The Implications of Increased Commercialization of the Microfinance Industry:

What can we learn from the discussions that followed the Compartamos IPO?

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Throughout the conceptualization and writing of this paper, we benefited from the invaluable guidance and editorial comments provided by our Advisory Committee. The membership of this committee is as follows:

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This document was produced and published in July 2008 by:

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Partial support for the production of this document was provided by the Ford Foundation

Introduction

The Compartamos IPO

Compartamos, a Mexican microfinance institution (MFI) affiliated with the ACCION network, is the largest-scale MFI in Latin America, as well as the most profitable. On April 20, 2007, Banco Compartamos completed an initial public offering (IPO) of its stock. The IPO was considered a huge success in the financial markets, and the majority of shares were purchased not by the socially-responsible investment community but rather by commercial investors and hedge fund managers.

The Compartamos IPO is one of the most significant events to happen in microfinance, arguably ranking second only to the 2006 Nobel Peace Prize to Muhammad Yunus and the Grameen Bank in drawing public attention to microfinance. It raises a number of very significant issues regarding the commercialization of microfinance and the appropriate balance between the dual goals of providing fairly priced financial services to the poor and seeking profitability for the owners of microfinance institutions. These issues motivated extensive and vibrant discussion within and beyond the microfinance industry.

What we can learn from these discussions

This extensive discussion following the IPO, although inspired by the specifics of the Compartamos event, touches on a broad range of issues bearing on the potential shift of microfinance from the social-investor world into the commercial-investor world. This paper seeks to pull together and distill the diverse arguments and positions that were articulated.

This paper is divided into two parts:

Part I provides background on the Compartamos IPO and then summarizes highlights of the industry discussion, and articles appearing in the public media.

Part II goes beyond the specifics of the Compartamos IPO, addressing the broader implications of the commercialization of microfinance.

Part II is divided into seven key questions in four main topic areas:

Profits

1. Are high profits and high interest rates consistent with social bottom line missions?
2. Can the mutually agreed upon goals of scale and sustainability be achieved without using high-profit IPOs as a means to those ends?

Organizational Structure

3. Do IPOs alter governance in such a way that it is harder to balance social and commercial objectives?

Funding and Commercialization

4. Is the industry going through a pivotal shift from a donor/non-profit focus to commercial focus?
5. What are the implications of using grant funding to generate future for-profit entities?

Supervision and Regulation

6. Are free-market forces (e.g., competition) sufficient to reduce interest rates or should the industry look at promoting codes of ethics, transparency efforts, and/or some forms of regulation?
7. What implications might high-profit commercialization have on public perceptions about microfinance and on potentially increased government regulation of the microfinance industry?

Information sources for this paper

This paper presents summarized excerpts of publicly-held discussions and public documents that took place following the IPO. The content of this paper has been structured to give all sides a fair presentation of their views.

The **Timeline of IPO Discussion** summarizes the appearance of the public documents and discussion. When news of the IPO hit the public media, discussions started immediately on MicrofinancePractice (MFP), the largest microfinance listserve discussion group. In the following months, MFP members sent over 900 emails related to the IPO and its implications. Discussion later started on the Devfinance Listserve (DFN), comprising nearly 200 emails.

This email discussion was nearly entirely from those outside of Compartamos and ACCION. To promote dialogue in the first week after the IPO, CGAP initiated a moderated email debate between a representative of the practitioner community and Compartamos; in the end Compartamos shareholders objected to the publication of the debate. CGAP subsequently published a Focus Note with extensive analysis of the IPO in June 2007.

A month later, ACCION published their InSight article and held a 1-hour webinar. Other than brief press releases, these were the first public discussions of the IPO by ACCION. Starting two months after the IPO, Compartamos and ACCION staff began participating in conferences to discuss the IPO, including the SEEP Conference in October and the Tufts Microfinance Dialogue in November. Where such events were documented, we have drawn from those sources to summarize the arguments presented.

Starting in June 2007, the public media started regular publishing of prominent articles addressing the issues and implications of the IPO. Several of these are listed in the timeline and are summarized in Part I of this document.

The sources used in this paper are listed in Annex 1, with internet links to these sources. In addition, the paper contains hyperlinks for each source used in this paper. Clicking on that hyperlink will take you to the full version of that source on the internet.

Timeline of IPO Discussion

Month 1		
	April 20	The IPO took place
	April 23	Discussion begins on MFP listserve
	April 25	CGAP-sponsored debate on Compartamos IPO begins; Compartamos shareholders later rescinded agreement to publish debate
	April 27	ACCION Press Release Applauding Compartamos on IPO
Month 2		
	June 7	CGAP releases Focus Note; ACCION announces upcoming webinar
	June 12	Portfolio.com story
	June 13	Salon.com story
	June 18	Wall Street Journal story
Month 3		
	June 27	ACCION holds 1-hour webinar; ACCION publishes InSight article on the IPO
	July 9	Business Week story
	July 12	Microcredit Summit E-news Debate
Month 4-6		
	Sep 21	PBS NOW: “Who’s making money from microcredit?”
	Oct 24	SEEP Conference Panel: “Who Benefits?”
Month 7-12		
	Nov 2	Tufts Microfinance Dialogue
	Dec 13	Business Week: The Ugly side of micro-lending
	Apr 5 2008	New York Times story

PART I: The Compartamos Initial Public Offering

Part I contains three sections:

- **Section I** gives a brief history of Compartamos leading up to the IPO.
- **Section II** provides some of the first public announcements made in the week after the IPO.
- **Section III** provides quotes from news stories that followed the IPO.

Those who are familiar with Compartamos as an institution and have followed the reports on the IPO may prefer to skip to Part II, which addresses the issues discussed following the IPO.

Section 1: History of Compartamos and lead-up to the IPO

Overview of this section

This section covers a brief history of Compartamos prior to the IPO, an overview of the financing it received since 1990, a description of the IPO process, a summary of the results of the IPO, and information on ACCION's return on its investment.

History of Compartamos

ACCION InSight, The Banco Compartamos IPO, June 2007 (page 2)

Link: publications.accion.org/micro_pubs_list.asp

Throughout the last 17 years, Compartamos, which began its credit operations in the states of Oaxaca and Chiapas, has experienced remarkable expansion and growth while attaining and then maintaining high levels of profitability. Today, Compartamos stands out as one of the best performing MFIs in the world and one of the largest in Latin America in number of clients, providing loans to over 630,000 Mexicans as of March 2007.[1] As of the end of 2006, it operated through 187 branches in 29 of the 32 Mexican States. In the view of many, Compartamos has become a world model for other microfinance institutions. Since its inception, Compartamos has mostly served women entrepreneurs largely in rural settings, with 98 percent female clients. Its clients are involved in a variety of economic activities, such as food trade, handicraft production, and farming.

After achieving financial self-sufficiency in 1997, Compartamos began the process of launching a regulated financial institution – a SOFOL (*Sociedad Financiera de Objeto Limitado)* – with a legal charter to provide working capital loans. In 2000, the NGO's microfinance operations, personnel and loan portfolio were transferred to *Financiera Compartamos S.A de C.V,* which began life with US$6 million in equity investments from IFC, ACCION Gateway Fund, Profund, Compartamos A.C. (the founding NGO) and other Mexican private investors.

Throughout the 2000-2006 period, return on

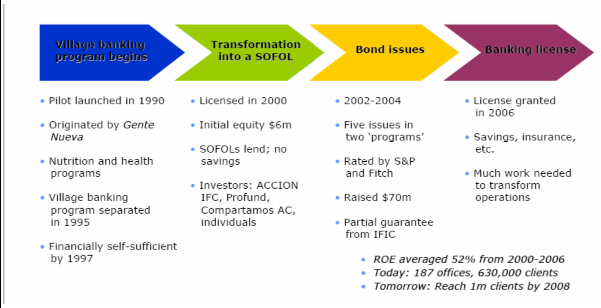


Figure 1: Evolution of Compartamos (source: ACCION

[1] There are updated figures available for the current number of clients as well as many other figures quoted in this paper. However, we have chosen to use figures as stated in the original texts quoted here rather than revising the numbers, as in some cases revised numbers may be inconsistent with other information contained in the quoted section.

equity averaged 52 percent. This rapid growth and strong profitability allowed Compartamos to begin accessing the capital markets, and in 2002, *Financiera Compartamos* issued its first US$20 million bond on the Mexican Stock Exchange. During the next several years, Compartamos raised approximately US$70 million on the bond market

The SOFOL legal structure did not allow Compartamos to capture savings. In June 2006, *Financiera Compartamos* received a commercial bank license from the Mexican Ministry of Finance and Public Credit and changed its name to *Banco Compartamos S.A., Institución de Banca Múltiple*.

Financing History

CGAP Focus Note, CGAP Reflections on the Compartamos IPO, June 2007 (page 2)

Link: www.cgap.org/p/site/c/template.rc/1.9.2440

Compartamos operated from its inception in 1990 until 2000 as a not-for-profit, nongovernmental organization (NGO). During this period, it received US$4.3 million in grants or near-grant soft loans from international development agencies and private Mexican sources. The NGO made tiny loans to poor and lower income women, mainly in rural areas. By 2000, the Compartamos NGO was reaching 60,000 borrowers. To tap commercial funds for even faster growth, the NGO and other investors set up a regulated finance company, organized as a for-profit corporation. Around that time, USAID granted $2 million to ACCION, a not-for-profit international provider of technical assistance and investment capital to MFIs. With the money, ACCION (1) provided $200,000 in technical assistance to the Compartamos NGO, (2) gave that NGO $800,000, which it used to buy stock in the new finance company, and (3) lent $1 million to the finance company as subordinated debt.

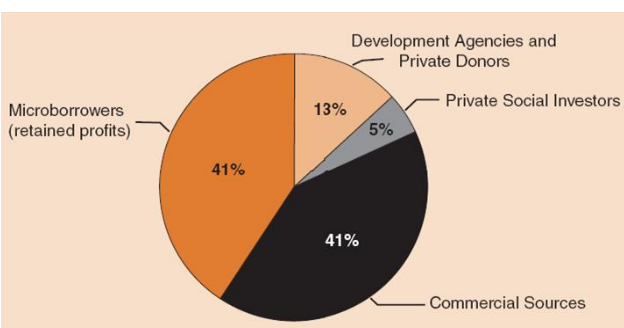


Figure 2: Source of Compartamos Assets, December 2006 (source: CGAP Focus Note)

Year	Source	Amount ($000)
1990	USAID	50
1993	IDB grant	150
1993	IDB loan (near-grant terms)	500
1995	Alfredo Harp & family	1,300
1995–98	Other private Mexicans	300
1996	CGAP	2,000
2000	USAID (to ACCION)	2,000
	Total	6,300

Figure 3: Grants and Soft Loans for Compartamos Operations (source: CGAP Focus Note)

In addition to grants and near-grants, the for-profit Compartamos finance company received over $30 million in loans from public development agencies and $15 million from private socially oriented investors. These loans were generally at market interest rates or above. Beginning in 2002, Compartamos was able to issue roughly $70 million in bonds on the Mexican securities exchange. Most of these bonds were partially guaranteed by the International Finance Corporation (IFC), which charged a fee of 2.5 percent of amounts guaranteed. In addition, the company raised about $65 million by borrowing from Mexican banks and commercial lenders. In June 2006, the finance company received a full banking license. As a bank, Compartamos is authorized to take deposits, but had not done so up to the point of the IPO in April 2007.

In addition to $6.3 million in grants to Compartamos and ACCION, there has been over $45 million in loans from development agencies and social investors to the for-profit finance company and bank. Some of these loans have had a degree of a concessional element.

The IPO Process

ACCION InSight, The Banco Compartamos IPO, June 2007 (page 7)

Link: publications.accion.org/micro_pubs_list.asp

A ten-day road show was organized in which 54 one-to-one meetings, ten conference calls, and eight open meetings were carried out in the U.S., Europe and Latin America. Throughout a road show, the underwriter receives final purchase orders from previously targeted investors who want to participate in the offering. The orders specify the amount of shares desired and the price the investor is willing to pay, which are quoted in reference to a suggested price. The process of assembling all orders is known as building the offer book. Because expressions of interest received were so much above initial expectations, the initial estimated price was increased. During the marketing period, the estimates of Compartamos' implicit market valuation were revised upward several times.

When all the orders were in, they amounted to 13 times the number of shares available for purchase. The orders might have been even higher, had the number of shares that any one buyer could obtain not been capped at 10 percent of the offer. The underwriters then allocated shares across those who made offers, taking into consideration the need to both build a suitable ownership mix and maximize the proceeds of the sale. As a result of this process, the final price was determined to be MXN 40 per share. Bidders were informed of their receipt of shares at the end of the day on April 19, 2007, and when markets opened on April 20, 2007, trading of the Compartamos shares began on the Mexican Stock Exchange.

Compartamos' share performance shortly after the IPO was strong. The price rose 32.3 percent on the first day of trading, and after two weeks it reached MXN 59.93 (approximately US$5.50) – a premium of 49.8 percent above the offering price. As of June 26, 2007, the price was MXN 63.5, giving Compartamos an implied market valuation over US$2.24 billion.[2]

As a requirement of its licensing, Banco Compartamos is not permitted to pay dividends during the first three fiscal years of operation as a bank, and it must contribute all net income from such operations to net capital reserves.

The microfinance market in which Compartamos operates remains substantially untapped. Competition, though growing, is still in its early stages, promising continued strong earnings for the next few years.

Compartamos is not the first microfinance institution to issue shares on a public stock exchange. Bank Rakyat Indonesia (2003, listed on the Jakarta, Singapore and other stock exchanges) and Equity Bank (2006, on the Nairobi Stock Exchange) preceded it. Both were very successful, but did not yield as high a return to investors as the Compartamos issue. Of the three institutions, only Compartamos originated as an MFI.

