated the conversation—and funder/investor perspectives—during the last few years. It seems MF’s image may have bottomed out. So this may be a good time to extract lessons that MF’s 40-plus-year history has to offer. Is MF a model for impact investing or an anomaly? The workshop organizers believe that MFIs are the singular success story in financial inclusion and impact investing. Understanding why MF has succeeded and where it can go, and disseminating its lessons, should be of significant benefit to other impact companies and to the wider financial inclusion and impact investing communities.

This paper, funded by the CALMEADOW Foundation who also provided support for the workshop, reflects the workshop deliberations. It is intended as a tool to spark further discussion and to serve as a reference point in defining strategy with respect to microfinance as well as impact investing in general. It would not have been possible without the collaboration and support of the diligent and qualified staff of the Martindale Center at Lehigh University.

*Alex Silva, Executive Director
CALMEADOW*

EXECUTIVE SUMMARY

In March 2017, a gathering of microfinance and impact business practitioners, investors and analysts was held at Lehigh University, sponsored by Lehigh's Martindale Center, the Financial Inclusion Equity Council, and Calmeadow, and organized by Grassroots Capital Management and LIPAM International. The purpose was to assess the state of microfinance in light of its successes and setbacks, and in the context of the maturation of the sector's funding mix to a majority of commercial funding amid the growing "impact investing" movement.

Has microfinance run its course, to be absorbed by the mainstream financial sector and supplanted by more innovative and disruptive double bottom line technologies and models? Or does it remain a unique—even revolutionary—accomplishment: a scalable and profitable business model that largely preserves its social commitment and represents the best infrastructure for reaching billions of poor families and communities around the world? And can investors—whether commercially-oriented, or social impact driven, public institutional, high net worth individuals and those of more modest means—afford to bypass microfinance given the urgent challenges of climate, inequality, population pressures and the Sustainable Development Goals (SDGs) timetable?¹

With the aim of informing and shaping the dialog about the future of microfinance and the broader impact investment movement, this paper summarizes the discussion at Lehigh in four parts: (i) Current state of microfinance²; (ii) How we got here; (iii) Current challenges; and (iv) Where do we go from here? While multiple viewpoints were expressed and no consensus reached on some issues, in most critical areas the participants' diverse perspectives coalesced around key findings:

1. Microfinance products and services are increasingly incorporated into mainstream commercial finance, even as MFIs remain a distinct and unique resource

- A key success marker of microfinance has been the incorporation of microfinance products and clients into mainstream commercial financial service providers. This move towards the mainstream promises better capacity to further scale, to achieve efficiencies, and to develop new products and delivery channels, although not necessarily to deliver lower costs or robust client protection.
- Over the next ten years, the delineation of "the microfinance industry" will further blur with large portions of the market being served by commercial banks and/or other institutions other than MFIs. MFIs as distinct institutions will become less central to providing financial services to their target populations, or will themselves evolve into institutions with broader mixes of products and clients extending beyond the traditional microfinance universe.
- At the same time, the unique characteristics and value of microfinance are important to recognize. As David Roodman noted, "There is no Grameen Bank of vaccination. One does not hear of organizations sprouting like sunflowers in the world of clean water supply, hiring thousands and serving

millions, turning a profit and wooing investors. Yet one does in microfinance.... More than any other domain of support for the global poor, microfinance comprises spectacular indigenous institutions."³

- The microfinance sector overall is healthy, profitable, and continues its several-decades-long robust growth trajectory, and remains the largest element of impact investing portfolios. Microfinance worldwide today serves hundreds of millions of clients and their families, has attracted more than \$30 billion in cross-border investments, and the large majority (~80%) of microfinance institutions (MFIs) operate profitably.
- Thanks to this success, the industry has been dramatically successful in engaging with capital providers. The majority share of capital for MFIs now comes from commercial sources.
- Microfinance represents a unique infrastructure, with ongoing, sustainable and trusted relationships with, by most estimates, billions of individuals. In reassessing and repositioning over the next ten years, the industry needs to carefully consider how best to utilize and preserve unique capabilities and proximity to clients to address challenges of health care, education, agricultural productivity, and gender equality without losing focus and undermining the successful business model.

2. Traditional microfinance is a proven model, but it faces persistent challenges from new competitors and disruptive technologies

- The industry is still growing but at a slower pace. Many MFIs seek growth via product line expansion.
- In the face of mainstream bank encroachment, together with digital disruption, some microfinance institutions will die, and many others will merge or be acquired. But these are normal and ultimately healthy market functions.
- New digital technologies, fintech, present both serious competitive threats, but also substantial opportunities for leveraging MFIs' core strengths.
- Indeed, microfinance is at the forefront of melding high tech to increase efficiency and outreach while preserving the high touch necessary to create social value and truly understand and benefit poor clients.
- However, MFIs face significant hurdles in—and need patient risk capital to support—developing the skills, institutional capacity and infrastructure to expand product offerings beyond traditional microcredit, particularly if venturing into non-financial services and digital finance.
- While steady progress on social metrics is being made, microfinance struggles—along with the rest of the impact investment community—to communicate impact to investors and ensure continued and meaningful commitment to the double bottom line.

¹ <http://www.undp.org/content/undp/en/home/sustainable-development-goals.html>

² For purposes of this report, microfinance refers to the term defined by the World Bank Group: "financial inclusion efforts to expand access to affordable financial products and services that meet clients' needs—transactions, payments, savings, credit and insurance—delivered in a responsible and sustainable way."

³ Roodman, 2012, p. 222.

3. As the lines between microfinance and fully commercial financial services blur, a key caution moving forward is in maintaining adequate focus on the social agenda.

- As MFIs become driven by purely commercial interests or disappear entirely, what is lost? In light of the success of microfinance in scaling and in attracting commercial capital, it may be tempting to declare victory and go home. Yet given the magnitude of social challenges still facing the world, exactly what victory would the industry be declaring? Has the microfinance agenda been achieved? Or has the industry just moved the goalposts: no longer put poverty in the museum, but give everyone bank accounts and mobile wallets?
- Even though the microfinance community represents the most successful example of melding market instruments with a social mission, it cannot yet legitimately declare victory. Substantial elements of microfinance's original agenda are unlikely to be taken up by mainstream finance. In particular, MFIs are a unique instrument to help achieve the SDGs, fundamentally differentiating them from commercial players, for whom social goals are not a primary strategic objective.
- The challenge facing the microfinance community is to devise a strategy to enable microfinance to continue to pursue those aspects of its original outreach and social value agendas that commercial players will not.

4. Microfinance's successful four-decades-long gestation holds many lessons for the path forward.

- Microfinance has blazed the path from high subsidy dependence and limited scale to achieving massive, sustainable scale—at least 25 MFIs have more than one million borrowers, and in excess of 85% of all microcredit borrowers are clients of MFIs with over 100,000 clients—and continual innovation, tapping a full range of capital sources, all while largely preserving social mission and avoiding “greenwashing.”⁴
- Microfinance's success in achieving scale and attracting capital is a result of a four-decades-long process of product development and testing, gaining insights into customer needs, earning client trust, building infrastructure, training, collecting data, benchmarking, and developing a robust supporting ecosystem. Much of that gestation was funded by non-commercial capital and grant funding.
- Other impact sector innovators, and microfinance itself tackles broader challenges, can shorten this development phase by taking advantage of lessons drawn from microfinance's evolution and by using technologies and data not available during microfinance's development phase.
- While newer impact business models may be able to shorten the journey, they would do well to take note of the key factors enabling microfinance's success: in particular, deep understanding of diverse customer needs, hard earned over decades through high-touch methodologies, experimentation, and capacity building, all supported by patient, often subsidized, risk capital.
- It is unlikely that innovators pushing new frontiers will be able to completely leapfrog trial and error phases or the need to build track records for unproven business models. A key

lesson from microfinance is that concessional funding may well be required. Subsidized risk capital that targets capacity building and frontier innovation will remain important for widening product portfolios and deepening impact.

- Hence, maintaining a balance of influence between more-commercial and more-social investors is essential if microfinance and other impact sectors are to maintain a meaningful commitment to social value creation, and to continue to push the envelope in achieving the SDGs. That balance might be better preserved through greater commitment to impact measurement and transparent validation, and by exploring alternative social-mission-driven corporate structures such as Public Benefit Corporations.

With these core findings in mind, the authors pose four key tasks for like-minded participants in the industry to address over the next 2-3 years which will have a defining effect on what microfinance looks like, and indeed, whether it survives as a distinct business model over the coming 10 years and beyond:

- Support responsible BOP financial services by mainstream FSPs by vigorously promoting the client protection and multi-stakeholder input initiatives, such as the SMART Campaign and B Corp / GIIRS ratings.
- Develop “best practices” and models for incorporating digital and mobile technologies into microfinance products while preserving and enhancing protections and value added for poor and excluded clients.
- Cultivate patient investors willing to prioritize and maybe even subsidize innovation by rigorously testing and disseminating models for how MFIs can serve as platforms or infrastructure to deliver other SDG-targeted products and services without undermining the sustainability and business discipline of MFIs' core business.
- Develop and resource a concerted effort and strategy for preserving and enhancing the double bottom line character of microfinance: by promoting and cultivating corporate structures, boards of directors and governance processes that reflect the double bottom line balance; encouraging the adoption of mission “hardwiring”⁵, social output metrics, and scorecards to promote accountability; and calling out greenwashing and practices and operators that persistently harm clients.



⁴ Greenwashing is usually understood as corporate efforts to present an environmentally, or in this case socially, responsible public image to deflect attention from or compensate for less admirable activities.