Why Was the IPO so Successful?

Bringing Microfinance to Scale, ACCION webinar, 27 June 2007, Lauren Burnhill (ACCION, SVP Financial Markets and Services), Alvaro Rodriguez (ACCION Board Chair and Compartamos Board member)

Lauren Burnhill (14:30): The 158 Qualified investment buyers (QIB) interested in purchasing IPO shares had to have US$100M under management; that means these are investment professionals who evaluate financial market and emerging market opportunities every day; they were given information on the

[2] Since June 2007, the stock price has fluctuated significantly. The values indicated here are not the current values.

offering and the initial pricing and the fact that the offering was oversubscribed and that the price paid was so healthy was a decision made by the international capital markets, not by Compartamos. One of the extraordinary things about this IPO is that over 158 of the world's leading institutional investors elected to purchase shares in Compartamos. Almost every investor that the underwriters and Compartamos management spoke with placed an offer for shares. All of them placed offers much higher than the final allocation meaning that they had significant interest in acquiring shares and in participating in Compartamos going forward.

Alvaro Rodriguez (16:30): It's interesting to look at why these qualified investors saw Compartamos as such a promising investment opportunity, so there are different dimensions to this. The first one is Compartamos-specific issues, the first being its excellent growth potential and obviously it has a tremendously good profit record. The management was very appealing to the markets, and the fact that Compartamos had been working for a long time in governance issues and transparency was also very important to the market, and obviously one very important point is the banking license and the fact that the quality of the portfolio had been, and is, very good for Compartamos.

(17:20) Now, specific to the Mexican microfinance market, the market in Mexico is mostly untapped, competition is in its early stages and this gives Compartamos pretty good earnings expectations.

(17:37) Another dimension is the Mexican financial market. As you probably well know, the Mexican financial market is quite well-developed and has a good regulatory environment, and interestingly enough there has been a lack of other banking IPOs on top of the fact that from Mexico there has been quite a small number of IPOs in general, so this had a pent-up demand and investors thinking that Mexico has a good investment perspective, the fact that a new IPO perspective was coming was quite appealing. The Mexican environment had a good impact on the success of this IPO , the fact that the new administration – there was a good feeling about it – and the markets, and Mexico was achieving and has been achieving the lowest risk spread ever. Globally, there were also factors that affected the IPO… Financial services is a hot sector for US and European investors, with microfinance gaining significant recognition among investors and Mexico being much more appealing for this type of investor globally.

Results of the IPO

ACCION InSight, The Banco Compartamos IPO, June 2007 (page 5)

Link: *publications.accion.org/micro_pubs_list.asp*

On April 19, 2007, Banco Compartamos became the first Latin American microfinance institution (MFI) to offer equity though an Initial Public Offering (IPO). Unlike many IPOs, Compartamos did not raise funds for its own operations or expansion through the IPO. It was a secondary, not a primary, sale – i.e. no fresh capital came into Compartamos as a result of the sale.[3] In fact, Compartamos did not need to raise new equity in early 2007. It has other means of financing growth.

Compartamos is under-leveraged relative to other banks (40 percent capital adequacy ratio versus 16 percent for Mexican banks on average). This gives it room to grow from its existing equity base through borrowing and deposits. Moreover, equity can continue to

[3] A secondary sale means that existing shareholders sold a portion of their shareholdings, cashing out some of their investment, rather than the institution selling new stock to bring money directly into the company. In other words, Compartamos did not directly increase its resources as a result of the IPO. Instead, the shareholders received the $450 million from the IPO.

grow through retained earnings, as it has in the past.

Shareholders in Compartamos, including ACCION International, the International Finance Corporation (IFC), Compartamos NGO, and private Mexican investors sold 29.9 percent of Compartamos' stock in a secondary offering listed on the Mexican Stock Exchange. The total proceeds from this sale were US$468 million, with purchases by 5,920 institutional and retail investors from Mexico, the United States, Europe and South America.

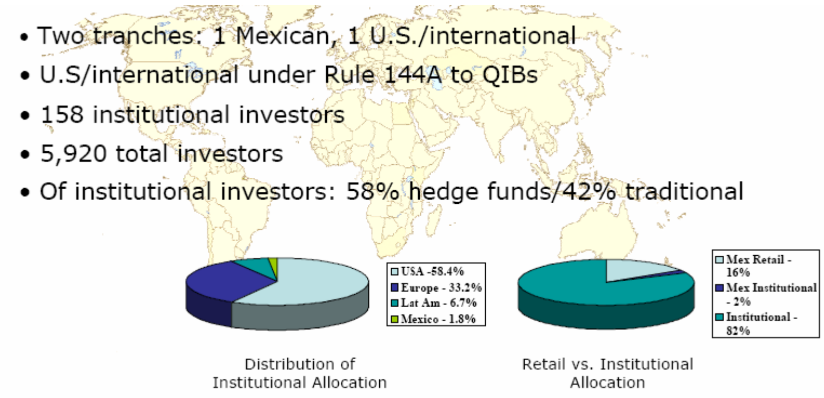


Figure 4: Sale of IPO stock (source: ACCION InSight)

More than a new phenomenon, the IPO represents the culmination of an ongoing strategy within microfinance to enlist the private sector in microfinance: the commercial model of microfinance. The success of the IPO has brought an unprecedented level of excitement about microfinance into the investment banking world. It has sent the message that service to the poor and profits can go hand in hand, a message that will undoubtedly attract more private sector players to microfinance and possibly to other market-led approaches to poverty.

ACCION's Investment

ACCION InSight, The Banco Compartamos IPO, June 2007 (page 11)

Link: publications.accion.org/micro_pubs_list.asp

The initial $1 million investment ACCION International made in Compartamos in 2000, through its Gateway Fund,[4] has yielded a return far beyond the most optimistic expectations. ACCION International is cognizant of its responsibility to use the proceeds of the sale to further the microfinance industry's aims of addressing poverty through financial services and is embarking on a daring but thorough strategic planning exercise to define how best to leverage these new resources. The scale of the proceeds [from the sale of 50% of its stock holdings] (US$134,965,740 net of fees) will allow ACCION to pursue new equity investments, work in additional countries and regions, develop creative initiatives, and strengthen itself to be able to carry out its mission even more effectively. The bulk of the IPO resources will be maintained as strategic reserves, which will assist in covering a share of ACCION's operating budget. The remainder of ACCION's budget will come from consultancy fees, dividend income, and fundraising. Grants from private and public sector donors will continue to be crucial, as the challenges of addressing poverty through financial services remain much greater than the resources at hand. Grants will be applied to less proven, riskier ventures with high potential for impact.

[4] The Gateway Fund was originally established in 1997 with donations from USAID and CGAP.

Section II: Initial Reactions and Announcements

Overview of this section

As soon as news of the IPO hit the public media, discussions started immediately on MicrofinancePractice (MFP), the largest microfinance listserve discussion group with over 2,500 members. This spearheaded the extensive and spirited discussion of the following months.

The topics discussed in Part II of this paper contain significant content from the email discussions. This present section provides only the initial announcements from microfinance practitioners, which gave motivation for why the IPO should be discussed, and the initial official announcement from ACCION.

Is this where microfinance is going?

MFP Discussion, 23 April, Chuck Waterfield (CEO, MFI Solutions)

Link:[finance.groups.yahoo.com/group/Microfinance Practice/message/6868](finance.groups.yahoo.com/group/MicrofinancePractice/message/6868)

Something just happened that is very important for us to reflect on.

Compartamos, working in Mexico, currently has 600,000 clients. They have kept their interest rates at over 100% for many years (effective interest rate is currently 105%, as stated on their own website). This is startlingly high to people inside of microfinance as well as outside of microfinance.

They have gotten very profitable. For the last several years, they have generated an annual ROE of over 50%. As they reached profitability, their interest rates did not come down. They continued to keep them high and generate high profits. Last year they made $57 million in profits.

Friday they went "public". Various members of the board and staff have become multi-millionaires (valued in US dollars). This is a non-profit institution started with grants. They are generating extremely high profits that now, as a publicly held institution, go to their share-holding board and staff and to their external shareholders.

Is this the future of microfinance? Is this where other MFIs are hoping to go? Is this the "solution to poverty"? Do the "benefits" of this market-based approach outweigh any potential costs that will come from public attention? Will these actions cause concern about how the "deeds" of microfinance more-and-more appear to contradict the "words" we say? Will microfinance become the home of the profit-maximizing investors instead of the area that donors and non-profits use to effect beneficial economic and social change?

I strongly believe it is the most important current issue in microfinance. I think it is time we stop avoiding this issue. I think we need to openly discuss this. I don't believe it is necessary to "pick on Compartamos." Rather, we should be looking at the bigger "philosophical" picture, of where microfinance is going. I think this is an essential issue for us to clarify.

ACCION Applauds Compartamos on its IPO

April 27: first press release by ACCION

Link:[finance.groups.yahoo.com/group/Microfinance Practice/message/6907](finance.groups.yahoo.com/group/MicrofinancePractice/message/6907)

ACCION affiliate Compartamos of Mexico is the largest microfinance bank in the Western hemisphere, and has been a leader in the field for some time. ACCION applauds its partner on the success of its recent IPO – and would like to address some of the questions that observers have raised about the meaning of this transaction for microfinance and ACCION.

The success of Compartamos' public offering of 30% of its equity is the result of more than 17 years of hard work and innovation. This work produced a microfinance institution capable of reaching more than 600,000 poor entrepreneurs, with outstanding loan balances averaging $446 each – and with losses of less than 1%. Compartamos's success is also the success of the entire industry, and a model for the type of microfinance that accesses the capital markets to achieve scale.

ACCION's original 18.5 percent investment in Compartamos is a matter of public record, and our return from the public offering, in which we sold approximately half of our holding, was significant. Such a return to a publicly-supported charity like ACCION can mean only one thing: We now have more resources to achieve our mission of providing people with the tools they need to work their way out of poverty.

In order for Compartamos to expand and cover costs, it charges interest rates above the commercial Mexican rate, a practice common in high-touch, relationship-based microfinance worldwide. The returns received have become retained earnings and allowed the institution to nearly double its reach over the last three years, from 350,000 to well over 600,000 clients – something it could not have done any other way.

This IPO validates the crucial role that the capital markets, both domestic and international, can play in scaling microfinance. At the end of the day, this landmark transaction benefits the entire field.

We need to discuss the implications for the future of microfinance

MFP Discussion, 1 May, Chuck Waterfield (CEO, MFI Solutions)

Link:[finance.groups.yahoo.com/group/Microfinance Practice/message/6924](finance.groups.yahoo.com/group/MicrofinancePractice/message/6924)

My sole interest in starting this discussion a week ago is to promote dialogue and discussion over the implications for microfinance. I still strongly believe this is the most important issue currently in microfinance. I believe the implications of this event will extend far beyond Mexico, and have influence on the entire microfinance industry.

The fundamental issues are not about the Compartamos IPO per se, but about the implications for the *future* of microfinance. Some see this IPO as "greatly expanding opportunities for the poor to access financial services," persuasively demonstrating that consistently high profit margins can potentially attract large amounts of money into microfinance, and not just from social investors but from the entire spectrum of the market. But others have said they see this with concern, as "profit-maximizing" behavior that takes advantage of the poor.

My perspective is that for two decades we have been struggling to find the acceptable breadth of that middle section of the non-profit/for-profit continuum that some of us call "socially-responsible business". If profit-maximizing businesses are drawn in by what we have demonstrated is possible, we could soon see the microfinance industry routinely criticized for charging very high interest rates to the very poor, making higher profits than most other industries, and then – instead of reinvesting that profit to expand services to the poor – those profits start to be directed to private corporations and individuals. And many MFIs were created initially with public funding, adding a new dimension and complexity to the issue of IPO-generated wealth.

I encourage us to enter into serious discussions about these issues. What are the ramifications and implications for the poor? What are the ramifications and implications for government regulation of microfinance? What are the long-term ramifications and implications for the microfinance industry as a whole?

These are not simple questions. There are myriad complexities.

Section III: Excerpts from the public media coverage

Overview of this section

Immediately after the IPO there were brief, factual articles in the press that presented financial numbers but did not address the social or mission aspects of Compartamos's work. Six weeks later, shortly following the publication of the CGAP Focus Note on the IPO, financial magazines started to publish articles that addressed the issues of high profits resulting from making loans to the poor. This section provides, in chronological order, short excerpts from some of these articles. The factual, financial data has been edited out, as that information is reported elsewhere in this report. We have left the implications and perceptions as expressed in each article, as they are provide an insight into the reactions of those outside the microfinance industry to the IPO event. By following the hyperlinks you may view and read the complete articles.

Outsize Returns from Investing in Microfinance

Conde Nast Portfolio.com, 12 June 2007, By Felix Salmon

Link: www.portfolio.com/views/blogs/market-movers/2007/06/12/outsize-returns-from-investing-in-microfinance

In April, Mexico's Banco Compartamos went public, raising $450 million. The people who had invested money in the bank during its early days found themselves sitting on enormous profits. It was a glorious day for Mexican capitalism – except for one small problem: Banco Compartamos is a microfinance institution, devoted to improving the lives of the poor. What was it doing, then, improving the lives of already-rich private shareholders instead?

The Compartamos numbers are stunning. It has a return on equity of more than 50% – something more or less unheard-of in the banking world. The interest rates that it charges borrowers are more than 100% per annum. When the company went public, private individuals, including Compartamos's directors and managers, owned more than 32% of the company; they're now wealthy people indeed.