⁵ “Hardwiring” social mission refers to unambiguous articulation of and commitment to the company's objectives and character in corporate documents and clear communication with investors and other stakeholders, reinforced, where possible, by adoption of specialized corporate structures, like the “Public Benefit Corporation” in the US. For more on this, see https://www.grassrootscap.com/wp-content/uploads/2014/02/Hardwire_Jan2014.pdf

Meaningful progress on these objectives will require focused collaborative efforts: by “responsible investing” and impact investing communities to require strong client protections in BOP financial services; by microfinance practitioners, analysts and academics to develop models for digital financial services and new products; by microfinance and impact industry associations to promote metrics, standards and codes of conduct and enforce accountability; and by investment managers and lead investors to cultivate the patient capital necessary for continued pro-poor and double bottom line innovation and outreach.

“One of the great successes of microfinance in the past 25 years is that we have been able to open the road to the jungle: we now know where and how to reach poor and rural clients and understand better their behaviors when dealing with their money.”

-Renée Chao-Beroff



INTRODUCTION

What prospects and challenges face microfinance today? After enthusiasm peaked with Muhammad Yunus' Nobel Peace Prize in 2006, microfinance went through a period of debunking and criticism: it hurt more poor clients than it helped; its impact on poverty was negligible at best; it offered overpriced and low-quality products and would not survive competition from new technologies and more disciplined competitors. As these critiques abated in the face of corrective soul-searching by practitioners and more nuanced research, microfinance confronted new challenges: claims of obsolescence and irrelevance. The very term "microfinance" fell out of fashion, with many investors and managers downplaying or dropping the term from their marketing materials and public outreach and refocusing their investment programs to new sectors (Dunford 2016). Microfinance thought leaders began to push the sector to evolve and embrace financial inclusion more broadly.⁶

But these apparent setbacks mask more fundamental successes: Financial inclusion now encompasses many actors that are not traditional microfinance institutions (MFIs) or don't consider or portray themselves as such, vastly increasing the capacity for scale and scope of financial services for the BOP. Social investors once directed towards microfinance now focus on other sectors—health, education, off-grid energy—because of the success of microfinance in scaling a sustainable BOP impact model. And beneath the anxiety generated by the threat from digital and mobile financial services there is active work underway to incorporate these new technologies to improve microfinance products and services.

In the popular dialogue, the key challenges facing microfinance can be boiled down in shorthand:

- **Water, water everywhere, but where is the risk capital?**⁷ Microfinance is attracting commercial investments but losing its social content as it becomes a subsector of mainstream finance. Commercial capital dominates balance sheets and social investors are moving on.
- **Nobody goes there anymore; it's too crowded:**⁸ As mainstream commercial finance absorbs—and dominates funding for—the sector, entrepreneurs and social investors are drawn to more "innovative" bright shiny objects.
- **Incumbent dinosaurs:** MFIs are too wedded to their business models to respond to disruptive competitors and are destined to be eaten or die.
- **All investing will soon be impact investing:** Social value and the double bottom line are just the latest marketing fads for investment advisors and "greenwashing" has overwhelmed microfinance.

Yet microfinance remains the largest impact sector in the developing world by far, has direct client relationships with hundreds of millions of poor families, and provides the only bottom of the pyramid (BOP) business model that has achieved consistent profitability at scale. While microfinance may not have put poverty in a museum, it is a unique and

revolutionary innovation: a scalable, sustainable business model to engage the poor in the market economy in a non-exploitative way that builds assets, skills, and opportunity, creating well-run institutions where none existed, while treating people with respect where other institutions traditionally had not.

How was this achieved? What is required going forward to build on the unique accomplishments of microfinance? How can it productively respond to challenges ahead? And what lessons can be gleaned from the microfinance experience to guide the larger impact business community? Recognizing microfinance's successes in financial inclusion and impact business models, articulating why it has succeeded, and suggesting where it can go in the future can benefit both the microfinance community itself and the wider financial inclusion and impact investing communities.

This white paper summarizes discussions at a workshop held at Lehigh University in March 2017 on the future of microfinance and of microfinance investment, and their relevance to other, emerging, impact investment opportunities. The Lehigh workshop brought together leaders from the microfinance community—operators, investors, academics and analysts—and representatives of the broader impact investing and financial inclusion communities for a series of open discussions.

The paper takes stock of the diverse views expressed on the current state of microfinance, key factors in its unique success, and how it is responding to continuing challenges. We hope that the paper can contribute to the ongoing dialogue on these issues within the microfinance and financial inclusion community, as well as help inform and shape the development of the broader impact investment movement.

Most importantly, we hope to build on the discussion to engage collaborators in addressing in a timely fashion the key challenges facing microfinance and impact investing so that in 10 and 20 years' time microfinance can evolve to play an even more influential and effective role and fully fulfill its revolutionary potential.

"Stop framing microfinance as an escape from poverty, and instead as the cheapest employment and management training program the world has ever seen."

-Timothy Ogden

⁶ See, e.g. Dunford, 2016.

⁷ Pace Elizabeth Littlefield.

⁸ Pace Yogi Berra.

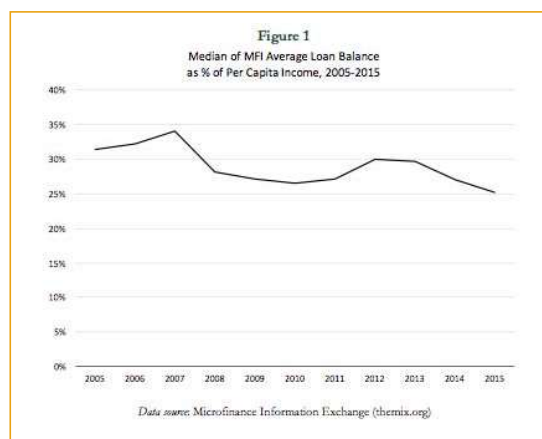
CURRENT STATE OF MICROFINANCE

In 2001, Marguerite Robinson produced her seminal book on microfinance, *The Microfinance Revolution: Sustainable Finance for the Poor*, in which she defined the microfinance revolution in terms of commercial microfinance:

*"The microfinance revolution is a commercial revolution based on new financial technology and greatly accelerated by the information revolution that developed concurrently. It began in the 1970s, developed in the 1980s, and took off in the 1990s.... These combinations enabled institutional profitability and long-term viability, making possible large-scale formal-sector financial outreach to low income segments of the population."*⁹

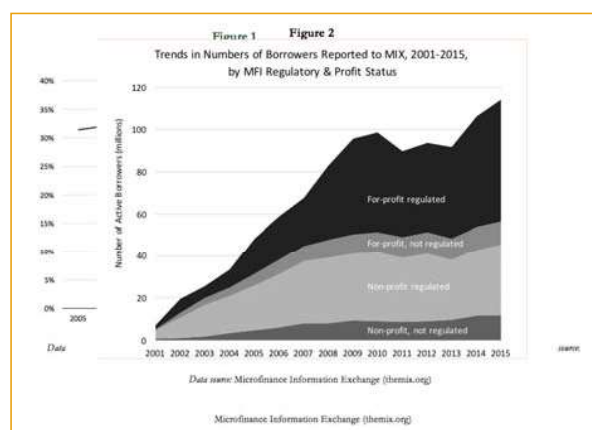
In the years since, microfinance successfully achieved the milestones its proponents set in aiming to realize this promise at meaningful scale:

- Outreach far surpassed the original—wildly optimistic—goal of 100 million clients.
- MFIs moved from being largely NGOs with relatively small scale to include a mix of formal, regulated credit unions, cooperatives, commercial banks, and non-bank financial intermediaries (NBFIs) playing a significant role in national financial sectors.
- MFIs successfully "cracked" the capital markets, diversifying funding sources beyond donors to include local deposits, well more than 100 specialized investment funds with an estimated \$13.5 billion of assets under management,¹⁰ and more than a dozen initial public stock offerings (IPOs) worldwide.¹¹
- Commercial sources of capital now make up the majority of investment in the sector.¹²
- Mainstream global and regional commercial banks have entered the sector, acquiring MFIs or launching subsidiaries dedicated to microfinance.
- The sector has largely preserved its focus on the BOP with the median average loan balance at MFIs holding well below 30% of per capital income (Figure 1) and a growing emphasis on new financial products that often provide value to more poor clients: savings, insurance and remittances.¹³
- Microfinance consistently ranks as the largest single sector among "impact investments" according to annual surveys; combined with other BOP finance, "financial inclusion" dwarfs any other impact sector.¹⁴



Taken together, these accomplishments place microfinance as the only "impact" business model that has achieved an extended track record of solid profitability, meaningful scale, liquidity for investors, and capacity, commitment and understanding of client needs to continue innovation to reach deeper into poor and excluded populations.

The trajectory of the sector has been dramatic. In 1997, the Microcredit Summit Campaign estimated there were 13 million clients of microfinance institutions. By the start of 2014, the most recent Campaign estimate available showed a 16-fold increase, to 211 million clients worldwide.¹⁵ As Figure 2 illustrates, from a different source of data on MFIs reporting to the Microfinance Exchange, as the industry expanded rapidly after 2000, it evolved from services dominated by non-profit, often unregulated institutions, to one where the majority of clients are now customers of regulated for-profit MFIs. Meanwhile a number of the largest MFIs continue to operate as non-profits. Commercial investment in the sector expanded rapidly as well, growing at a 20% annual clip on average for more than a decade through 2016.¹⁶



⁹ Robinson, 2001, pp 28-9.

¹⁰ Synbiotics, 2017.

¹¹ Watkins, forthcoming.

¹² Synbiotics, 2017.

¹³ Microcredit Summit Campaign, 2016.

¹⁴ Synbiotics, 2017.

¹⁵ David Roodman, 2012a.

¹⁶ Sourssourian and Dashi, 2015.

"Microfinance is dead from the perspective of the donor [but has] developed beyond our wildest dreams"
-Damian von Stauffenberg

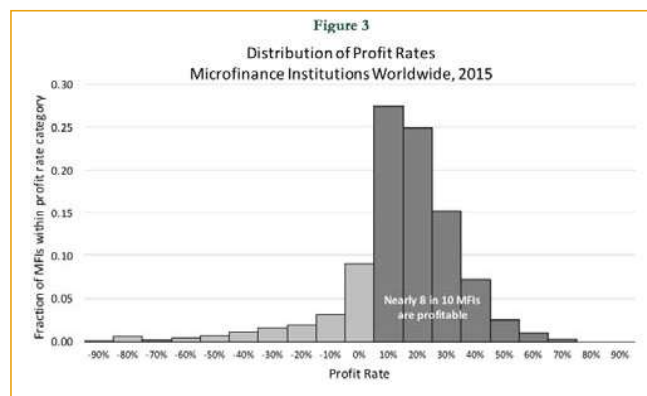
*As David Roodman noted in his book Due Diligence, "...support for microfinance has succeeded, not in turning clients into entrepreneurial heroes, but in building microfinance institutions and industries that compete and innovate, cater to poor people, create jobs, and enrich the national economic fabric."*¹⁷

Lehigh workshop participants outlined how this dramatic growth has taken many different forms regionally and institutionally. In Latin America, many MFIs are regulated, deposit taking institutions and the line between MFIs and commercial banks is blurring. There has been no abandoning of poorer clients. Indeed, "mission" is creeping downward towards poorer clients. In Asia, India is becoming the center of microfinance and the sector is evolving rapidly, most recently with the licensing of the new Small Finance Banks that are aiming at the small and medium-sized enterprise (SME) sector as well. Microfinance is becoming part of the mainstream financial sector both in India and elsewhere in the region, such as Cambodia. In China, the lack of a reliable regulatory framework is an impediment. Meanwhile Bangladesh, once a leader in the early years, has become complacent, with little product development. Africa is building on the microfinance revolution with a mobile banking revolution, still very much a work-in-progress. A high-tech, low-touch model of offering some BOP financial services is showing efficiency gains, but for many clients it seems that access to knowledge and a trusted counterparty is an essential complement to better access to capital.

Currently, while many MFIs are still structured as non-profits, commercially oriented MFIs provide the majority of microcredit and other microfinance services, including the vast majority of microsavings accounts, fostering large-scale outreach to hundreds of millions of poor people. To reach this scale, MFIs needed large amounts of capital, much more than could be obtained solely from donors. As data accumulated that profits could be made in microfinance doors opened to other mainstream commercial sources of capital beyond client savings deposits, such as external private investment funds, debt financing, and public stock offerings. Deep-pocketed private investors got interested. By the end of 2014, microfinance had attracted an estimated \$31 billion in cumulative investments across international borders, about a third from private sources.¹⁸

The track record of profit also led existing big multinational banks like Citicorp in the US, Canada's Scotiabank, and Spain's BBVA, among others, to move down-market into microfinance, often partnering with organizations already active in the sector.

These shifts and resulting flow of big money have enabled MFIs to expand rapidly and completely changed the industry, in both hopeful and troubling ways. In 2015, as shown in Figure 2, nearly 8 in 10 MFIs operated profitably.



Note: For clarity, excludes MFIs in the extreme tails, reporting profits (losses) exceeding 100% (-100%). Source: Modified from Watkins, forthcoming. Data source: Microfinance Information Exchange (themix.org).

There are at least 25 MFIs with one million borrowers or more (Table 1). Nearly all have healthy returns on equity, and been growing rapidly, with sustained double-digit annual growth rates for a decade or more. Nineteen of these 25 million-plus borrower MFIs are for-profit. About half of all borrowers do business with these largest MFIs (Table 1). Three-quarters of all other microcredit borrowers are clients of MFIs with over 100,000 clients. A similar pattern emerges for savings where about two dozen MFIs have more than a million depositors. Table 2 also analyzes the performance of MFIs by size, demonstrating the advantages of scale in serving a larger number of poor clients and in increased sustainability and profitability, as well as lower prices for clients.

Table 1. Million-plus Borrower MFIs

MFI Name	Country	Active Borrowers	As of Date	Annual Growth % (2007-16)	Return on Equity (%)	Profit Status	Legal Status
BRI	Indonesia	8,900,000	12/16	9.6	20.3	Profit	Bank
Grameen Bank	Bangladesh	7,180,000	12/15	1.9	-1.8	Profit	Bank
Bandhan	India	6,525,623	3/16	28.2	16.0	Profit	Bank
ASA	Bangladesh	6,207,689	6/16	1.5	17.2	Non-profit	NGO
BRAC	Bangladesh	5,356,521	12/16	-2.0	26.7	Non-profit	NGO
Bharat Financial (SKS)	India	5,323,061	3/17	14.1	13.7	Profit	NBFI
Janalakshmi	India	4,622,578	3/16	68.1	13.9	Profit	Bank
Share	India	3,771,000	3/16	16.0	18.1	Profit	NBFI
Ujivan	India	3,625,000	3/17	58.1	11.9	Profit	Bank
SKDRDP	India	3,612,431	3/16	22.7	3.6	Non-profit	NGO
Capitec Bank	South Africa	3,507,819*	2/17	22.1	25.7	Profit	Bank
Compartamos Banco	Mexico	2,835,127	3/17	14.5	30.2	Profit	Bank
PROSHIKA	Bangladesh	2,770,106*	12/16	5.2	n/a	Non-profit	NGO
Equitas	India	2,744,336	3/16	76.9	19.8	Profit	Bank
Satin	India	2,300,000	3/17	68.8	5.1	Profit	NBFI
Caja Popular Mexicana	Mexico	2,271,299*	7/17	12.6	18.4	Non-profit	Credit Union
Asmita	India	2,150,000	3/16	16.0	n/a	Profit	NBFI
CrediAmigo	Brazil	2,030,821	12/15	27.0	11.1	Profit	Bank
African Bank	South Africa	1,500,000	3/16	n/a	6.7	Profit	Bank
ASA Philippines	Philippines	1,273,136	12/16	39.1	98.1	Non-profit	NGO
Asirvad	India	1,193,328	3/17	79.7	13.3	Profit	NBFI
Grameen Koota	India	1,153,000	3/17	28.9	12.8	Profit	NBFI
Spandana	India	1,060,000	3/17	-1.3	-65.3	Profit	NBFI
AgroAmigo	Brazil	1,037,554	12/16	14.7†	n/a	Profit	Bank
Utkarsh	India	1,010,208	3/16	91.1†	18.5	Profit	NBFI

*Notes: Annualized growth rate in CAGR for number of borrowers. Table does not include the Vietnam Bank for Social Policies or the Postal Savings Bank of China, large but essentially government-run subsidized banks. *Capitec Bank is number of loans; Caja Popular Mexicana and PROSHIKA is number of members. †AgroAmigo annual growth rate from 2008; Utkarsh from 2009.
Data source: Microfinance Information Exchange (themix.org); Bank Rakyat Indonesia, Annual Report 2016; Capitec, Annual Report 2016; qpm.coop/solides-emprestat4; proshika.org/what-proshika-does.html.

¹⁷ See: <https://data.worldbank.org/indicator/FB.AST.NPER.ZS?end=2016&start=2009>.
¹⁸ See Federal Financial Institutions Examination Council (US), 2017.

Table 2. Measures of outreach and efficiency, by MFI scale

MFI scale	Small	Medium	Large	Very large
active	less than 10,000	10,000 to 100,000	100,000 to 1 million	more than 1 million
Share of total number of MFIs (%)	41	41	16	2
Share of all borrowers (%)	1.3	12	38.2	48.6
Share of all savers (%)	2.6	20.5	48.1	28.8
Median real interest rate + fees (as % of loan, inflation adjusted)	22.2	20.6	17.8	13
Median profit margin (% of revenues)	8.8	9.4	17.1	22.8

Source: Modified from Watkins, forthcoming. Data source: Microfinance Information Exchange (hemix.org); data for December, 2013. Note: Interest & fees row reports "Yield on Gross Portfolio," using real rates, adjusted for inflation.

As Tables 3 and 4 highlight, international MFIs have been able to reach scale and sustainability largely regardless of legal structure or geography. Table 3 summarizes key performance metrics of MFIs from 2009–2016 by legal type (NGOs, credit unions, NBFIs, and banks) and according to whether or not they are regulated institutions. The growth rate data for assets and loan portfolio represent the median compound average annual increases for MFIs of each type over the period, while portfolio at risk (PAR), write-off ratio, and return on equity (ROE) represent the 7-year average of the median annual rates. MFI non-performing loan rates (e.g. PAR90) have been, except for MFI rural banks, generally comparable or better than mainstream commercial banks. For example, according to International Monetary Fund data, the average median annual PAR90 for all banks worldwide during that same period was 3.9%.¹⁹ Except for credit union MFIs, the median return on equity performance has been similarly comparable to mainstream commercial banks; average return on equity for all US banks, for instance, has been hovering between 7.5% and 10% since 2010.²⁰ The share of loan portfolios that need to be written off as non-recoverable remains low, with median rates at 1% or below for all types of MFIs.