Now, profit is not necessarily a bad thing. But excess profits like these must ultimately come from somewhere, and in Compartamos's case they seem to have come from its customers.

It is hard to avoid serious questions about whether Compartamos' interest rate policy and funding decisions gave appropriate weight to its clients' interests when they conflicted with the financial and other interests of the shareholders.

Other observers, with less of a history with Compartamos, might be less charitable still. In a narrow sense, the bank serves the poor: the poor are its clients, after all. But in a broader sense, it now concentrates on serving its shareholders, who are going to want to see its enormous profits go up, rather than down. It's good that Compartamos is making money. But it doesn't need to be making this much money.

Cashing in on extreme poverty

Salon.com, 13 June 2007, By Andrew Leonard

Link:www.salon.com/tech/htww/2007/06/13/compartamos/

On April 20, Mexico's biggest microfinance lender, Banco Compartamos, struck gold in an initial public offering. Considering that Compartamos' client base is 600,000 very poor Mexicans who pay interest rates as high as 100 percent a year for access to Compartamos loans, the lucrativeness of the public offering immediately struck some longtime participants in microfinance as troubling.

Nonprofit donors interested in supporting financial services for the poor may want to think more carefully about the conditions under which they give their money.

One cannot be too shocked if a for-profit corporation starts acting like other businesses. But in the Compartamos case, a controlling majority – two thirds of the shares – was held by three pro-bono shareholders who were committed to development objectives, not profits. At a minimum, one wants to ask why they did not insist that greater weight be given to the interests of Compartamos' clients.

While the Compartamos IPO may stimulate investors' interest in other MFIs, it may also have less fortunate results for some other MFIs in Latin America and elsewhere. A number of countries are seeing a strong backlash against high microcredit rates from populist politicians, media, and social activists. In the present environment, MFIs are going to have to pay more attention to the political consequences of their interest rates.

Mexico Compartamos IPO Raises Tough Issues for Microfinance

Dow Jones Newswires, 18 June 2007, By Wailin Wong

Link:www.accion.org/NETCOMMUNITY/Page.aspx?pid=756&srcid=293

NEW YORK (Dow Jones)--In most initial public offerings, the market cheers when the debut produces huge profits for the company and its investors. But the case of Mexican microfinance institution Compartamos has prompted hard questions and soul-searching among its industry peers.

The lender's challenge to maintain a so-called double bottom line of improving clients' social welfare and generating returns for shareholders is an issue more MFIs could face as the industry grows.

The heightened attention has brought with it a backlash from some critics, who said MFIs charge overly high interest rates and don't do enough to pull their clients out of poverty. Compartamos' IPO adds a further set of concerns to the mix about corporate governance and how the lender uses its resources.

Microfinance Draws Mega Players

Business Week, 9 July 2007, by Keith Epstein, Geri Smith, and Nandina Lakshman

Link:www.businessweek.com/magazine/content/07_28/b4042068.htm?chan=search

If you think microfinance is the exclusive domain of do-gooders seeking a free-market cure to global poverty, think again. While much of the money flowing into loans for the working poor is indeed ponied up by people with high-minded goals, these days it’s coming increasingly from those with a sharp eye for the bottom line – raising new questions over how to balance the altruistic mission of microfinance with the pursuit of profits.

The high interest paid on microloans makes the operations surprisingly profitable. So hedge funds, venture capital firms, and other big investors are angling to get into the business.

The rush of money into microfinance has raised questions about the hefty profits some microlenders earn. One, Mexico's Banco Compartamos, made a splash in April when it staged an initial public offering. A June 11 report by CGAP faulted the bank for interest rates that reach 100% annually. The report questioned Compartamos's 56% return on equity and found an obvious conflict between the welfare of clients and investors. "If you want to attract private capital you have to show high profits," says Richard Rosenberg, the report's author. "But they don't have to be this high."

The Ugly Side of Microlending

***Compartamos: From Nonprofit to Profit.* Behind its gentle image is a tough, highly lucrative bank**

Business Week, 13 December 2007, By Keith Epstein and Geri Smith

Link:www.businessweek.com/magazine/content/07_52/b4064045919628.htm

Banco Compartamos portrays itself as the gentler lender to Mexico's poor. *Compartamos* means "let's share," reflecting the philosophy of its founder, José Ignacio Avalos Hernández.

Fueled by annual interest rates that can exceed 100%, it is one of Mexico's most financially successful banks, providing investors with an average annual return on equity of 53% over the past seven years.

In its initial public offering in April, like other early investors, Avalos reaped an extraordinary return: The $250,000 he borrowed to invest in 2000 grew in value to $100 million.

Compartamos retains an altruistic public image. In a glossy promotional book entitled *Historias de Exito*, or *Stories of Success*, the bank boasts: "Our clients are agents of change who are building a better country and world." Among the inspiring narratives is that of Eva Yanet Hernández Caballero. A visit reveals a tale more complicated than the one Compartamos tells.

Over four years, beginning in 2001, she, her mother, and a sister took out a series of loans ranging from $200 to $1,800, at an APR interest rate of 105%. They rolled one into the next and used the money to increase their weekly output from 800 dozen pairs of socks to 1,500 dozen.

Then things unraveled. Wholesale customers fell behind on payments. Compartamos' steep interest rates took an unremitting toll, as Hernández and her relatives each missed several $130 payments to the lender. That was a lot for the rest of the 23-member borrowing circle to make up. Resentment surfaced. Soon after Compartamos trumpeted her story in 2005, Hernández and her family were banished from the group.

Such frustrations are inevitable, says Carlos A. Danel, co-chief executive of Compartamos. However, "the rule is you're liable for each other's loans." The bank's rates are fair, he says, and have fallen significantly in recent years.

Compartamos representatives supervising the groups earn bonuses of up to 120% of their salary based on growth in the numbers of clients and loans. They urge borrowers to seek more credit as soon as they pay off each loan.

Persistent indebtedness can create daunting burdens for customers. Few working-poor clients understand the concept of interest rates, Danel admits. "What matters [to most borrowers] is: How much do I have to pay every week or every month or up front?"

After Success, Problems for Microfinancing in Mexico

New York Times, 5 April 2008, by Elisabeth Malkin

Linkwww.nytimes.com/2008/04/05/business/worldbusiness/05micro.html?_r=2&scp=1&sq=compartamos&st=cse&oref=slogin&oref=slogin

VILLA DE VÁZQUEZ, Mexico — Carlos Danel and Carlos Labarthe turned a nonprofit that lent money to Mexico's poor into one of the country's most profitable banks. But not all of their colleagues in the world of microlending — so named for the tiny loans it grants — are heaping praise on the co-executives of Compartamos. Some are vilifying them as "pawnbrokers" and "money lenders."

They are the center of a fractious debate: how far should microfinance go toward becoming big business?

"Microfinance started in the 1970s with a focus on using this breakthrough to help end poverty," said Sam Daley-Harris, director of the Microcredit Summit Campaign. "Now it is in great danger of being how well the investors and the microfinance institutions are doing and not about ending poverty."

Both sides agree that there is a need for capital, too great to be met by the donor groups that initially financed microlending. But Compartamos's decision to go public last April became a flashpoint.

Critics say that Compartamos manages its business to benefit its investors, not its borrowers. The bank began as a nongovernmental organization in 1990, started by a Catholic social action group called Gente Nueva, whose inspiration was a visit by Mother Teresa to Mexico.

After Compartamos became a for-profit company in 2000, costs fell as efficiencies increased, but the bank kept interest rates high. Compartamos is more efficient than other Mexican microfinance institutions and its own borrowing costs are lower, thanks to its strong credit rating. Critics charge that it has not passed those savings on to its customers.

Profit is not a dirty word in the microfinance world. The question is how much is appropriate.

PART II:
Broader Implications of the Commercialization of Microfinance

Overview of this section

In the months following the Compartamos IPO, the microfinance industry invested a significant amount of time discussing the issues and implications of the commercialization of microfinance. ***Part II*** *addresses the broader implications of the commercialization of microfinance, divided into the following seven key questions in four main topic areas:*

Profits

1. *Are high profits and high interest rates consistent with social bottom line missions?*
2. *Can the mutually agreed upon goals of scale and sustainability be achieved without using high-profit IPOs as a means to those ends?*

Organizational Structure

3. *Do IPOs alter governance in such a way that it is harder to balance social and commercial objectives?*

Funding and Commercialization

4. *Is the industry going through a pivotal shift from a donor/non-profit focus to commercial focus?*
5. *What are the implications of using grant funding to generate future for-profit entities?*

Supervision and Regulation

6. *Are free-market forces (e.g., competition) sufficient to reduce interest rates or should the industry look at promoting codes of ethics, transparency efforts, and/or some forms of regulation?*
7. *What implications might high-profit commercialization have on public perceptions about microfinance and on potentially increased government regulation of the microfinance industry?*

Topic 1:
Are high profits and high interest rates consistent with social bottom line missions?

Overview of this section

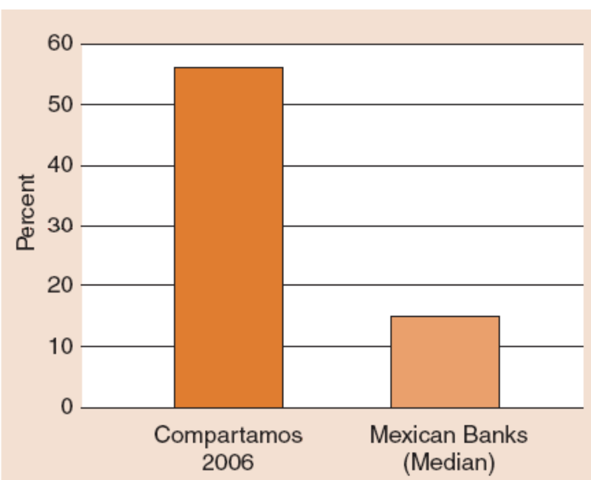
Of the seven topics to be addressed in this part of the paper, this topic generated the highest level of discussion and could be argued to be the fundamental issue coming out of the IPO. Compartamos generated very high profits in the years prior to the IPO and did so through charging very high interest rates relative to the rest of the global microfinance industry (although there are other MFIs within Mexico with similar interest rates). Compartamos has often expressed its commitment to a social bottom line. Others argue that there is a matter of degree – and balance – that must be respected by double-bottom line institutions. The discussion below presents these arguments.

The Size of the Profits

CGAP Focus Note, CGAP Reflections on the Compartamos IPO, June 2007 (page 3)

Link: www.cgap.org/p/site/c/template.rc/1.9.2440

The most important source of concern about the IPO in the microfinance community has been the huge profits the IPO produced—in particular, the profits for private shareholders. To approach this issue, we need to begin by distinguishing between the *existence* of profits and the *size* of the profits. We see nothing wrong with the fact that shareholders make profits out of Compartamos.

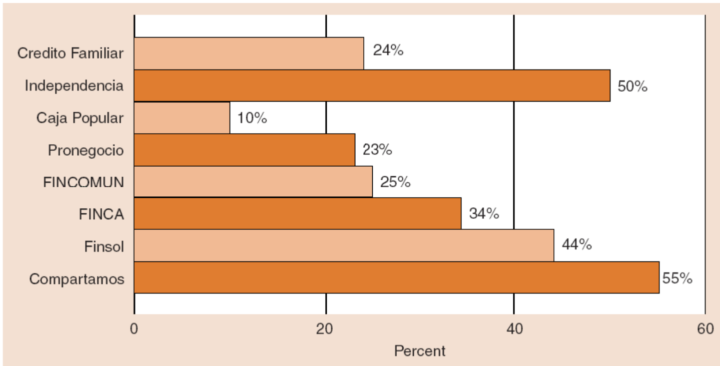


Sources: MIX Market; 27 Mexican Banks in BankScope database, excluding Credomatic as an outlier because of its –533 percent ROA.

Figure 5: Return on Average Equity (source: CGAP Focus Note)

The more difficult question has to do with the size of the profits. Even people who favor a commercial approach to most microfinance have to scratch their heads when they see shareholders making annual returns of 100 percent on their investments, compounded for eight years running. To assess whether this is reasonable or ethical in the context of a company and a majority of its investors who have a social objective, one should look at the sources of those profits, and their uses. To what extent do the profits come out of the pockets of poor customers? And are the profits used for further service to more poor people, or do private investors capture them?

When one looks at the large returns that Compartamos' initial shareholders earned on their investments, it seems probable to us that the largest portion of those returns is attributable to Compartamos' past track record of very high net earnings. Those net earnings were high because Compartamos charged its borrowers interest rates that were considerably above what the company needed to cover its costs. IPO purchasers paid high prices for Compartamos shares, creating huge returns for the selling shareholders, because they expected the pattern of past profits to continue and even grow. Those past profits came directly out of the pockets of Compartamos' poor borrowers, creating a conflict between the welfare of those



Sources: MIX Market, Mexican Banking and Securities Commission (www.cnbv.gob.mx).
Note: Consumer lenders (top two bars) lend mainly to salaried workers. MFIs (bottom six bars) lend mainly to unsalaried microentrepreneurs.

Figure 7: Return on Average Equity, Compartamos vs. Mexican MFIs and Consumer Lenders (source: CGAP Focus Note)

borrowers and the welfare of Compartamos' investors.

Thus, we would argue that one should not automatically be concerned because the initial Compartamos shareholders made very high returns on their investments. More precisely, the concern should focus on the large portion of those returns that were created by charging higher-than-necessary interest rates to borrowers.