Table 3. Performance Metrics for Median MFI, by Legal Structure, 2009-2016

	Bank	Credit Union/Co-op	NBFI	NGO	Rural Bank	Regulated	Not Regulated
Assets Compound Annual Growth Rate (CAGR, %)	20.4	24.6	30.7	29.9	37.1	29.5	23.8
Gross Loan Portfolio CAGR (%)	23.4	29.4	34.8	29.4	47.7	35.1	20.8
7-year Average of Annual:							
PAR90 (% of loan portfolio in arrears >90 days or restructured)	2.7	4.1	2.2	2.2	5.1	2.7	2.2
Write-off Ratio (% of gross loan portfolio)	0.9	0.5	1.0	0.7	0.7	0.7	1.0
Return on Equity (%)	10.4	5.8	7.5	9.3	11.4	8.3	8.9

Data source: Microfinance Information Exchange (hemix.org)

Table 4. Performance Metrics for Median MFI, by Region, 2009-2016

	Africa	East Asia & the Pacific	Eastern Europe & Central Asia	Latin America & the Caribbean	Middle East & N. Africa	South Asia
Active Borrowers CAGR (%)	21.5	10.9	29.7	19.8	22.4	16.4
7-year Average of Annual:						
PAR90 (%)	3.8	1.4	2.7	3.4	1.5	0.9
Write-off Ratio (%)	1.3	0.2	0.5	1.6	0.6	0.1
Return on Equity (%)	4.6	10.6	8.0	7.7	10.3	11.1

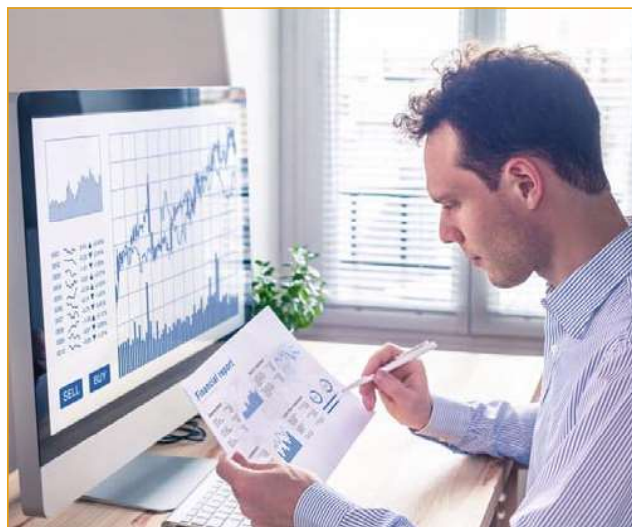
Data source: Microfinance Information Exchange (hemix.org)

Table 4 suggests that MFI growth and performance has been healthy across most geographic regions as well. Double-digit annual growth in the number of active borrowers for the median MFIs in all regions continued during 2009-2016, and the median MFI loan portfolio in all regions also outperformed the 3.9% median bank PAR90 worldwide. Only in Africa did returns on equity significantly underperform worldwide mainstream banking.

Median write-off ratios are remarkably low for MFIs in Asia, while the median African and Latin American MFIs were closer to the average 1.3% loan charge-off rates of all US banks during the same period.²¹

Lehigh participants were generally enthusiastic about the changes that dramatically larger and more diverse capital flows and new technologies have enabled. But they were also quite sensitive to the unique challenges that face double-bottom line business that achieve financial success and capital markets access. On one hand, impact investors, donors and the broader public, in part echoing the sector's poverty-alleviation messaging, continue to challenge MFIs to preserve the priority of benefitting poor clients. On the other hand, growing, financially successful MFIs are perceived as golden geese, tempting targets for government intervention or takeover by unscrupulous operators. Moreover, the extent of (specifically) microcredit's impact on poverty has been questioned in both the press and academic literature, dampening impact investor enthusiasm for microfinance more generally even as evidence of the value of other "micro" products like savings, remittances and insurance accumulates.

In short, the microfinance sector overall is healthy, profitable, continues its several-decades-long robust growth trajectory, has proven attractive to commercial capital providers—as noted, the majority share of capital for MFIs now comes from commercial sources—and at the same time remains the largest element of impact investing portfolios. Lehigh participants broadly agreed that microfinance remains a compelling investment proposition, both for commercial investors and for investors seeking social impact, not only directly, but also—importantly as impact investors appear to be increasingly attracted to other opportunities—in lessons drawn from the long history of how the industry was built so successfully.



¹⁹ Data source: Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports of Condition and Income, retrieved from <https://www.federalreserve.gov/releases/chargeoff/chgallsa.htm>.

²⁰ Robinson, 2001.

²¹ Data source: Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports of Condition and Income, retrieved from <https://www.federalreserve.gov/releases/chargeoff/chgallsa.htm>.

HOW MICROFINANCE GOT HERE

The forty-year path of microfinance to its current position of prominence and success encompassed three key phases and several critical components. The main phases were (1) developing the business model and demonstrating profitability and scalability; (2) developing a deep supporting ecosystem and institutional capacity; (3) “cracking” mainstream international capital markets. Understanding this path and these factors can help highlight what features must be protected and preserved and what may be required for other aspiring social impact business models to gain traction, whether in deepening and leveraging microfinance itself or outside the sector.

“A very serious concern is that while MFIs know what needs to be done to deepen impact, they’re not doing it because profit has become the ultimate driver.”

- Sanjay Sinha

A main leitmotif throughout is the importance of targeted subsidy. More than the success of microfinance on purely commercial terms, the central and essential role of subsidy—not for market distorting price reductions, but rather for innovation, benchmarking, and infrastructure and capacity building—is perhaps the most salient takeaway from microfinance for fostering emerging business models aiming for social impact.

Developing the business model & demonstrating profitability at scale

Microfinance gained widespread attention during the 2000s, as it began to reach beyond a small group of government agencies and philanthropies to develop new sources of capital to support growth. This growing visibility was capped in 2006 with the awarding of the Nobel Peace Prize. However, any analysis of how microfinance emerged as fully attractive to commercial investors and mainstream financial institutions, even while remaining today’s leading impact investment, must look much farther back, to the 1970s and 80s, when the initial experiments and pilot projects providing credit to the poor were undertaken. These pilots were almost entirely funded by grants; any “investments”, largely donor soft loans, were on highly subsidized, non-commercial terms. This extended period of experimentation during which several billions of dollars were devoted to microfinance projects resulted in solid business models and, as we will see below, an ecosystem that supported the transition of that model from exclusive reliance on subsidy, to a more diverse funding base, and eventually to an ongoing absorption into mainstream commercial finance.

During this initial phase in the 1970s and 1980s few institutions were taking what Marguerite Robinson called a “financial systems approach” to microfinance.²² But a few pioneering MFIs, such as Bank Dagang Bali (BDB) in Indonesia, began charging fees and microcredit interest rates that, together with keeping loan losses in check, enabled their own revenues to cover all their costs—what’s known as independent self-sufficiency—while simultaneously ensuring affordability for their clients. In the 1980s, another Indonesian bank, Bank Rakyat Indonesia (BRI), was the first to profitably operate a large-scale microfinance banking system, with millions of clients, without relying on donors. BRI succeeded by leveraging its ability to take deposits from its clients, turning its clients’ deposits around into microlending.

These institutions at the forefront proved that MFI financial viability beyond the charity of donors was possible, laying the basis for commercialization of the industry to truly take off in the 1990s. Once they were able to demonstrate profitability, MFIs like Banco Sol in Bolivia and ACLEDA in Cambodia took the next step, transforming from charitable NGOs into commercial banks. Access to deposits and attracting commercial investors resulted in explosive growth.

Developing a supporting ecosystem and institutional capacity

While demonstrating profitability was a necessary condition for engaging new sources of funding, many other pieces needed to come together to form the ecosystem of infrastructure to support investors looking for return on capital as distinct from donors providing outright grants or with a high tolerance for and expectation of loss. Much of this ecosystem was supported or encouraged by donors. Key components were:

- Standardized financial performance metrics;
- Longitudinal databases and peer group analysis;
- Specialized institutional rating agencies with trained analysts;
- Training of human resources, particularly the development of managerial talent;
- The emergence of supervisory and regulatory frameworks that would allow MFIs to take on shareholder structures and in some cases, access public deposits;
- Industry associations and collaboration networks at both national and international levels;
- Persistent outreach and education of new investors;
- The creation and maturation of specialized commercial investment managers and microfinance investment vehicles (MIVs) that could underwrite and monitor diversified pools of microfinance assets, enabling channeling large volumes of investments into MFIs; and
- Even creation of a facility to offer hedging services for microfinance investment funds and others providing loans to MFIs in local currencies.

²² Symbiotics, 2017.

This complex support ecosystem for microfinance, painstakingly put in place and supported by substantial donor funding, succeeded in promoting industry transparency and establishing and spreading best practices. Experimentation and demonstration were central. For example, ProFund, launched in 1995, was the first private, profit-seeking venture capital fund that exclusively targeted microfinance.²³ ProFund proved private investment in commercial MFIs could be profitable over the long haul. Before then, in the 1990s, the sector had no commercial investment track record. Most of the sector's funding came from non-profit, government, or similar development-related sources with social missions.

Looking to fill that gap, ProFund sought to demonstrate to others that providing financial services to the poor could not only sustainably pay for itself but return a profit. The main original sponsors were the non-profit Accion International, two private foundations (Calmeadow of Canada and FUNDES of Switzerland) and the French social business SIDI—in other words, subsidized, patient, impact investment capital. Other socially-oriented investors soon joined. Through investment and advising, ProFund fostered numerous high-profile successes, demonstrating profit and commercial potential via several different mechanisms: transformations from NGOs to banks; public-private partnerships (e.g. MiBanco in Peru); commercial down-scaling of mainstream banks into microfinance (e.g. Sogesol in Haiti); and even public stock offerings (e.g. Compartamos in Mexico). When ProFund liquidated after 10 years, as planned, it generated an 6% average annual return for its investors, especially notable given political instability and currency volatility in Latin America during the period. More importantly, the demonstration effect clearly worked. Within a year after ProFund closed in 2005, at least 20 other private microfinance funds were actively investing in Latin American microfinance.

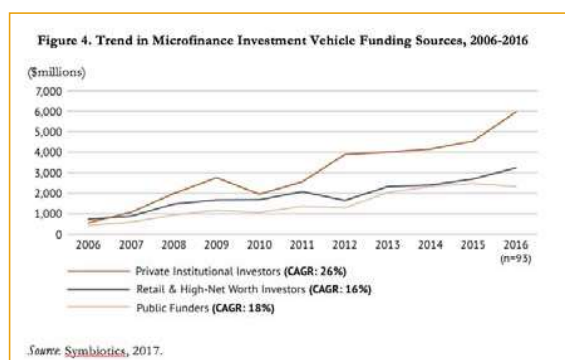
Cracking mainstream international capital markets

The result of such pioneering proof of concept efforts in the 1990s was an explosion in the 2000s of managers and vehicles seeking to intermediate private investment in microfinance. The most recent (Symbiotics 2017) report surveyed 93 MIVs with a combined market size estimated at \$12.6 billion out of a total estimated asset base of \$13.5 billion.²⁴ The market size has more than quintupled since 2006, representing a compounded growth rate of 20% for total assets and 22% for microfinance portfolio. Debt represents the majority of the investments (82%), with equity at 16%. By the end of 2016, more than half (58%) of total MIV investment had gone to the largest MFIs, those with more than \$100 million in assets.²⁵

In terms of sources of funding, while early investments were largely from public, development-related sources, commercial interests now dominate. As of December 2016, private institutional investors financed 52% of MIVs' capital while public funders contributed 20%. Financing from institutional

investors has grown the fastest since 2006 at a rate of 26% annually (Figure 4).

As many managers established a track record, and more data accumulated on loss rates, exits, and secondary market liquidity, purely mainstream investors increasingly turned their attention to the sector. Commercial MFIs can now access mainstream international capital markets through all the usual international financial channels, such as corporate debt issues, and both private and public equity financing. Global banks now make substantial microfinance investments directly themselves, with acquisitions and mergers accelerating, and global investment firms provide services helping MFIs issue debt and sell shares. More than a dozen MFIs have now had IPOs, some (e.g. Compartamos Banco, SKS, Equity Bank, Equitas Holding, Ujjivan Financial) establishing shareholder valuations in the billions of dollars.



In short, the top tier MFIs have full access to international financial tools. As in any industry, only the most successful firms with long term growth potential can climb into that rarified tier, attractive to global capital markets. Inevitably, many firms never achieve track records attractive to purely commercial investors. But the top MFI performers have.

The debate over social impact

At its initial stages when most MFIs were NGOs, the emphasis of MFIs and the sector at large was on poverty alleviation and on social impact. Over the decades, as many MFIs transformed to become commercialized institutions with external investors, there was much more emphasis on operational performance and financial sustainability. Commercialization fueled a schism in the sector, with Muhammad Yunus, for example, criticizing the high interest rates charged to poor clients and the focus on profitability for wealthy investors. This split was openly debated when Compartamos launched its IPO. Its high interest rates and return on assets and equity were publicly disclosed and the

²³ This paragraph draws on Oberdorf, 2006.

²⁴ Robinson (2001) argues that poverty intervention requires an array of support mechanism and that loans are inappropriate for those in most abject poverty. Muhammad Yunus, on the other hand, has argued that microfinance should serve the poorest of the poor. Indeed, as chairman of CGAP's Advisory Board, he pushed to have CGAP named the Consultative Group to Serve the Poorest of the Poor. Other advisory board members generally advised against this name change, as did management.

²⁵ The global Smart Campaign is committed to embedding client protection practices into the institutional culture and operations of the financial inclusion industry. Since 2009, the Campaign has certified more than 80 global institutions in Client Protection and worked with industry leaders to amplify the importance placed on "doing no harm." For information on their Client Voice Project, see <http://smartcampaign.org/tools-resources/1075>.

founders and early investors, such as the non-profit Accion International and the World Bank's International Finance Corporation, reaped substantial rewards from modest financial investments in the institution.

Perhaps the strongest argument of proponents who believe microfinance is working is that hundreds of millions of clients are voting with their feet, suggesting they value MFI services. Whether or not it helps large fractions of them escape poverty remains an open question. In recent years, the work of leading academic researchers has called into question the role of microfinance in alleviating poverty. At best their research seemed to suggest that, for the majority of clients, microcredit supported income smoothing and had the ability to prevent the working poor from falling into deeper poverty, but that only a minor fraction of clients saw substantial impact on various measures of their well-being. This research largely focused narrowly on microcredit, not microfinance more broadly. The literature is thinner on microsavings or microinsurance. Yet many commercialized MFIs now offer microsavings services, often together with microinsurance and other services, most often built on the infrastructure made possible by scaling microcredit. Microsavings is recognized by practitioners as being as or more important as microcredit for MFI clients, and so far, the limited academic evidence generally supports that conviction. Nevertheless, the lack of clear evidence of impact on poverty reduction has contributed to dampening enthusiasm from a number of investors, donors and development finance institutions, who now conceive financial inclusion investment opportunities more broadly.

Similarly, detrimental to the sector's attractiveness to some investors, individual country crises have suggested that MFIs risked over-lending, some clients falling deeply into debt and inextricable arrears. In addition, prevailing high interest rates rationalized by the need to be sustainable, has led many external analysts to question the commitment of commercial MFIs to their social missions. While knowledgeable insiders recognize that microcredit on its own cannot eradicate poverty, nor serve the very poorest who need comprehensive forms of poverty intervention, most would argue that together with other areas of support—education, health care, sustainable agriculture, infrastructure—microfinance and MFIs can significantly contribute to poverty alleviation.²⁶ This suggests that, as discussed below, MFIs should, to the extent they are capable, continue to offer increasingly diverse arrays of financial services to their clients and continue innovating, seeking ways to deepen their impact.

"Microfinance is like an aspirin. It helps soothe the aches, but by itself it can't solve the underlying chronic causes of poverty."

- Alex Silva

In part as a result of these concerns about social impact, the microfinance industry itself has taken social impact and attention to clients ever more seriously. In the last decade, focus groups and other methods such as financial diaries and the Smart Campaign's Client Voice Project,²⁷ together with standardized indicators and transparent reporting like the Social Performance Task Force and MIX Market have helped measure, track and report the social performance of MFIs. MFIs' boards of directors and senior management are creating specialized impact departments and bringing in external advisers to assist in developing social impact goals, analyzing performance, and strategizing to enhance future impact. It is increasingly clear that MFIs recognize the need to continuously and convincingly demonstrate that they are meeting social missions and benefiting clients.

The challenges ahead

The broad arc outlined above of microfinance's development is more or less settled history among industry participants; there is little disagreement on the very substantial accomplishments and successes of microfinance, as well as where it has, so far, fallen short. There is also general agreement on the critical success factors. Beyond this general consensus, the Lehigh discussion surfaced key issues facing microfinance—and by implication impact investing. What is required to build on microfinance's accomplishments to date, to preserve a balance between financial and social priorities, and to make meaningful contributions to meeting the SDGs?

Product diversification

Even as MFIs have commercialized and scaled, product diversification remains the siren call of future growth and profitability, and it is widely acknowledged that a wider array of services is beneficial to clients. As evidence accumulates that savings, insurance, and remittances have impact—greater than the traditional core credit product—on the lives and well-being of poor families, many MFIs have expanded beyond credit. But often motivated by social value to clients, MFIs have struggled to make these services remunerative and scalable enough to satisfy more-commercial investors. In some cases, more remunerative larger-scale lending to somewhat larger enterprises, SME lending, is gaining ground, in part with hopes of higher impact on economic growth and job creation. Overall, the long-anticipated diversification of product offerings for core clients has, for the most part, been sluggish. Though product line data is scarce, services beyond working capital loans and savings products appear to remain a small portion of the portfolios of most large MFIs.

²⁶ Robinson (2001) argues that poverty intervention requires an array of support mechanism and that loans are inappropriate for those in most abject poverty. Muhammad Yunus, on the other hand, has argued that microfinance should serve the poorest of the poor. Indeed, as chairman of CGAP's Advisory Board, he pushed to have CGAP named the Consultative Group to Serve the Poorest of the Poor. Other advisory board members generally advised against this name change, as did management.

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Among the difficulties in adding new products are: (i) the ability of MFI management and boards of directors to adequately assess the risks of new products; (ii) the ability of MFIs to re-calibrate compensation incentives for their staff—for instance branch loan officers are most often compensated in part on an incentive basis, and calibrating the incentives to have loan officers and branch⁷⁴ managers promote new products has proven difficult; (iii) the availability of medium-term capital to avoid excessive maturity mismatches while ramping up longer-term products; and (iv) challenges of training staff to manage the new products. For example, loan officers who are accustomed to providing short-term, character-based, working capital loans with little or no collateral, might now need to provide medium-term small enterprise loans with combinations of fixed and variable collateral (i.e. dynamic assets such as rotating inventories).

“Large MFIs are ill-equipped to broaden services too widely; they have been doing cookie-cutter loans for so long and are so good at it.”

- Ira Lieberman

At a strategic level, boards and management, saddled with pressing problems of profitability brought about competition and a changing enabling environment, have difficulty in taking a long-term perspective with respect to profitability. New products, while in the long term a possible response to competitive pressures, in the short term require investment and normally have lower margins, with net income benefit only in the long term.