Acceptable Levels of Profit

Tufts University Microfinance Dialogue, 2 November 2007, Carlos Danel (Co-CEO, Compartamos)

Link: fletcher.tufts.edu/ceme/publications.shtml

The dialogue on the role of profit and the acceptable levels of profits for a microfinance institution included questions directed to **Carlos Danel** asking whether "making a fortune off of the poor" was ethical. Danel responded that one needed to look at the level of profits differently, separating out the IPO proceeds from the regular yearly profits of the institution. Concerning the IPO, Danel stated that the founders never expected to make a great deal of money, so the IPO was a surprise to everyone. Danel reminded the audience that two-thirds of the IPO proceeds went to social investors including ACCION International, enabling firms like Compartamos to spread the wealth around the world in the form of increased financial services to the poor. Danel continued, "I am very satisfied in what we have done, because we believe that we are making a difference in other people's lives. You can like it or you can criticize it, but for God's sake do something."

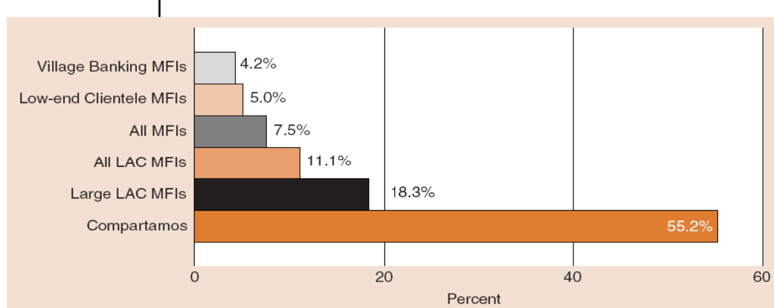
Compartamos' interest rates and profits

SEEP Conference Presentation, 20 October, by Chuck Waterfield (CEO, MFI Solutions)

Link: www.microfin.com/SEEPConference

I think we do need to start with a basic understanding of the Compartamos IPO in order to discuss the implications of that IPO on the future of the industry:

- First, their average loan sizes increased consistently and dramatically over the past ten years, with nearly a ten-fold increase, starting at $100 and growing to nearly $1000 last year.
- Despite this significant increase in loan size, interest rates have remained extremely high throughout those years. They have an effective interest rate of 105%, with taxes included. For sustainability, smaller loans tend to have higher interest rates than larger loans. However, an interest rate of over 100% would be considered high even with small loans of $100; it is exorbitant when charged on $1000 loans.



Source: MIX Market and MicroBanking Bulletin #14 Trendline Benchmarks (medians).

Figure 6: Return on Average Equity, Compartamos vs. Microbanking Bulletin Peer Groups (source: CGAP Focus Note)

- As a result of the SOFOL privatization in 2000, profits belong to the private shareholders. Decision-making becomes influenced not just by societal goals; there is now a large degree of self-interest that comes into the process.
- Due to their loan size and interest rate decisions they made, their profits have been constantly at the highest levels in the industry, with an average annual ROE of over 50% [as shown in Figure 6]. What we have is a textbook example of the magic of compounding. Say you invested $1000 in Compartamos seven years ago. That $1000 would now be worth $17,000 – a 50% ROE yields a 17:1 return over 7 years. One year later your $17,000 is worth $26,000. Because of compound growth, your investment keeps growing, exponentially, as long as ROE remains so high.
- We watched this take place for six years. The original total share investment in 2000 was $6M. Share equity grew to $125M by the end of last year [as shown in Figure 8]. That additional $120M of profit all came from the interest paid by their clients over the course of a few years.
- So to summarize the pre-IPO activity, Compartamos kept interest rates high, pursued aggressive growth in loan size, generated major profits, and under the new structure, all of that profit belonged to that small group of shareholders. All of that profit was generated by the over-100% interest rates paid by their clients, and, what I find rather sobering, 98.5% of their clients are poor, rural women. Just last year alone the shareholders made an average of $120 in *profit* off of each one of those women.

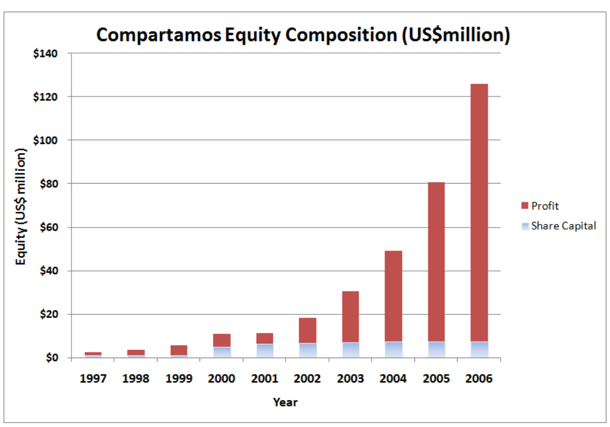


Figure 8: Compartamos Equity Composition, US$milliion (Source: Waterfield Presentation)

- Then in April the IPO took place. During the pre-IPO road show, they showed these compound returns to potential private investors. The shares were then snapped up rapidly, the majority of them (68%) by hedge fund managers, who look for the most aggressive returns in the market.
- In the IPO, the original shareholders cashed out 30% of their share holdings. No new capital was raised for Banco Compartamos in the IPO. Instead, the investors took out a portion of their gains. Several of the key staff and board members of Compartamos personally saw their holdings grow to as high as $150 million **each** from the IPO. ACCION's $1M investment became worth approximately $300M.

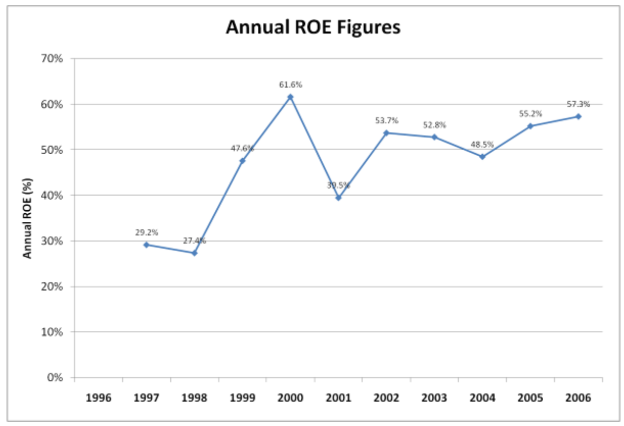


Figure 9: Annual Return on Equity, Compartamos (source: Waterfield Presentation)

- The original shares, purchased with a combined total of $6M in 2000, became worth over $2 Billion [as shown in Figure 10]. That is why you now hear talk about the 300:1 return that the shareholders received. They invested $6M. The first $120M pre-IPO increase in wealth came from the interest paid by the clients in the past few years. Then the additional $1.8 billion in share value came from the speculation of new shareholders thinking

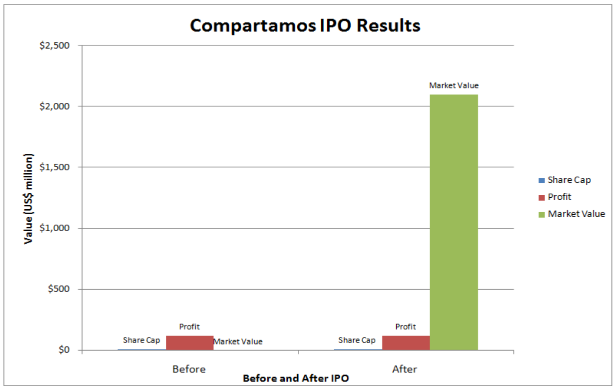


Figure 10: Compartamos IPO Results (Source: Waterfield presentation)

that they, too, could make huge profits off of loaning to the poor.

Can market demand be related to social usefulness

MFP/DFN Discussion

29 April 2007 and 15 June 2007, Narasimhan Srinivasan (Microfinance Consultant, India)

Links:finance.groups.yahoo.com/group/MicrofinancePractice/message/6912 finance.groups.yahoo.com/group/MicrofinancePractice/message/7095

I would like some more information and clarity on some statements made by ACCION in their press release [see page 9 of this publication]:

> *"In order for Compartamos to expand and cover costs, it charges interest rates above the commercial Mexican rate, a practice common in high-touch, relationship- based microfinance worldwide."*

Was there any consideration at ACCION or Compartamos boards of the impact of such rates on micro-borrowers? Retained earnings could have been returned to the borrowers. Was it fair to retain such earnings?

Investors were lured by the earnings per share and price to earnings ratios reported, which were built on the high interest earnings paid out by clients from their hard earned incomes.

How many of us would like to pay 100% interest on credit card dues because of the product advantages (no waiting for a banker to approve the loan, etc.) or pay a 100% interest on a loan for medical treatment because we are desperate? How many of us would be willing that our bankers charge us higher rates than elsewhere in the market so that the bank can make an IPO that would "mainstream" their financial and business model.

It is nice to talk about microfinance clients deserving this kind of a "sophisticated and high cost service" ; but if *we* were those clients would our "informed views" remain the same?

25 June, Ruth P. Goodwin-Groen (PhD candidate in Economics, University of Bath UK)

Link: www.microfin.com/dfnpostings1

This discussion reflects a deeper struggle we are all experiencing whether we come from a business, development or government background. Namely: how to marry the financial resources and efficiency of business with the poverty focus of development and, governments' agendas – so that those who have been excluded from economic growth (at many different levels) can be included.

C. K. Prahalad proposed the solution to poverty in his book "The Fortune at the Bottom of the Pyramid". In early 2005 he met privately with the chairperson of one of the world's biggest banks to discuss business opportunities in catering to poor people. This was the answer:

> "The chairperson responded bluntly. "We don't care about making profits [on such a business], "he said, with the bank's CEO sitting beside him. "There's something even distasteful about the idea of making money off people who earn less than $1 a day."" (Quoted from: Brugmann J. and C. K. Prahalad (2007) "Co-creating Business' Social Compact" *Harvard Business Review*, p. 80)

Brugmann and Prahalad argue in this article that it is the **combination** of business with social activism that makes the difference for poor people. So the business world is increasingly trying to figure out how to have a social conscience – but it is not easy.

Whichever sector we come from, we know we cannot make a real difference to financial inclusion unless we effectively learn from each other and work together. But it requires a completely new mind-set for all of us and is really hard to change traditional cultures of business or development or government.

12 September, Paul Rippey (Manager, DFID Financial Sector Deepening Project, Uganda)
Link: www.microfin.com/dfnpostings2

Rich Rosenberg argues [CGAP Focus Note, p.17] that 100% interest loans do enhance borrower welfare; otherwise the women would not come back for more. I'd like to pause at that statement – "otherwise the women would not come back for more" – to note the error of confusing market demand with social usefulness. Why on earth would we think that continued demand for loans on the part of MFI clients implies that the loans "enhance borrower welfare"? This non sequitur has been befuddling microcredit donors for years.

As I keep pointing out, there is strong market demand for saturated fats, drugs and alcohol, on-line video games, and commercial sex. So what? Microcredit may or may not be of net social benefit, but the fact that people keep taking loans provides absolutely no evidence that microcredit does more good than harm.

There are, in fact, substantially more people lined up to buy fast food and get into casinos than those shopping for organic oat groats and enrolling in zen meditation centers, so on that limited evidence we might assume an inverse relationship between market demand and social utility. But, in fact, I think we just don't know the net benefit of microcredit, and by concentrating on numbers of borrowers, we are looking in the wrong place to find it.

Why are Compartamos's interest rates so high?

Bringing Microfinance to Scale, ACCION webinar, 27 June 2007, Beth Rhyne (ACCION, SVP), Lauren Burnhill (ACCION, SVP), Mario Otero (ACCION, President), Alvaro Rodriguez (ACCION Board Chair and Compartamos Board member)
Link: www.microfin.com/webinar

Beth Rhyne (9:42): Compartamos's basic strategy has been to charge interest rates that would yield profits and then retain those earnings so that it could grow fast and then gain access to the capital markets to position it to raise finance more in the future.

Lauren Burhart (25:00): One of the challenges they faced as a SOFOL that will be eased now that they are a bank and part of the public markets is that of playing a leading role in the microfinance industry. There have been moments where when we looked at the ability to lower interest rates we realized that lowering interest rates could effectively set off a pricing war amongst microfinance providers – SOFOLS and NGOs – and because Compartamos was more advanced in its development and more profitable, it could have done very well in those wars, but it would have had a very detrimental effect on the industry. It is important to recognize that it is not just the institution that needs to be considered in determining policies, but the industry as a whole.

Alvaro Rodriguez (41:30): The IPO is attracting significant amounts of private investors into the sector, and private entrepreneurs thinking about starting MFIs. This will bring a significant amount of competition and that will only benefit the clients in many ways – better service, lower interest rates, etc, etc. There was also a question on interest rates, whether this was discussed throughout the IPO process and whether investors had expectations that those interest rates were going to come down. In the majority, they **do** have an expectation that they will come down. The reason why the valuation of Compartamos is so high is basically because of growth prospects and not so much because of profitability and margins. The growth projected is so great and that gives a tremendously positive valuation for Compartamos.

Beth Rhyne (50:40): Many people have made the case that the interest rate could have been lower. There are a lot of people who have a variety of opinions on that also within Compartamos and ACCION. Some people agree that it could have been, others that it couldn't. But basically, the strategy was laid out as this is happening this way because

Compartamos has ambitious outreach goals and doesn't have the access to financial markets that are needed to raise funds privately. Therefore, the best financial option was retained earnings. That strategy was one that ACCION supported throughout the period. We can all debate whether that was the right strategy and have a variety of opinions on it. Certainly it is possible to imagine a setting in which Compartamos could have been a successful organization in terms of continuing to serve clients and have charged a lower rate. I think the contention is that it would have been smaller and wouldn't be in the position it is now. It's always easier to look bad. The strategy they **have** followed has gotten them in a place where they are poised for very significant social impact in the coming years.