Non-financial services

MFIs' competence in offering working capital loans and general purpose loans is indisputable. And while progress may be slower than hoped in offering other financial services, there is also little dispute that as MFIs are able, this is a natural and constructive extension of their relationship with their clients. More controversial is the possibility of using the microfinance infrastructure to deliver other, non-financial products. Certainly, the poor need education, health care, water for drinking and irrigation, roofs, and electricity at least as urgently, and probably more so, than financial services. MFIs have advantages in accessing the poor, understanding their needs, and serving as distributors. And for now, there is no other sustainable infrastructure that reaches the hundreds of millions of families that microfinance institutions already serve.

But is the logical step to use MFIs to deliver at least some of these additional services? Should MFIs stick to what they know best? Or, should they utilize their platforms and high-touch understanding of diverse client needs to deliver the much-needed expanded offerings and increase access to other types of services? Must investors seeking real innovation in these other areas focus on building entirely new infrastructures,

perhaps utilizing new technologies not available during the development phase of microfinance, to deliver such services to transform the lives of poor people and address global challenges? Or might it be better to leverage MFIs' experience and infrastructure?

Through many decades of investment and governance-strengthening support by donors, social investors and other sources of patient risk capital, MFIs have evolved into well-run, professional institutions that employ tens of thousands of people often from the same demographics as the clients they are looking to serve. In particular, microfinance uniquely provides last-mile distribution to reach rural areas and remote clients. The urgency to achieve the SDGs and the lack of alternatives to get there create a powerful argument for using the MFI infrastructure to facilitate, if not directly provide, other services. In this view, MFIs would re-embrace their social mission roots and focus on client outcomes, rather than on specific products or business models. The narrow emphasis on efficiency and cost-cutting, though useful for scale and lowering prices to increase access, is not what stimulates evolution and innovation. Rather, innovation comes via prioritizing R&D, investing in staff to explore and execute new ideas, making use of proven distribution systems, and building on the social capital that MFIs have long nurtured.

There is an equally compelling view—stemming from serious doubts that MFIs can succeed as impact players outside of their core microlending and savings businesses—that MFIs should stay in their lane, instead using a networked approach and teaming with organizations with complementary competencies.

Although consensus between these alternative visions remains elusive, some examples give hope that MFIs can remain innovation leaders in expanding access to services well beyond their traditional core. Turning first to innovations widening BOP financial services:

- Equity Bank in Kenya has made significant moves into education, e.g. loans for capital improvement and equipment for schools, handling payroll for teachers, and special savings accounts for parents who need to pay school fees.
- Also in education, HEFF is a higher-education-specific investment fund managed by OMTRIX, Inc. in Costa Rica. It has financed MFIs throughout Central and South America to develop higher education loans for students. Even though a number of the portfolio's MFIs were quite substantial and sophisticated, HEFF nevertheless needed to provide significant technical assistance to the MFIs on how to nurture education-focused product development, marketing groups and product launches.
- Caspian Impact Investment Advisers, a private impact fund manager focused on socially responsible businesses in India, helped develop the nascent affordable housing market in India by making investments in affordable housing providers as well as supporting the microfinance institutions in their portfolio, like Equitas Holding (now Equitas Small Finance Bank) and Ujjivan Financial to expand into housing loans.
- Pamiga Association, which provides technical assistance and

financing to a network of 15 rural MFIs in East and West Africa, has over the last couple of years offered loans to MFIs in its network for solar energy and irrigation products. It has rapidly become clear that to do so successfully also requires offering SME financing to enterprises that can go the “last mile” and install, maintain and offer installment payment systems (pay-go) to their clients.

Turning to examples beyond financial services:

- BRAC in Bangladesh offers a wide array of client services, run as stand-alone businesses separate from their huge microfinance business. BRAC operates, among other services, thousands of primary schools for girls, a (stock-exchange listed) bank targeting small businesses, and advisory services for entrepreneurs.
- High-touch MFIs also have a significant advantage as last mile delivery channels for complementary services like health services. Pro Mujer in Latin America offers health care screening, health education, dental care, and other health care assistance, largely subsidized by their MFI operations. Pro Mujer did half a million chronic illness screenings for clients in the same locations they go for microfinance services, eliminating separate trips and waiting times.²⁸
- Leveraging MFIs’ delivery channels too, Kenya’s impact-venture-capital-backed BURN Manufacturing partners with MFIs to finance and distribute cookstoves that save poor clients hundreds of dollars annually in charcoal, improve their health, and cut carbon emissions.

There clearly is no one way to address product diversification. Care must be taken to determine where MFIs can be directly involved and where they need to step aside and facilitate engagement by other partners. For the foreseeable future, though, it seems that well-managed MFIs are well and often uniquely placed to offer or facilitate attractive and effective channels for reaching clients who need more diverse services. *That said, the historic pathway to microfinance’s current success also suggests that for those additional services to reach sustainability at scale—whether through MFIs or not—will similarly take time and patient risk capital for experimentation, for identification of best practices, and for widening infrastructures and staff, managerial, and board skill sets.*

Fintech

Of all the innovations roiling the microfinance community, the rapid emergence of fintech—varying combinations of mobile money, data mining, and algorithmic underwriting—probably results in the most strategic-level angst about competitive threats and new opportunities. Digital financial services reduce costs by innovating around the need for face to face interaction, reduce risk via data and algorithms, and increase outreach by saying yes to more potential clients with customized, individually tailored product design and delivery. The fintech threats and opportunities vary by region: most prevalent in parts of Africa, less so in most of Asia, least of all (for better or worse) in Latin America. But regardless of how imminent the

threat or opportunity is perceived to be, management and boards at every MFI face the need to decide how to incorporate at least some elements of fintech into their operations.

Microfinance has decades of success growing and strengthening a high-touch business model. As growth slows, should MFIs now abandon that approach and use high-tech to go low-touch for cost efficiency? If MFIs stay their course, will they be overtaken by new entrants with new models, like Chinese online peer-to-peer lender Yirendai, which had an IPO on the New York Stock exchange last year? Or instead, will MFIs find innovative high-tech ways to further leverage their deep relationships with clients and understanding of client needs?

“The future of finance in Africa will be based on high-tech, high touch. We don’t need tens of thousands of loan officers doing administrative work or group lending. We can transform the nature of the relationships into more knowledge-based relationships, enabling clients to grow and get out of subsistence.”

-Renée Chao-Beroff

Sticking with core competencies is often sound strategy. Has anyone yet seen a scalable, investible, high-tech, and high-touch financial inclusion innovation? Mobile payments networks like M-Pesa in Kenya and BiM in Peru are high-tech, but decidedly low-touch delivery channels. Low-touch too are big data algorithms like those of Yirendai and its corporate parent CreditEase used for automated credit scoring and risk management. However, as digital financial technologies like these mature, will BOP financial customers still need high-touch MFIs? As fintech-driven models become more sophisticated, can MFIs hope to deliver anything that technology sophisticated telecoms and global commercial banks cannot?

MFIs, clients, and even global banks themselves demonstrably think the answer is Yes. Most practitioners, while seeing the competitive threats from fintech, are rapidly appreciating how carefully selected and implemented elements can enable them to extend reach, reduce costs and prices, improve and deepen client services, and improve risk management.



²⁸
Pro Mujer, 2015.

"You need proximity to understand clients' needs and demands: for an appreciation of the heterogeneity of poor clients which may not show up in big data, to avoid exclusion because the client does not fit a given statistical profile or lack of connectivity, and to build long-term relationships that align client incentives with the goals of the institution."

-Claudio Gonzalez-Vega

One example of how fintech is being implemented aggressively to enhance high touch microfinance services comes from the large Spanish multinational bank BBVA, which is bringing the technical depth of the global bank to bear in the microfinance segment. The bank, through the BBVA Foundation, acquired and consolidated a number of MFIs in Peru and in the Dominican Republic. BBVA is just one of many global banks actively seeking growth opportunities by going "down-market" into microfinance, in the process blurring the lines between microfinance and mainstream banking. Recognizing that as a global bank they have limited understanding of BOP client needs—and that, as the Chair of the BBVA Foundation at the Lehigh event put it, "relationships matter"—BBVA keeps their microfinance group administratively separate.

BBVA have made a major push to bring handheld mobile connectivity, big data algorithms, and split-second automation to roving microfinance field officers for use during meetings with clients. One key aim is to enable hyper-personalized product design, instantly tailored to widely diverse needs and situations of individual clients and their families. The vision: technology as a complement to high-touch relationships, not a substitute. The goal is to use both technology and the relationship to deliver greater value to the client—improving financial literacy, building a financial life beyond credit, providing investment and business-strengthening advice, and pointing the client towards relevant non-financial services like health, agriculture extension, or business planning.

"How do you maintain focus on the client regardless of delivery channel?"

-Candace Smith

Clients, voting with their feet and wallets, also clearly value high-touch. A recent study by the MIX on alternative financial services delivery channels found that even where technology, like mobile banking and ATMs, had expanded clients' access to financial services, the fraction of active clients actually using those services is below 10 percent.²⁹ It appears that people prefer dealing with people. Clients use banking agents—often non-staff individuals under contract in their communities—more than any other alternative delivery channel. And it's a virtuous cycle: agents create the largest number of new

touchpoints that become available to clients. In part, this reflects the fact that fully automated transactions are a blunt instrument: ATMs are great at dispensing cash, but not so good at answering questions or responding to individual circumstances.

Similarly, indicative, the same study found that the value of client transactions at physical branches remains 30 to 60 times greater than at any other kind of point of service. High-tech may facilitate routine tiny transactions, lubricating the cash flows of daily life, but can't substitute for client preferences for high-touch on big-ticket transactions. Designing and creating superior options for these latter big-ticket needs—saving for weddings and school fees, enabling microenterprise capital investments, weathering long illnesses, paying for funerals and solar lamps—is fundamentally at the core of microfinance's value to the poor.

"Fintech can increase risk. Lower operating costs make it feasible to absorb write-offs from high rates of over-indebtedness. But write-offs lead to bad credit histories for clients, which will lead to blacklisting and financial exclusion."

-Alex Silva

An important related area of concern centers on the potential for fintech to exacerbate the digital divide. Cheap 2G/SMS mobile phone services are very widespread, and mobile payments are already ubiquitous in some places. Yet it is also clear, as detailed recently by Leon Perlman, a Fellow at the Center for Financial Inclusion at Accion, that the infrastructure needed for smart phone based (and hence more elaborate) digital financial services is not so well established.³⁰ Deep penetration of smart phones or reliable broadband internet remain a long way off for most of the world's poor. In this context, it is well worth noting that compared to disruptive but infrastructure-reliant low-touch fintech entrants, MFIs are much better positioned to deliver high-tech services while mitigating the digital divide. Yirendai's automated credit decisions scour the web and other sources to dig up information to score borrowers and enable direct peer-to-peer transactions, but they require ample digital footprints and robust digital access on both sides. They also need good data on clients that may not be available in many of the areas served by MFIs. Kiva's main quasi-peer-to-peer lending model still relies on MFI relationships with clients. As some observers have noted, when the digital footprint is light, as is often the case with BOP clients, one-size-fits-all alternative underwriting results in collateral damage with a high incidence of borrowers blacklisted after failing to repay a small "tester" loan.³¹

²⁹ Navarro and Stephens, 2017.

³⁰ Perlman, 2017.

³¹ Wright, 2017.

Most importantly, long-term proximity to clients affords MFIs a window into the lives, needs, and dreams of the hundreds of millions of poor individuals they serve. Without that understanding, better designed, more tailored, higher impact products and services won't come, no matter the technology. Commodity products will always drive fintech, but also can exclude as much as include. Microfinance first succeeded by devoting decades to exploring ways to deliver credit with a priority on inclusion.

"If you're not moving, you're dying. Pursuing alternative banking channels that are powered by fintech, such as agency and mobile banking, doesn't mean you close the branch office. The branch evolves to serve different purpose: perhaps it's where clients go for financial advice."

- Ami Dalal

Despite broad agreement on the potential of fintech in microfinance and financial inclusion, there is significant unease about many MFIs' abilities to effectively embrace it. Exploiting fintech opportunities will not come easy, but MFIs that fail to search for a viable combination risk succumbing to nimbler competitors, or at minimum, will offer their clients suboptimal, lower impact services.

What MFIs need moving forward is to ensure that budgets, innovation management skills, staff recruiting and training systems, and supply chains are all up to the task. MFI leaders and governance boards need to be fully on-board about the strategic imperatives of fintech, and knowledgeable enough to drive tech-embracing changes. In an era where the majority of capital in microfinance is coming from commercial investors mainly focused on financial returns, a big question remains, however, about whether commercial or social impact investors alike—tempted by new entrants offering price-competitive "unbundled" products—will see their way to funding the experimentation, infrastructure, and institutional capacity-building needed. All three critical actors—management, directors, investors—must be deliberate in thinking through how double bottom line MFI business models can uniquely deliver value to clients.

"Product innovators can't be incumbents. MFIs are not the right channel to reach remaining underserved; we need disruptive technologies to deliver microfinance with different economics."

- Michael Chu

Innovation and Incumbency

Implicit in the discussions about fintech is the more fundamental question: have MFIs exhausted their innovative potential? Particularly given the disruptive forces being unleashed by the proliferation of smart phones, big data and mobile money, have MFIs reached the end of their natural lifespan and would they best serve their clients by stepping aside and allow more resources to flow into more innovative business models? Can disruptive innovators ever be incumbents?

It took decades of iteration and experience for leading MFIs to scale and achieve operational sustainability with their low-tech, high-touch model. Committing to high-tech introduces an entirely different set of skill requirements and partners for MFIs, and undoubtedly will bring a host of unforeseen new problems to overcome. Yet given the pace at which new entrants are flocking into BOP financial services—thanks to MFIs proving the profit potential—MFIs do not have the luxury of decades to work out kinks this time around.

Skepticism over the future of microfinance and financial inclusion reflects doubts that today's leading incumbent MFIs—once the disruptive innovators themselves—can ever generate disruptive forces of the magnitude needed to make meaningful progress towards achieving objectives as ambitious as the SDGs.

There are arguments on both sides. In Bangladesh incumbency seems to have bred stasis and complacency. Across the border in India incumbents are rapidly innovating, with leading MFIs moving aggressively into long-standing gaps in housing, vehicle, SME, and agriculture financing.

The future of microfinance and financial inclusion, and the challenge for those who prioritize social value for clients, is in taking advantage of the strengths of incumbent MFIs, particularly their four-decades-deep hard-earned understanding of heterogeneous client needs at the BOP. As donor and impact investor attention is captured by new frontiers—health care, budget schools, smallholder agriculture, off-grid energy—realizing the value of this experience going forward faces two challenges.

"If you do want to see the microfinance institutions innovate, in ways that are socially good for the customers, the banks won't provide that financing—you have to have impact investors who are structuring their investments to drive innovation."

- Timothy Ogden

First, microfinance must convincingly deliver to investors the often unwelcome message that MFIs—professionally governed, managed and staffed, with reliable access to capital markets, diversified product offerings, and unique penetration at the BOP—offer the best available platform to design, test and in many cases, deliver—directly or as orchestrator—products and services to create social value. Even where new channels or specialized institutions can be effective, as in the case of mobile money or housing finance, new entrants will need to learn how to fit narrow product expertise into the complex and sophisticated financial lives of poor people, much as microfinance needed to learn that clients need more than a three-month group loan with weekly repayments.

Second, while the bulk of microfinance portfolios may be fully commercially sustainable and attractive to conventional investors or lenders, innovation and experimentation to reach the still excluded or to broaden portfolios of services will continue to require patient, mission-aligned investors and grant subsidy or below market financing—the model that fertilized microfinance to begin with.

Subsidy and patient capital

Subsidies are commonly seen as anathema to “investing.” Yet, more than the success of microfinance on purely commercial terms, the central and essential role of subsidy (i.e. patient capital, the oft-preferred euphemism)—not for market-distorting price reductions, but rather for innovation, infrastructure and capacity building—is the salient takeaway from microfinance for newer social business model innovators and their investors. Investors need to maintain the discipline to fuel the same sort of long-view nurturing that brought microfinance not only to the forefront of impact investing but also now to the commercial mainstream.

“We see our role as pushing capital into places where it won’t otherwise go, or won’t go in the required amounts.”

- Roland Dominice

The Lehigh discussion confirmed continued diversity of views on microfinance’s relationship with subsidy and patient capital going forward. There is general agreement that certain types of subsidy are in principle harmful, such as interest rate subsidies or support that keeps inefficient MFIs on prolonged life support. So too, there is a compelling logic in the notion that continuing subsidies to large-scale, profitable, commercial investment-worthy microcredit operations is not necessary because top tier MFIs can access mainstream capital markets. However, there is disagreement on how reliant even the most-commercial MFIs continue to be on subsidy, with one recent study asserting that substantial, albeit cost-efficient,

subsidy continues, largely in the less visible form of below market rates of return on investments.³² Nevertheless, many in the microfinance community acknowledge, more or less publicly, that continued subsidy is necessary to ensure a continued commitment to poorer and more inaccessible clients and continued innovation to improve outreach and impact. Subsidies will in most cases be necessary to incubate deeper and wider product offerings until they become sustainable and to demonstrate attractiveness to commercial investors.

If investors and donors push to expand beyond alternative energy and microfinance into education, health care, housing, or agricultural value chains, they will need viable institutions with adequate capacity to do so. A main lesson from microfinance is that one way to build such capacity is through targeted subsidies. For those MFIs with the institutional capacity and financial sustainability to get there, targeted donor and impact investor subsidies for technical assistance to expand infrastructure and skills within the MFIs make good sense. The sophisticated microfinance business models have a proven track record at innovating and an unparalleled understanding of the needs of the poor and disenfranchised populations they have been serving.

A corollary lesson for both commercial and impact investors is to recognize the need for a blend of capital reflected in governing bodies and a progression of investment vehicles in order to preserve the social-financial double bottom line character of impact investments and to ensure that pro-poor innovation remains a priority. The commercial microfinance opportunities available today only exist because the progression existed and the financial/social balance was largely maintained.

Life after “all investments are Impact Investments”

Given all the preceding discussion, it is jolting that among the broadest of all takeaways from the Lehigh workshop was a developing consensus that “impact investing” and microfinance are parting ways. On the one hand, many self-proclaimed impact investors do not consider microfinance a true impact investment, in large part because of the critical role that subsidy played in its evolution. On the other hand, impact investing cheerleaders predict that someday soon, all investing will be impact investing! Many microfinance practitioners and MIV managers have come to feel that the very term “impact” is now a source of confusion and causes more harm than good. How did we come to this and what can we continue to nurture the essential community of double bottom line investors despite the baggage?

³² Cull, Demirgüç-Kunt, and Morduch, 2016.