Maria Otero (54:30): There is a question from a listener of why did clients choose to come to Compartamos despite high interest rates?

Alvaro Rodriguez (54:40): I would invite any of you to come to Mexico and look at some of the markets where Compartamos operates. Oaxaca has clear competition, there are towns with an MFI operating on every block. So some parts of Mexico already have strong competition. Clients do have a choice, and we see clients migrate to other MFIs and we see clients come back! Interest rates are but one variable of the whole equation. They are seeing much better service. Also, we see MFIs under-cutting on price to gain clients, but we're not seeing them live very long, so what good does it have if they aren't going to be serving their clients for very long? … I think we need to divert the discussion of the interest rates – it is much more to do with what it will take to be able to provide financial services to the majority of the population.

Interest Rates, Expansion, and Poverty Alleviation

Tufts University Microfinance Dialogue, 2 November 2007, Carlos Danel (Co-CEO, Compartamos) and Inshan ali Nawaz (CEO, First Microfinance Bank, Pakistan)

Link: fletcher.tufts.edu/ceme/publications.shtml

In response to a question about the interest rates Compartamos charges, **Carlos Danel** responded that interest rates for Compartamos clients have dropped approximately 30% in the last five years. Danel added that he does not "look at the poor as different people." This was one of the reasons that traditional banking left the poor unbanked in the first place. Rather they are clients of Compartamos and should be treated equally. Danel reiterated that Compartamos seeks to provide a better life for its clients through extending financial services to as many as of them as possible.

Inshan Ali Nawaz responded to the interest rate discussion by arguing that the question of interest rates is really a question of the ultimate objective of the institution. "There is nothing stopping us from charging 70% [interest rates]," he said, explaining that the First Microfinance Bank does not currently charge its clients those rates because their objective was fundamentally different from that of

Compartamos. Articulating a concern that seemed to be in the minds of many in the audience, Nawaz stated that the true objective of his microfinance institution was poverty alleviation, not profit maximization.

Free markets should also be fair markets

Microcredit Summit E-news Debate, 12 July, Jonathan Lewis (CEO, MicroCredit Enterprises)

Link: www.microcreditsummit.org/enews/2007-07_critcomment2.html

As a matter of principled commitment to free and fair markets, no microfinance institution has the "right" to charge price-gouging interest rates just because it can. No microfinance organization ballyhoos a mission statement which includes generating lucrative profits from excessive interest rates charged to impoverished borrowers.

The most orthodox and compelling rationale for microfinance usury is that high interest rates will catalyze investment and eventually create interest-lowering competition. Unfortunately, competitive microfinance markets in many parts of the world are a long way off. While the poor wait, should the borrower of today pay sky-high interest in order to attract private capital so the borrower of tomorrow will have the same opportunity to pay usurious interest rates?

Ideally, microloan pricing should be determined between a borrower (willing buyer) and a local microfinance institution (willing seller). Sadly, poor borrowers, burdened by functional and financial illiteracy and without other economic options, are in no position to speak truth to money any more than they can speak truth to power.

We in microfinance uphold the market reality, which demands that interest rates sustainably cover a local microfinance institution's expenses. No margin, no mission. Nonetheless, there is something unseemly about the very wealthy earning unnecessarily excessive profits off the unbearably poor.

Some argue that to help desperately poor people help themselves, they must be charged extraordinarily high interest rates which, in part, are needed to enrich well-intentioned investors who require financial returns to justify their doing social good. Is that the best we can do?

Some interest rates are offensively predatory. This is a matter of degree and circumstance, and fair-minded people can differ. For this social investor, the microfinance interest rates underpinning the Compartamos IPO are dangerously comparable to microloan-sharking.

Fair Pricing

ACCION InSight, The Banco Compartamos IPO, June 2007 (page 13)

Link: publications.accion.org/micro_pubs_list.asp

The tremendous success of the Compartamos IPO has provoked debate and reflection about the commercial model of microfinance. Some observers, and ACCION is in this group, see the IPO as the culmination of a long process of preparing microfinance to move into the mainstream financial sector. At the other extreme, some observers have seen the IPO as troubling because it allowed investors to reap extraordinary returns made possible in part by high interest rates.

The following observations help frame the discussion on Compartamos' interest rate policy to date:

- *Rates of Competitors*. In the Mexican market in which Compartamos operates, Compartamos' rates are clearly within the market range for microfinance.
- *Use of Profits for Growth*. Compartamos kept the vast majority of the profits generated by the high interest rates as

retained earnings and used them to finance rapid expansion.

- *Use of Profits for Building Financial Strength*. High profits have given Compartamos a wide range of options for growing and expanding its range of services, as it is now planning to do.

A more philosophical question is whether Compartamos' pricing policy is in accord with the principles of fair pricing. Fair pricing is a hallmark of pro-consumer policy and a value widely espoused in the microfinance industry. It is seen as a key differentiator separating microfinance from predatory practices.

But the definition of fair pricing has never been thoroughly debated. Opponents of the commercialization of microfinance might suggest that only cost-recovery pricing is fair. Supporters of commercialization recognize that profits are a necessary part of the equation, but may not agree on whether financing growth is an acceptable rationale for maintaining high profits. One clear lesson from the Compartamos experience is that there is an urgent need for greater discussion and consensus-building among industry participants on the issue of fair pricing as a cornerstone of pro-consumer finance.

Explanation of Compartamos Interest Rates

MFP Discussion, 7 April 2008, Chuck Waterfield (CEO, MFI Solutions)

Link[finance.groups.yahoo.com/group/MicrofinancePractice/message/8838](finance.groups.yahoo.com/group/MicrofinancePractice/message/8838)

Compartamos argues that they charge clients approximately 82%, a figure they base on their portfolio yield. The cost paid by the clients, is actually 105% or can even be argued to be 129%, Compartamos tells their clients that loans are charged an interest rate of 4% per month. Compartamos also (I expect) tells them what their weekly payment would be. The Compartamos website also has repayment schedules posted. On that website, they state the APR is 105%, including the value-added tax.

How does a stated 4%-per-month interest rate become a 105% interest rate? To begin, let's do a bit of background on what interest rates mean. The textbook definition of interest is "the charge for the use of money over time." However, many finance institutions use a variety of techniques to mask the actual cost of the loan. In response, governments have passed consumer protection laws, such as the US "truth-in-lending" act, which distill the mixture interest and fee calculation methods down to a basic, consistent measure called the "Annual Percentage Rate," or APR.

Figure 11 shows the average Compartamos loan of US$1,000 for 16 weeks, but charged with 48% annual interest charged on a "declining balance". "Net loan balance" is shown in red and the "interest rate balance" in green (compulsory savings is not yet shown in this graph). As you can see, each week, interest is calculated on the amount actually held by the client in the previous month.

Unfortunately, this is *not* what Compartamos does. Like many MFIs, they instead use a method generally called "flat interest," a method not invented by the microfinance industry but one that has been very commonly utilized by the microfinance industry. In this

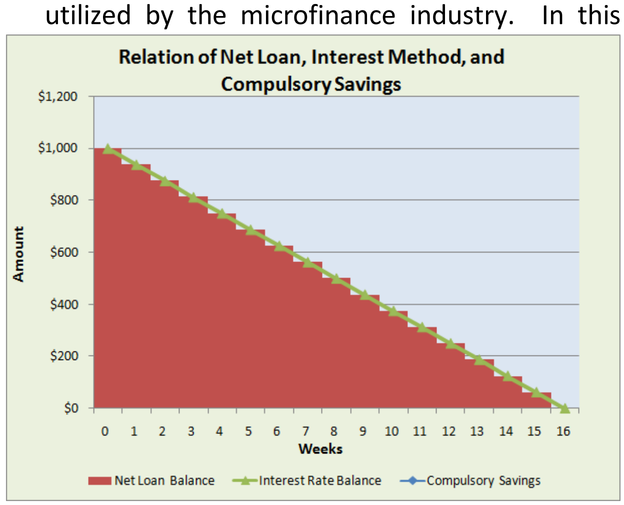


Figure 11: : Declining Balance Interest Rate Method

approach, the quoted interest rate is charged on the *original* loan balance, even though the client does not have (and often *never* had, as we will see) that much money at her disposal.

Figure 12 shows the green "Interest Rate Balance" line as a flat line. In Week 1, interest is charged on $1,000 and the client has $1,000. Each week, the client pays back part of the loan, but interest is still charged on the original loan amount. In Week 15, the client has only $62 to invest in her business, but she is still charged interest on $1,000. Such a system appeared in lending because it allows the institution to charge nearly twice as much interest for the same nominal quoted interest rate. The 48%

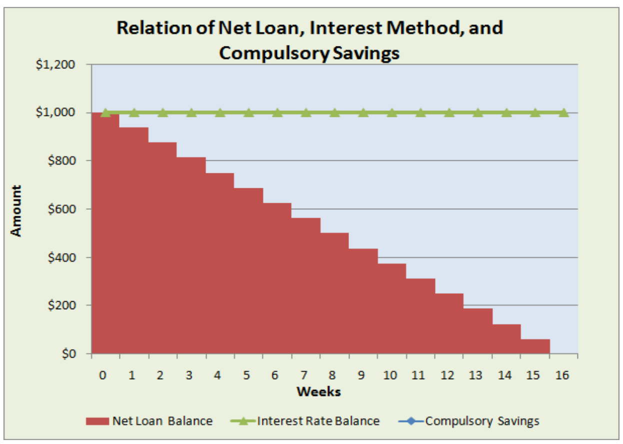


Figure 12: Flat Interest Rate Method

flat interest results in an APR of 86.8%.

The APR is almost twice as much as the quoted interest rate. In looking at the above graph, you can see why. The area shaded red shows the length of time that the client has different amounts of money. With the green, flat interest line you can visualize a rectangular box. If you visualize the red area as a diagonal straight line, then you can see that the line divides the green rectangular box in half. Thus, interest is being charged on twice the amount actually held by the client.

Still, we are short of the 105% interest rate that Compartamos notes on their website repayment schedule. But there are more issues: first, Compartamos does not charge 4% flat interest per *month*. They charge 4% flat interest every *four weeks*. If one uses the "convenience" of saying that a month is four weeks, there are actually thirteen months in a year. Thus, Compartamos is charging an additional month of interest from what they tell their clients, and 48% becomes 52%. With 52% annual flat interest, the APR increases to 93.7%.

Fees and commissions are very common in microfinance, and they often have a significant impact on the total cost of the loan. To my knowledge, Compartamos does not charge any fees. However, they do charge a value-added tax. This is required by Mexican law and is calculated as 15% of income. This VAT adds an incremental 13.4% to the APR, now raising it to 107.1%.

We are now very close to the stated rate of 105% given by Compartamos. Why the slight difference? Compartamos does not actually calculate flat interest in their repayment schedule. They actually are calculating interest based on a declining balance calculation. Compartamos *advertises* a low "flat interest" rate to the client, and then applies a *completely different* interest rate internally, when generating the repayment schedules that the clients must legally follow.

Now we will move on to an analysis of how that 105% APR actually becomes a 129% APR. Compartamos also actually requires all clients to "save" 10% of their loan amount and does not pay any interest on the savings. The client comes to Compartamos to get a loan – say $1,000. In order to get the loan, she must let Compartamos have $100 in an off-limits "savings account." If the client fails to pay, Compartamos seizes the savings. In other words, this is not savings, but rather it is partial loan collateral.

This compulsory savings requirement results in a significant additional cost to the client. She wants to borrow $1,000 for her business. She gets only $900 to invest in her business, but she is charged interest on $1,000. Figure 13 helps to visualize this. There is now a blue line at $100 indicating the "Compulsory Savings" balance. Note also that the red "Net Loan Balance" is now lower. In Week 0, the client has $900, while interest is charged on $1,000. The red area is now a smaller percentage of the green, rectangular area. In fact, in the last two weeks, the client actually has a *negative* net loan balance. She has *more* of her money ("savings") held by Compartamos than she has invested in her business. And even with a *negative* loan balance, she is being charged interest on the *original* loan balance of $1,000. This compulsory savings requirement adds 21.8% to the APR, raising it to 129%.

Finally, let's look at what this 129% APR really means for the client. The client borrows $1,000 and pays $170 in interest and VAT over the 16-week life of the loan. That seems much lower than a 129% interest rate. But 16 weeks is also much less than a year. If the client turns around again borrows $1,000 and goes through another cycle, and continues for a year, she will have paid a total of $552 in interest and VAT over those 52 weeks.

And the client has much *less* than $1,000. In fact, the $1,000 loan is never a $1,000 loan, but rather a $900 loan for one week. Then the client starts paying back the loan, and the loan balance drops. What is the average loan balance over those 16 weeks? Just $431. So to have an average of $431 for a year, the client is paying $552 a year to Compartamos. This makes the impact of an APR of 129% more evident – it is the equivalent of Compartamos simply allowing the client to keep a credit-card loan balance of $431 for an entire year and then charging the client $552 for that privilege.

An interesting statistic is the client's "Breakeven Borrowing Point": 8.6 months. At 8.6 months into the year, the client is already behind, having paid more in charges than the actual loan amount. She has paid $431 to borrow $431 for 8.6 months. She continues her debt cycle month-after-month. If she could, instead, mobilize $431 of her own money and be satisfied with that amount, she could be freed from borrowing from Compartamos. She would have $552 of additional income each year to spend on her family. To me, that is profound. It demonstrates clearly that when interest rates are extremely high, it is far better to save to finance your needs rather than to borrow.

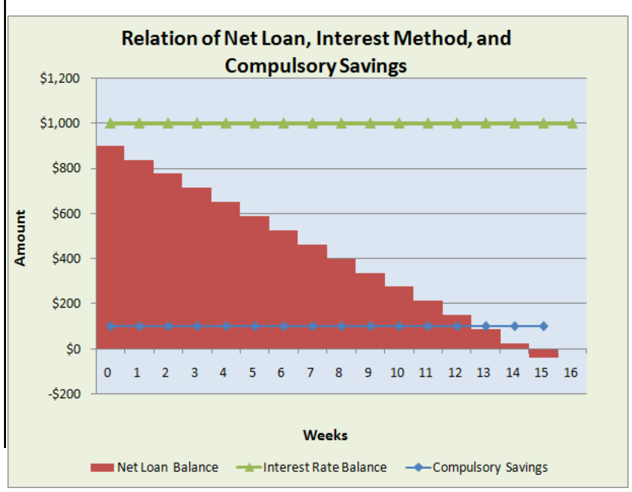


Figure 13: Flat Interest Rate with Compulsory Savings

Topic 2:

Can the mutually agreed upon goals of scale and sustainability be achieved without using high-profit IPOs as a means to those ends?

Overview of this section

About fifteen years ago, the microfinance community reached a broadly-held consensus that MFIs should strive for scale and sustainability in order to provide financial services to a large number of the poor. The industry has been making progress toward both of those goals and progressing in blending funding sources composed of savings, concessional and commercial loans, and equity investments coming from social investors and, to a lesser degree, commercial investors. The Compartamos IPO has been portrayed as a landmark event that will help to trigger a much higher degree of interest among commercial investors, and it is argued that this interest could dramatically increase the flow of total financing into the microfinance industry. Others have argued that there are other means to reach the dual goals of scale and sustainability, achieving the same ends, but without using high-profit IPOs that deliver large profits to external investors.

History of Compartamos's interest rates

CGAP Focus Note, CGAP Reflections on the Compartamos IPO, June 2007 (page 9)

Link: www.cgap.org/p/site/c/template.rc/1.9.2440

When Mexico was hit by heavy devaluation and inflation in 1995, Compartamos, still in a pilot phase of operations, responded by raising its effective annual interest rate above 100 percent, in order to provide real (inflation-adjusted) yields that were sufficient to cover its lending costs. When inflation dropped back to normal levels, the founders and managers deliberated about whether to lower the rates. They had a choice about the matter because they faced little direct competition and were in a near-monopoly position with respect to their clients. They decided to leave the high charges in place, in order to fund the rapid expansion of outreach to new clients.

It seems to us that as long as Compartamos was an NGO, it was not unreasonable to defend this high-interest-rate, high-retained-earnings strategy. Basically, it "overcharged" existing clients for the sake of outreach to potential future clients, and all profits accumulated in the NGO.

Once Compartamos commercialized its operations in 2000, the trade-off between public and private benefits changed, because private shareholders entered the picture. Higher charges to borrowers correlate directly with higher profits captured by investors, including private investors. To that extent, there is a direct and obvious conflict between the welfare of clients and the welfare of investors.

Stockpiling earnings to fund growth

Microcredit Summit E-news Debate, 12 July, Maria Otero (President, ACCION)

Link: www.microcreditsummit.org/enews/2007-07_suppcomment1.html

Compartamos has pursued two ambitious goals throughout this decade. One was to reach a million clients by 2008; another was to establish long-term viability by gaining full access to the formal financial system. The strategy they followed involved stockpiling earnings in order to fund portfolio growth and expansion.

ACCION, as a minority shareholder in Compartamos, has expressed many opinions in board discussions on interest rates and growth policy. In the final analysis, we stand behind the strategy they've adopted. Regardless, we take very seriously the issues raised by the IPO debate. The event has provoked a healthy discussion on what constitutes fair pricing, and the role of profits in the commercial model of microfinance. ACCION will continue to participate actively in the discussion of these issues.

Growth through profit was the best option at the time

ACCION InSight, The Banco Compartamos IPO, June 2007 (page 14)

Link: publications.accion.org/micro_pubs_list.asp

Compartamos might have reduced interest rates somewhat, but instead used profits to achieve unprecedented outreach and to position itself for even greater outreach in the future. The fundamental question is whether this strategy works in the best interests of the clients. One way to look at this question is to ask whether Compartamos could have achieved its current outreach and position for future outreach in any other way. Instead of current clients financing growth through reinvestment of profits, perhaps Compartamos could have turned more to investors (by borrowing more or raising more equity). Compartamos' board and management have maintained that the retained earnings strategy was the best option at the time. Until Compartamos built credibility with the capital markets it would have no other strategy. Without retained earnings, growth would have stalled. ACCION, in its role on the board, has supported Compartamos' in pursuing this growth strategy. Rosenberg, who has advised Compartamos management informally for many years, maintains that this argument has progressively weakened since 2000, as Compartamos has increasingly full access to capital markets. His points are well taken and deserve full consideration by all Compartamos' shareholders and management.

Leverage and savings

DFN Discussion, 26 June & 12 September, Dave Richardson (Senior Manager, WOCCU)

Link: www.microfin.com/dfnpostings3

For me, the core issue of this debate is: Should the Compartamos model be venerated and replicated as the poster child of Microfinance for the future?

I have reviewed some recent financial information from the largest credit union network in Mexico, Caja Popular Mexicana (CPM) over the same time period as Compartamos, 2001-2006. The differences are too significant to ignore. At the heart of the matter are the loan interest rates, which in CPM have fluctuated between 20-25% while the loan interest rates in Compartamos have hovered around 100%.

My most startling discovery was in the area of financial leverage, or the debt to equity ratio. CPM has a total savings deposit base of 3,333,022 accounts for a total of $928 million dollars. Since "commercialization", the debt-equity ratio of Compartamos has *dropped* from 2.06:1 in 2001 to an incredible 1.36:1 in 2006. I am dumbfounded at this result, since I always thought commercialization meant that you could go out and access debt capital and significantly *increase* your leverage. Financial leverage is an important tool used by all financial institutions to make efficient use of capital and fund rapid growth.

According to my calculations, Compartamos could multiply its debts by *seven* times without raising one additional penny of equity and be well within the Basel guidelines. The statement that Compartamos needed to overcharge current borrowers to fund future borrowers seems to violate every textbook explanation of how rapid growth should be funded when debt capital exists.

ACCION In-Sight (page 15) talks of “the great alignment” of interests among the stakeholders and that the IPO is a “powerful validation” of the commercial model of microfinance [see page 35 of this publication]. There is no doubt that Compartamos has found a very profitable niche in the market.

However, was the IPO good for the poor women entrepreneurs? Was there any new money made available for on-lending? Not only was there no new money, but the *structure* of the financial condition of Compartamos radically changed.

Instead of using savings deposits as the cornerstone of microfinance and the retained earnings of the members as risk capital, I see no reason to go for the IPO except one: Massive wealth, which is precisely what has happened in this most impressive display of “for-profit” microfinance. Compartamos has won the triple crown of high dividends, high executive and board compensation, and high stock prices, which have rewarded everyone “far beyond the most optimistic expectations” (Accion InSight, p.11).

Using profits to expand outreach depends on the stage of history

CGAP Portfolio Newsletter, June 2007

Link: cgap.org/portal/site/Portfolio/Jun2007Lead/

Given the cost of labor in Mexico and the tiny size of Compartamos loans, a high interest rate was inevitable. But how high? Compartamos justified this practice as a means to fund rapid growth of its outreach to poor women: the profits were re-invested in new branches and staff. Was this a defensible strategy for an institution with a social objective – improving the welfare of present and future poor clients?

We at CGAP think that the answer depends on which stage of Compartamos's history one is discussing. Prior to 2000, Compartamos was a not-for-profit NGO. By law, it could make profits, but it had no owners. Any profits had to be used for the institution's social purpose. Thus, every additional percent of interest paid by current borrowers would go to benefit future clients, rather than escaping into the hands of private individuals. Also, during this period Compartamos probably did not have other practical options for funding such a rapid expansion of its services. Under those circumstances, we think that funding expansion with higher-than-usual profits could be defended.

But things changed after 2000, when Compartamos "commercialized" – that is, moved its operations into a for-profit company that sold its shares not only to pro-bono investors but also to a minority of private individuals. More importantly, Compartamos had other ways to fund its growth after 2000. It could (and did) sell bonds in Mexico, and socially-motivated international investors had begun creating large funds to invest in the debt and equity of high-quality MFIs.

It seems to us at CGAP that after 2000 there was a direct conflict between the profits of private investors and the financial interests of Compartamos borrowers. We don't think that Compartamos and its pro-bono majority shareholders gave enough weight to the interests of the borrowers when setting its prices.

Compartamos can grow through borrowing and deposits

ACCION InSight, The Banco Compartamos IPO, June 2007 (page 5)

Link: publications.accion.org/micro_pubs_list.asp

Unlike many IPOs, Compartamos did not raise funds for its own operations or expansion through the IPO. It was a secondary, not a primary, sale – i.e. no fresh capital came into Compartamos as a result of the sale. In fact, Compartamos did not need to raise new equity in early 2007. It has other means of financing growth.

Compartamos is under-leveraged relative to other banks (40 percent capital adequacy ratio versus 16 percent for Mexican banks on average). This gives it room to grow from its existing equity base through borrowing and deposits. Moreover, equity can continue to grow through retained earnings, as it has in the past.

Grow, yes; but growth through profits conflicts with social objectives

CGAP Focus Note, CGAP Reflections on the Compartamos IPO, June 2007 (page 11)

Link: www.cgap.org/p/site/c/template.rc/1.9.2440

It seems to us that Compartamos' decision to grow fast has been defensible from a development perspective—which is to say, the perspective of present and future clients.

But that brings us to the critical question: How should that growth have been funded? Compartamos and its shareholders say that unusually high profits were a necessary part of the equation: "[t]he returns received have become retained earnings and allowed the institution to nearly double its reach over the last three years, *something it could not have done any other way*." (ACCION press release, Apr 27; see page 9 of this publication)

We have not been privy to Compartamos' financing alternatives and decisions, but that statement is far from self-evident for us, at least when applied to the period after Compartamos commercialized. The years since 2000 have seen what can only be described as a flood of new publicly owned or socially motivated investors who are anxious to invest large amounts in debt and equity of MFIs. We have little doubt that Compartamos has turned down expressions of interest from a number of these investors since 2000.

The company was not heavily leveraged. Compartamos may have faced a tradeoff between paying a few more percentage points on its borrowings on the one hand, and lowering the interest rates charged to its clients on the other. Might not a business with a strong and effective social motivation choose the latter?

But more to the point, why couldn't Compartamos have taken equity investments, which would allow it to expand its funding—including borrowing more—without hurting is debt-to-equity ratio?

Was a lower financial return for existing investors weighed against the benefit to clients in the form of a lower interest rate?

Looking at the facts available to us, ***it is hard to avoid serious questions about whether Compartamos' interest rate policy and funding decisions gave appropriate weight to its clients' interests when they conflicted with the financial and other interests of the shareholders***. It is not clear how much Compartamos' decisions on those issues differed from what one would expect from a purely and forthrightly profit-maximizing company and its investors.

One cannot be too shocked if a for-profit corporation starts acting like other businesses. But in the Compartamos case, a controlling majority—two-thirds of the shares—was held by three pro-bono shareholders who were committed to development objectives, not profits. At a minimum, one wants to ask why they did not insist that greater weight be given to the interests of Compartamos' clients.

Topic 3:
Do IPOs alter governance in such a way that it is harder to balance social and commercial objectives?

Overview of this section

The microfinance industry has accumulated years of experience in having non-profit institutions as well as for-profit institutions with primarily non-profit ownership experiment with balancing social and commercial objectives in their decision making. Now, with IPOs happening in microfinance, we find governance changing due to the entry of some investors who are interested primarily in the financial returns. Will this affect the way that management grapples with these issues? Some argue that this could be one of the most critical issues confronting microfinance, and that we may find ourselves at a major transition point for the industry.

How do for-profit boards manage the double-bottom line?
DFN Discussion

23 June, Beth Rhyne (Senior VP, ACCION)
Link: www.microfin.com/dfnpostings4

I'd like to highlight the difficulty of guiding decision-making (regarding mission-related issues such as pricing policy) when the ownership mix of the MFI includes non-profits, social investors and purely commercial investors, which is a mixture we are going to be seeing for a long time to come.

How do the boards of such institutions manage the double bottom line? There are some tools, for example, social performance measurement. Institutions should set up specific social performance objectives and measure whether they are achieving them. Consumer protection codes are another set of tools. They usually include fair and transparent pricing as a stated value, so they call attention to interest rate policy as one of the key double bottom line issues. These are good tools, but they are only as strong as the will to use them (or the legal requirement).

A quote from Herbert Muller, board chair of BancoSol, suggests another reality. He said that balancing financial and social objectives surfaced in one guise or another at nearly every BancoSol board meeting because so many decisions require the board to apply general principles to specific situations. From this I conclude that the way the double bottom line is actually managed in mixed-ownership MFIs is by talking about the principles in governance meetings early so that consensus develops, and then continuing to talk, meeting after meeting, to apply and sometimes recalibrate the principles. I understand that exactly this kind of a process has been going on inside the Compartamos board over the years.

25 June, Chuck Waterfield (CEO, MFI Solutions)
Link: www.microfin.com/dfnpostings4

Compartamos is a socially-mandated company that makes profit exclusively off the very poor, prides itself in its social mission, and talks about its adherence to a "double-bottom line". It is being held by some as a success and an example for the microfinance industry to follow.

Beth provides some Insight into the challenges of decision-making processes when pursuing multiple objectives.