Discussion of impact investing has grown increasingly active. There's a conference nearly every week. Several weekly clipping services—even a daily one—share news of the latest impact investments and conversions. The tenor of the discussions often seem to drift toward hype: the convictions that, someday soon, all investing will be impact investing, that the entry into impact investing of large-scale asset owners and mainstream global financial firms is good, and that, in the words of the GIIN's Amit Bouri, "every investment has an impact."³³

Simultaneously, however, questions persist about whether microfinance should be disqualified as an impact investment, either because of its non-profit origins—common wisdom is that subsidies and "investing" do not mix—or because randomized controlled trials find that the average benefit to clients of microcredit is modest. Even so, microfinance and its sister, financial inclusion, remain year in, year out as the largest impact sectors in annual investor surveys. But if microfinance is not impact investing, what is?

The term "impact investing" has achieved its financial industry apotheosis: it means whatever we need it to mean to market new products. And indeed, the discussion at the Lehigh workshop largely acknowledged that given the multiple dimensions of impact, impact investing is whatever an investor thinks it is. But the conclusion that followed was not that the activity the term purports to encompass has consolidated into an important position in the investment world, but rather that it has outlived its usefulness. It is time to jettison the term and in its place require more specificity, rigor and accountability from investors and entrepreneurs.

Must impact investments improve the lives and prospects of the poor? Or can activities that have no deliberate targeting of the poor, like renewables in rich countries or organic baby food, qualify? Do higher-than-market financial returns—or perhaps even market-average financial returns—disqualify a company as a target for impact investors? Does any company automatically qualify if it provides products and services that poor or marginalized people voluntarily acquire? Does an impact business model—like microfinance's—that achieves commercial success and reliable access to conventional capital lose its impact label? Are impact companies only those that require non-commercial impulses—eternal subsidy or heartstring tugging photos—to push capital their way?

The argument to move beyond the "impact" label rests on the largely unremarked fact that "impact" is no longer a matter of faith or of good intentions. Rather, microfinance's four decades of experience and research have tested the efficacy of specific business models, products and services in achieving not only financial goals, but also non-financial goals: better school attendance, better health, greater productivity. So too, much progress has been made in collecting data, setting conventions, and benchmarking performance with respect to non-financial value. Just maybe, the multiple dimensions of what we too often nebulously refer to as social impact can be more concretely mapped.

The filter that separates microfinance and all impact businesses from other investments is a demanding standard of specific, concrete information: what kind of non-financial value is being created and for whom? From this perspective, the holy grail of impact metrics—measures that will enable us to rank the impact of budget schools, working capital loans, health screening, and off-grid energy on a common scale—is an unnecessary distraction. Instead, impact is indeed whatever investors say it is, but with an important condition: investors have to say what they intend in terms of non-financial results, subject to the same scrutiny and third-party validation as their financial statements.³⁴

With non-financial objectives specified, and research in hand, investors can decide for themselves what they consider impact: more low-income finance? increased school attendance by girls? less carbon emissions? job creation? savings?

To proceed along these lines, two sorts of standards will be useful. First, investors and donors seeking impact need to commit to using some sort of widely-trusted, external, third-party "anti-hypocrisy" screen, like the Global Impact Investing Rating System (GIIRS)³⁵, that scrutinizes a company's human resource, supply chain, environmental, and community practices to ensure the company isn't making the world better by exploiting its workers or ravaging its community. Second, investors should demand a corporate structure, like the Public Benefit Corporation³⁶ in the U.S., that discourage a company from abandoning its non-financial objectives once it achieves commercial viability thanks to the impact subsidy it enjoyed. Unless impact investing means more than simply investing in general, in its embrace of everything it becomes nothing.

As microfinance evolves and broadens to financial inclusion, it continues to lead the way in its double bottom line dedication not only to scale, efficiency and financial returns, but also to pushing the boundaries of social impact measurement, assessment, and transparency. In this, microfinance simultaneously continues to well-earn not only its place as impact investors' top destination, but also its attractiveness in mainstream commercial finance.



³³ Bouri, 2017. (Bouri 2017)

³⁴ See, for example, the discussion in World Economic Forum, 2013; and also the Impact Management Project (impactmanagementproject.com).

³⁵ For details on GIIRS, see Richardson, 2012.

³⁶ <http://benefitcorp.net/businesses/benefit-corporations-and-certified-b-corps>

WHERE DO WE GO FROM HERE?

The microfinance community can recognize -- and should be recognized -- for a path-breaking success: developing and mainstreaming a scalable and investable double bottom line business model focused on the BOP, an accomplishment to date has yet to be replicated. As a victim of its own success, it faces challenges: disruptive business models and the drag of incumbency, the cynicism engendered by greenwashing and co-optation. In some ways, this is potentially a golden age for microfinance, with enthusiasm and expertise of diverse types—product innovation, operations, governance, IT, capital markets, sector specialists, academics—galvanized by the SDG framework. Within the SDG landscape, microfinance, with its unique 40 year track record of trial, error and demonstrable success, can play an important role as a touchstone to guide the emergence of new impact business models in new sectors, steepening the learning curve and sidestepping pitfalls and dead-ends.

But there is a real risk that the opportunity offered by this golden age will be squandered. To be realized, three tasks should be addressed:

1. For microfinance, examples of successful “high-tech/high-touch” models that efficiently meet client needs and create appreciable social and financial value should be documented and disseminated. MFIs currently enjoy the advantages of incumbency and an unequalled penetration of the BOP with solid, trusted relationships, but this will not last.

2. Also for microfinance, clear guideposts should be shared on how to best use its infrastructure, market knowledge and relationships to optimize the delivery of the financial and non-financial products and services that can best advance the SDGs. MFIs cannot cannibalize their core business models to deliver sub-standard non-financial products. But neither can they under-utilize their unique networks and relationships.

3. The precondition for either of these objectives, and indeed for advances in other impact business models, is the disciplined maturation of the impact investing community. The sterile debate about what impact is and who gets to judge can be left behind. In its place should be clear threshold requirements for articulating what social value the business model aims to create, for whom, and what metrics will be used to hold management accountable for delivering. Investors can then select what dimension of social value they wish to support—hopefully many will fit within the SDG framework—and what financial/social double bottom line investment proposition they target. So long as they use a screen like GIIRS to weed out greenwashers, this approach can free us all from the unrewarding debates and enable focus on the urgent and existential challenges that confront our world.

During the balance of 2017, a working group of the Lehigh gathering will reach out to organizations already working on the key initiatives to offer support and input and help to develop and disseminate information and approaches that can help advance these urgent efforts rapidly in the small window of opportunity that exists.

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APPENDIX: ATTENDEES

Participant	Organization
Mark Degenhart	Accenture
Mercedes Canalda de Beras-Goico	Banco ADOPEM
Claudio Gonzalez-Vega	BBVA Microfinance Foundation and Ohio State University
Colin Sloand	BlackIvy Group
Alex Silva	Calmeadow
Georgina Vasquez	Calmeadow
Amie Patel	Elevar Equity
Anne Contreras	European Microfinance Platform
Timothy Ogden	Financial Access Initiative at NYU
Deborah Drake	Financial Inclusion Equity Council
Ami Dalal	FINCA
Anna Kanze	Grassroots Capital Management PBC
Steve Hollingworth	Grameen Foundation
Paul DiLeo	Grassroots Capital Management PBC
Michael Chu	Harvard Business School
Shannon Mudd	Haverford College
Momina Aijazuddin	International Finance Corporation
Jose Ruisanchez	Adviser Investment Fund for Developing Countries (IFU)
Janice Johnston Howie	Lehigh University / Martindale Center
Todd Watkins	Lehigh University, Martindale Center
Ira Lieberman	LIPAM International, Inc.
Sanjay Sinha	M-CRIL
Damian von Stauffenberg	MicroRate
Candace Smith	MicroVest
Renée Chao-Beroff	PAMIGA Association
Roland Dominicé	Symbiotics
Alison Fahey	The Abdul Latif Jameel Poverty Action Lab
Stella Dawson	World Bank
Jenifer Mudd	Independent Consultant

ADDENDUM: BLOGS AND VIDEOS ON FUTURE OF MICROFINANCE

In March 2017, a gathering of microfinance and impact business practitioners, investors and analysts was held at Lehigh University, sponsored by Lehigh's Martindale Center, the Financial Inclusion Equity Council, and Calmeadow, and organized by Grassroots Capital Management and Lipam International.

The official site for the workshop, Microfinance Industry: Revolution or Footnote? Lessons for the Next 10 Years, is: <http://cbe.lehigh.edu/centers/martindale-center/programs/microfinance-program>

WORKSHOP VIDEOS:

PANEL 1, Regional Development of Microfinance: https://youtu.be/qabO_EBU8BY

PANEL 2, Product Diversification: <https://youtu.be/ZC60IXIszEQ>

PANEL 3, New Entrants and Competitive Challenges: <https://youtu.be/p9P9XOG0bro>

PANEL 4, Financial Inclusion and Impact Investing: <https://youtu.be/tqhrv0JDSrs>

PANEL 5, Successes, Vulnerabilities and the Next Ten Years: https://youtu.be/ZmV5Ls_w2hE

POST-WORKSHOP BLOG SERIES:

"Microfinance Is Dead; Long Live Microfinance!": <https://cfi-blog.org/2017/04/20/microfinance-is-dead-long-live-microfinance/>

"Time to Ditch Impact Investing's Unproductive Self-Analysis": <https://cfi-blog.org/2017/04/27/time-to-ditch-impact-investings-unproductive-self-analysis/>

"Can MFIs Deliver What Poor People Need?": <https://cfi-blog.org/2017/05/04/can-mfis-deliver-what-poor-people-need/>

"FinTech in Microfinance: In Search of the High Tech–High Touch Unicorn": <https://cfi-blog.org/2017/05/11/fintech-in-microfinance-in-search-of-the-high-tech-high-touch-unicorn/>