The fundamental issue in multiple bottom lines is that we need to understand how to strike some acceptable balance between challenging and contradictory goals. The challenge is to find the tension of the middle-point, generally sacrificing a bit on each objective to satisfy each.

Compartamos, while trying to engage the middle/balance/tension decisions inherent in the double-bottom line, ends up charging the interest rates they do, targeting the profit margins they do, setting up a structure that makes the decision makers the recipients of that profit, and then extracts profit to the degree they did. They are arguably "off the charts" on every one of these points.

My concern: If this is what ACCION/-Compartamos do and advocate, what is coming next down the pipeline, when we have MFI boards dominated by the profit side of the double bottom line?

I struggle to find the "balance" in these decisions. Personally, I want to understand why Compartamos and ACCION believe they have achieved balance. I want to understand what struggles they did go through, and how they ended up making the decisions they did. Is this an example we are to celebrate and emulate?

I really believe that we should step back and look at ourselves from a bit of distance. We first thought "wouldn't it be great if we could cover our costs..." Then we said "some profit is necessary to cover risk and fuel growth". We reached that hurdle. But we have, to this day, *never* discussed or debated "how much profit is too much profit"? I hear some people in microfinance say: That is not a topic we should to discuss, as we should only stick to "objective" issues. I disagree.

23 June, Rich Rosenberg (CGAP Consultant)
Link: www.microfin.com/dfnpostings4

I think the core issue is not just the fact that large profits were made on high-margin interest rates to poor customer, but also the fact that this was done by a company controlled by pro-bono shareholders whose mission is not making profits but helping clients.

Observe that Finsol, an emerging purely private for-profit competitor of Compartamos, is charging rates that are about as high as Compartamos, including a profit margin that is only a little lower. I don't hear a lot of outrage about Finsol. Yes, it is extracting monopoly profits from poor customers because the market is immature and competition hasn't forced rates down (yet). But that's what we expect private companies to do.

I'd have a hard time characterizing Compartamos profits as "excessive" *if* purely private capital were involved. But that's not the case we're all discussing. The Compartamos capital was *not* purely private. The majority of it belonged to public-purpose shareholders – the Compartamos NGO, ACCION, and IFC. For me, the proper question is not whether the profits would have been excessive for a private pioneer company, but whether the high profits coming out of the pockets of poor people were defensible *in light of the mission of the majority shareholders*.

Dealing with the real set of facts in the Compartamos case, I find it quite possible to formulate reasonable judgments about what's excessive or not. The criterion is whether the interests of borrowers were given as much weight as they should have been by pro-bono shareholders whose objective was supposed to be welfare of beneficiaries, and for whom profits were supposed to be judged in terms of whether they promoted that objective or not. Reasonable people might disagree about the answer to that question, but I don't think there's anything fuzzy-headed about it.

I think the issue is: When not-for-profit microfinance operators bring in private investors, how should they handle issues like high profits?

I and others have raised concerns about whether the IPO and reaction to it will hurt MFIs elsewhere who are charging interest rates that look "high" but who are making much more modest profits. I think the public discussion of the deal so far, not only in the microfinance listserves but also in the mainstream press, bears out this concern.

24 July, Dave Richardson (*Senior Manager, WOCCU***)**

Link: www.microfin.com/dfnpostings4

Beth’s comment regarding the ownership mix governing Compartamos struck me as curious after a cursory review of the stockholder voting rights of Compartamos. Compartamos AC (a non-profit civil association) and the ACCION Gateway Fund (a for-profit subsidiary of ACCION, a non-profit, pro bono development company) controlled a majority interest of 57.25% of the voting stock (see table).

What need is there of guiding decision-making policies when two stockholders with social objectives can tell the other stockholders and management to *lower interest rates* and then, vote accordingly to force the issue? Notwithstanding their voting power, ACCION has publicly stated that they supported the Board decision to maintain high interest rates in pursuit of its growth strategy (ACCION InFocus, p.14).

But what of Compartamos AC, the non-profit NGO who controlled 39.20% of the votes? After reviewing the ownership structure of this NGO, I found that three of the four founding members just happened to be stockholders of Financiera Compartamos, the Finance Company (SOFOL). Furthermore, one of those three members was a Full Board Member and the other two were alternate Board Members. In other words, Compartamos, AC, the non-profit NGO who is the largest stockholder of the Financiera Compartamos (SOFOL), happens to be controlled by three Financiera Compartamos Board Members who are all private investors with a vested interest equal to 6.79% of the company!

This discovery spurred me on to look at the entire ownership structure of Compartamos. Of the 21 stockholders, three are institutional investors (Compartamos AC, ACCION, and IFC) with a vested interest of 67.82% and 18 are individual investors with a total of interest of 32.18% of the company.

Compartamos shareholders at the time of the IPO		
39.20%	Compartamos AC	
18.05%	ACCION Gateway Fund	
10.57%	IFC	
23.66%	Insiders (11 individuals)	
4.80%	José Ignacio Ávalos Hernández	Director
4.85%	Alfredo Humberto Harp Calderoni	Director
2.89%	Juan José Gutiérrez Chapa.	Director
2.80%	Carlos Labarthe Costas.	CEO
2.69%	Carlos Antonio Danel Cendoya.	Co-CEO
2.40%	Luis Fernando Narchi Karam	Alternate Director
1.41%	Juan Carlos Letayf Yapur.	Alternate Director
0.59%	Oscar Iván Mancillas Gabriele.	Business Development Officer
0.58%	Juan Carlos Domenzain Arizmendi	Alternate Director
0.36%	Federico Hernández Martínez	IT Officer
0.30%	Javier Fernández Cueto González de Cosío	Strategy/New Business Officer
8.52%	Outsiders (7 individuals)	
	Charbel Christian Francisco Harp Calderoni	
	Fausto Enrique Miranda Gutiérrez	
	Alejandro González Zabalegui	
	José Luis Labarthe Hernández	
	Miguel Ávalos y de Mendizábal	
	Pedro Fernando Landeros Verdugo	
	Alejandro Puente Barrón	

Looking more closely at the block of 18 individual investors, I discovered some interesting voting block linkages:

1. 11 stockholders held “insider” positions of voting power representing 23.67% of company – 5 of 10 Board Members (including 2 executive-level employees) and 5 of 10 Alternative Board members (including 2 senior-level employees and 1 non-board member who was a senior employee.
2. 5 stockholders were either executive or senior level employees
3. 6 stockholders were family members belonging to 2 families

4. 3 stockholders were the original founding members of Compartamos AC
5. Only 4 stockholders representing only 2.77% of the company were seemingly independent with no apparent linkage to anyone else.

These relationships seem to be fundamental in arriving at a very important point: The individual investor-stockholders with a for-profit orientation effectively controlled 71.38% of the Financiera Compartamos' voting power (assuming ACCION and IFC were "double bottom line" believers).

ACCION's Active Voice

Bringing Microfinance to Scale, ACCION webinar, 27 June 2007, Lauren Burnhill (ACCION, SVP)

Link: www.microfin.com/webinar

Lauren Burnhill (24:30): ACCION does take an active voice in discussing the strategy of the institution. We have always been very open on growth strategy and interest rate policy. As with any group of investors we sometimes have differences of opinion. It's important to stress, though, that we are absolutely and firmly behind the Compartamos management and the decisions they had made.

Why did Compartamos do an IPO?

ACCION InSight, The Banco Compartamos IPO, June 2007 (page 4)

Link: publications.accion.org/micro_pubs_list.asp

Each shareholder had its own reasons to sell shares. It was strongly argued inside ACCION that since Compartamos was now very attractive to a range of investors, ACCION should sell some of its shares, allowing more commercial investors to come in, and at the same time freeing capital that could be invested in riskier, earlier stage microfinance projects. Hopefully, ACCION could use the funds to help develop Compartamos-caliber institutions in other locations.

Aside from an IPO, direct private sales were a possibility. Selling a significant part of its capital to a single investor or investor group was not Compartamos' preferred choice. An IPO would provide a more diversified ownership base.

To ensure governance stability, Compartamos set a 30 percent limit on the amount of shares offered through the IPO. The amount any one investor could buy in the IPO was also limited, to no more than 10 percent of the offer, or about 3 percent of the bank.

The Double Bottom Line

Tufts University Microfinance Dialogue, 2 November 2007, Damian von Stauffenberg (Principal, MicroRate) and Guy Stewart (Professor, Harvard)

Link: fletcher.tufts.edu/ceme/publications.shtml

With regards to a double bottom line, **Damian von Stauffenberg** was skeptical. He challenged the existence of a double bottom line in practice, stating that "…this thing about the double bottom line… it sounds great, it's nearly irresistible. But in practice I believe that the double bottom line is mostly words…rarely do I see it… " In most cases, Stauffenberg argued, the goal of a double bottom line hurts the efficiency and effectiveness of MFIs. This means that instead of passing on profits to the poor, the lack of pressure to perform evaporates profits. The employees, rather than the clients, are the ones that benefit.

Guy Stuart, however, cast a more positive light on the existence of a double bottom line. Stuart explained that if microfinance institutions like Compartamos used their loan and credit networks to reach families in need of nutrition services, the goal of the double bottom line could be achieved. Stuart noted that a social oriented stock exchange, a concept proposed by Dr. Mohammed Yunus, could be a more reliable funder of social businesses, including microfinance. In general, he noted, there are too few businesses, funds, philanthropies and institutions that are actively willing to take a risk and fund social ventures that receive below market returns.

With double-bottom lines, which line gets sacrificed?

MFP Discussion, 21 September, Narasimhan Srinivasan (Microfinance Consultant, India)

Link:finance.groups.yahoo.com/group/MicrofinancePractice/message/7819

I am not convinced that investing commercial equity into MFIs is a good solution, especially when we know that many potential investors do it for profits. In spite of all best intentions it is difficult to ensure that mission drift does not occur when there is money to be made. The entire body of knowledge, processes and instruments related to corporate governance owe their emergence to the failure on the part of many corporations to resist temptation of making profits through any means.

Only in exceptional cases would commercial funders have society and community interests in their mind. The "double bottom lines" are creations of fertile minds; difficult to achieve consistently. The critical question is what will be chosen between the two goals when one has to sacrificed – profit or the poor customer? I have not seen many answers in favor of poor customer in the field.

I would argue that donors who finance MFIs at any stage should bar infusion of fresh equity from investors who want to buy out – donors should reserve the first right of refusal of any equity that the MFI's promoters have. Donors should also impose conditions relating to inclusion of clauses in articles and memorandum of association of the MFI that would ensure the clients interests are protected perpetually.

All arguments that profits are not a sign of anti-societal behavior, that large volume of funds are likely only when profits are available, or that commercial funding would make the sector professional, are hollow when one sees how little impact they have had so far. Why can't commercial funding enter this market without the tag of microfinance? Why don't the equity investors set up shop and offer competition to the existing MFIs? Why is it that they want to take a equity stake in an existing company? Anyone wanting to begin a finance operation for profit could do so; but they should not be allowed to call it microfinance - which today signifies that it is finance with a social orientation.

Dividends paid to shareholders

DFN Discussion, 14 July, Dave Richardson (Senior Manager, WOCCU)

Link: www.microfin.com/dfnpostings5

Due to Mexican law, there were no dividends paid from 2001-2003. Then, in 2004, a cash dividend was paid of 29.93 million pesos, or 50%. In 2005, a cash dividend of 20.7 million pesos was paid, or 34.5%. Finally, in 2006, the year before the IPO, a cash dividend was paid of 164 million pesos or 273%!! That hardly seems modest to me. By applying the time value of money to this dividend stream, the internal rate of return for 6 years was 25.8% per year! This yield does *not* include the residual capital of 1.3 billion pesos ($119 million USD) which came from accumulated profits).

Even though all of the Compartamos stockholders received enough cash dividends to pay back their initial investment of 60 million pesos, the 6-year compounded yield of 25%, was not enough to make them happy. They wanted an IPO to cash in on *future* earnings. So, if the social investors and pro bono shareholders with development objectives were not content with a 25% return, what makes you think that anyone will be able to define an acceptable profit?

IPO good for all stakeholders

ACCION InSight, The Banco Compartamos IPO, June 2007 (page 14)

Link: publications.accion.org/micro_pubs_list.asp

It is our contention that the IPO was good for all the stakeholders in Compartamos: the clients, the institution, shareholders and the microfinance industry. Here is a summary view of Compartamos and its stakeholders after the IPO:

- Banco Compartamos now has standing and recognition in mainstream financial circles around the world.
- The institutional shareholders who sold their shares have resources they can reapply.
- The individual investors who first capitalized Financiera Compartamos have reaped financial rewards well beyond levels that were hoped for This outcome raises the issue of the compensation of founders and management for their role in building successful MFIs, especially as non-profits transform into for-profits. A debate on this issue has long been neglected.
- "The IPO showed the capital markets that doing business with the poor can be profitable, which opens the way for huge amounts of capital to move into the fight against poverty," according to Alvaro Rodriguez, Chairman of the Board of ACCION and ACCION's representative on Compartamos' board.
- It is important to remember that the premium paid for Compartamos shares came from the new investors, who evaluated Compartamos and were willing to pay a significant price in order to become owners. These shareholders will have an interest in keeping total profits high, which may occur through pricing, growth, diversification of services, leverage or some combination.
- The governance of Compartamos has changed very little, despite substantial ownership change. Compartamos is still governed by social investors for whom the organization's social mission remains essential.
- The existing and future clients of Compartamos continue to have access to an institution The prices they pay for these services may be high, but price is only one dimension of the value they derive from their relationship with Compartamos.

What is striking about this list is the great alignment of interests among stakeholders. The alignment is not perfect, and interest rates are probably the most important dimension in which there is a direct trade-off. However, if one looks at the whole picture of stakeholder interests, it is clear that clients and shareholders value many of the same things in Compartamos. In its everyday operations, Compartamos creates value for shareholders primarily by offering value to clients.

Shareholder expectations will be for profits over lower interest rates

CGAP Focus Note, CGAP Reflections on the Compartamos IPO, June 2007 (page 15)

Link: www.cgap.org/p/site/c/template.rc/1.9.2440

The high IPO purchase price paid by the new shareholders sets in place high expectations about profitability. The new purchasers cannot realize a respectable return on their investment unless future profitability is considerably higher than it already was in 2006.

In light of what the new investors have paid for their shares, they will certainly have little sympathy for interest rate policies that do not stretch profits to the maximum. At the same time, it is important to recognize that the tension between social and commercial objectives did not begin with the IPO. It began with commercialization in 2000.

For us, the Compartamos commercialization and IPO reinforce a message that others in the industry have been emphasizing for some time now: ***those of us who are involved in MFI transformations may need to be clearer and more realistic in dealing with the inevitable governance consequences of those transformations.***

When microfinance operations move from a nonprofit entity to a for-profit one, complex issues of governance, incentives, and ethics are created.

Topic 4:

Is the industry going through a pivotal shift from a donor/non-profit focus to a commercial focus?

Overview of this section

For some thirty years, the microfinance industry was funded first with donor money, then gradually with socially-oriented investment money, and lately with increasing amounts of commercial money. At present, all three sources coexist, and many MFIs simultaneously draw from all three. The discussions below address some of the implications and complexities of this co-existence of funding sources and discuss whether the industry has reached a pivotal shifting point.

Only the profit motive will reduce poverty

Tufts University Microfinance Dialogue, 2 November 2007, Michael Chu (ACCION Board)

Link: fletcher.tufts.edu/ceme/publications.shtml

Michael Chu argued that to predict microfinance's future it is important to understand the past. Chu argued that there are four necessary characteristics of efforts to reduce poverty: scale, permanence, efficacy and efficiency. Chu said that the only thing that society has ever known that has had the ability to achieve all four of these goals is the "profit motive." Opening up microfinance to the capital markets, he said, is the only way microfinance will be able to achieve the scale necessary to alleviate poverty in the developing world. Attacking the problems of poverty, Chu added, will require mobilizing the "trillions of the capital markets, not the millions and billions of the social capital markets. Even the Gates and the Omidyars of the world pale in comparison to the capital markets."

Not *what* we sell, by *why* we sell it

MFP Discussion

14 June, Lauren Hendricks (Economic Development Unit Director, CARE)

Link:finance.groups.yahoo.com/group/MicrofinancePractice/message/7087

In my opinion, the difference isn't *what* you are selling, but *why* you are selling it. Coca Cola sells products in order to make a profit, MFI's sell products in order to improve the lives of the poor. We as an industry made the argument, which I still believe, that financial services should be provided on a commercial basis because we could reach more people more efficiently that with subsidized services.

The question before us now is can we reconcile providing commercial services with providing services ethically? Does operating commercially mean we will always strive to maximize profit, or can we provide commercial services and at the same time make the choice to limit profits in order to increase income levels for our clients?

And I really don't ask these questions rhetorically. Many mainstream companies in the US that aren't "pro-poor" grapple with this issue, shareholders looking for short term returns and not valuing long term investment. Can we really expect to get truly commercial investors in microfinance and still achieve maximum impact? On the other hand, can we ever mobilize the amount of capital needed to reach the 3 billion people in the world with access to financial services without purely commercial capital?

26 June, Sarah Haig (Asia Regional Director, Hope International)

Link:[finance.groups.yahoo.com/group/Microfinance Practice/message/7156](finance.groups.yahoo.com/group/MicrofinancePractice/message/7156)

Consider the parallel of a pharmaceutical company that provided vaccines (in this example, for a debilitating but non-lethal disease) at prices that the competition-less market supported, and which yielded sky-high returns for shareholders. Is this the same as selling iPods or even Coca-cola for maximum profit? I would argue no—there's a moral distinction between that which improves basic income/education/health and that which makes life more pleasant. I would identify this practice as exploitative and unethical—of course mothers will pay more than they can afford to get their kids vaccines, and the fact that they hand over the cash would not justify the price and profits of the company.

The difference, and it is moral and thus uncomfortably non-quantitative, is institutions and individuals making "windfall profits" from providing people in poverty a life-improving service rather than a fun new toy. By all means, let's provide financial services sustainably, but let's get rich off the wants, rather than the essential needs, of the poor.

I'm a microfinance practitioner, not a philosopher, so I wish that ethical boundaries could be clearly defined by a ratio that is reported alongside ROE and PAR. They can't be, but let's not prevent that from making us uncomfortable when intangible boundaries are crossed.

27 June, Rich Rosenberg (CGAP Consultant)

Link:[finance.groups.yahoo.com/group/Microfinance Practice/message/7172](finance.groups.yahoo.com/group/MicrofinancePractice/message/7172)

I think Sarah Haig makes a valid point. When it comes to monopoly profits, lots of us (me included) would feel there is a moral difference between selling basic necessities and selling more superfluous things. I wouldn't mind getting rich, but I wouldn't want to do it off of monopoly profits on malaria medicine.

What's moral is one question. What society should control or prohibit is another. The latter question often feels more difficult than the former.

Why is this IPO so significant?

Bringing Microfinance to Scale, ACCION webinar, 27 June 2007, Beth Rhyne (ACCION, SVP), Alvaro Rodriguez (ACCION Board Chair and Compartamos Board member)

Link: www.microfin.com/webinar

Beth Rhyne (37:00): We're only beginning to understand the implications [of this IPO]. Clearly we have a ringing endorsement of microfinance by the mainstream investors. They are very enthusiastic about microfinance and are seeing it as an activity with growth, profit, and social benefit. What we need to be doing is we need to see how the social benefit side fits in there and clearly there have been questions raised about interest rates, ownership mix, and the double-bottom line. We're taking these questions very seriously and think it is good that they are being debated and want to be involved in those debates. I would like to also say that the implications for Compartamos, although they didn't raise additional money, the fact of the IPO really positions Compartamos to do a lot more and to have new strategies, including a change in its growth strategy. It doesn't have to finance through retained earnings as its main source anymore, and I think that does allow it to reduce interest rates. I believe it will result in a reduction in interest rates in the near future. My own view of some of the issues is that a strong Compartamos is good for clients and we are going to be surprised with large scale and creative ways that Compartamos addresses the needs of its clients, as it has in the past.

Alvaro Rodriguez (59:50): In many ways, this is no different than any other industry. We're starting to see MF as a mainstream service. Yes, individuals did benefit from this, but that got the capitalist machine moving into microfinance to provide financial services to the poor, which is one of the objectives we are all working towards. It is the first time we are seeing MF truly as a commercial vehicle. … in the end we'll have more, better, cheaper services to the poor.

The IPO is leading microcredit in the moneylenders' direction

Microcredit Summit E-news Debate, 12 July, Muhammad Yunus (Managing Director, Grameen Bank)

Link: www.microcreditsummit.org/enews/2007-07_critcomment1.html

Some are saying that the IPO will give a significant boost to the 'credibility' of microcredit in global capital markets. But that's my fear, because it is the wrong kind of 'credibility'. It is leading microcredit in the moneylenders' direction. The only justification for making tremendous profit would be to let the borrowers enjoy it, not external profit-driven investors. The ideal model would be one that puts full or majority ownership of the MFI in the hands of the clients. Borrowers of Grameen Bank own 94 percent of its shares.

When socially responsible investors and the general public learn what is going on at Compartamos, there will very likely be a backlash against microfinance. The field may find it difficult to recover if corrections are not made. Supporters of microfinance should be working to make sure that MFIs can legally take and on-lend savings as Grameen Bank does, and as Compartamos is allowed to do, rather than rushing to capital markets.

I'm urging all microcredit practitioners to remain true to the essence of the microcredit movement, which dedicated itself for more than 31 years to expanding the reach of microfinance in order to put poverty in the museums where it belongs.

Microfinance has lost its innocence

Microcredit Summit E-news Debate, 12 July, Damian Von Stauffenberg (Principal, MicroRate)

Link: www.microcreditsummit.org/enews/2007-07_suppcomment2.html

The Compartamos share sale is a watershed – but not for the obvious reasons. That investors got $450 million for shares that cost them $6 million will soon be forgotten. True, an unpleasant odor is attached to excessive profits made by those doing business with the poor. But that will dissipate. It is a watershed because microfinance has lost its innocence. Pre-Compartamos, microfinance was associated in the public's mind with charity; nobody questioned that this was a cause worth giving to because it helped the poor to help themselves. Compartamos has exposed a different reality – a reality of large, unbelievably profitable microfinance institutions; of international investment bankers and Wall Street investors jostling for a share of those profits; of unappetizingly high interest rates.

To mourn this loss of innocence would be wrong. In reality, microfinance had outgrown donations long ago. To attract the money they need, MFIs have to play by the rules of the market. Those rules often have messy results. Where there is little competition, as in Mexico, huge profits can be made. Under those same rules, badly run institutions can fail and investors can (and will!) lose money.

The challenge of the post-Compartamos world is to recognize this reality. Over-eager investors will have to re-discover that it's dangerous to project past profits into the future; they will also find that, to get their money, fanged animals will don the sheep's clothing of microfinance. Networks that have made a roaring business out of raising donations will have to justify why they need donations in the first place. To attract investors Microfinance Funds will have to present facts and figures instead of pictures of poor women in bowler hats. In short, microfinance will have to become much more transparent. And that is altogether a good thing!

Topic 5:

What are the implications of using grant funding to generate future for-profit entities?

Overview of this section

There is nothing new about some segments of commercial finance making large profits off of lending to the poor. The commercial finance industry has not ever felt compelled to enter into deep discussions and debates about such entities. What has emerged from the Compartamos IPO is the issue of an organization using significant initial grant funding to initiate and subsidize the creation of a sustainable institution and then introducing private investors who personally benefit from profits generated by that institution. The material presented below discusses these issues.

Donors have a responsibility

MFP Discussion

24 April, Narasimhan Srinivasan (Microfinance Consultant, India)

Link:finance.groups.yahoo.com/group/MicrofinancePractice/message/6880

Donors have funded the formative stages of Compartamos as they have so many others. Is there not a responsibility on the donors who are using "public funds" raised for "good" causes to ensure that the outcomes are "good" and in the larger interest of the people? What do the donors stipulate when they provide funding to such organisations? Do they require that the organisations work in the interest of their clients; not seek super-profits, eschew exploitative relationships? In case the business models of donor-supported institutions turn exploitative, what is the remedy that donors have? Are there any contract provisions that could penalise the recipient in proportion to the damage that it inflicts on its clientele? If there are no such contract provisions, is it not time that these are introduced? The donor and funder community has to do some hard thinking.

26 April, Calvin Miller (Senior Officer, Rural Finance, FAO)

Link:finance.groups.yahoo.com/group/MicrofinancePractice/message/6891

I too think this is a very important issue and one which merits further discussion. If microfinance was simply a venture capital business, this would not be an issue and would in fact be good for the industry by attracting investment into the sector. However, for an industry that sells itself for the social improvement of the poor and uses a fair dose of public money at least in some stages of one's development, the issue becomes more complicated and opens the door to politicians wanting to put clamps on interest rates, etc. Unlike credit unions, MFIs often do have a governance structure which redistributes excess earnings to investors.

10 July, Rich Rosenberg (CGAP Consultant)

Link:finance.groups.yahoo.com/group/MicrofinancePractice/message/7275

Before commercialization, I and my CGAP colleagues thought Compartamos's high-interest-rate policy could be reasonably defended from a social perspective, on the grounds discussed in my paper – mainly that any profits were going to be used to reach future customers rather than escaping into anyone else's pockets.

While we certainly encouraged Compartamos to revise its interest rate policy after 2000, CGAP has had no legal voice in any Compartamos decision since our grant agreement expired.

The remaining issue for me is whether we should have framed the original grant agreement to stay in force longer, *and* kept a legal veto right over Compartamos interest rate decisions. I admitted in the paper that we did not consider this option when making the grant in 1996: it never crossed our minds that interest rates would stay that high after inflation declined and private parties were allowed in as minority investors.

On whether we should have kept a veto, I think my answer is probably "no." The first question is how long such a veto right should last. Five years (in which case it would already have expired)? Ten years? Indefinitely? The second, and related, question is whether it is reasonable for a donor to try to stretch its control over an organization into a future period where it can anticipate that the donor's contribution will be a very small fraction of the funds invested in the MFI. That doesn't sound right to me.

If we ever want microfinance to enter into the financial mainstream, the implication is that some microfinance operations will be carried out by purely commercial owners. And some of these owners will no doubt exploit their monopoly pricing power until the market gets saturated and competition restrains pricing. The only way to prevent this from happening is to keep commercially-owned institutions out of microfinance. However, at a stage where an MFI is controlled not by commercial actors but by pro-bono actors, the view of CGAP is that they should have priced differently.

Public grants leaking into private pockets?

CGAP Portfolio Newsletter, June 2007

Link: *cgap.org/portal/site/Portfolio/Jun2007Lead/*

Before commercialization in 2000, Compartamos's operations were supported by direct or indirect grants of about US$6 million from private Mexicans and international public donors, including CGAP. True, these grants did fund the start-up of an operation that eventually produced big returns for private for-profit investors. But these private investors paid for their shares with their own money, at a price that represented a premium over the book value of the loan portfolio that the Compartamos NGO contributed to the new for-profit company. All the donor grants went to non-profit NGOs. Any shares purchased with those grants remained the property of the NGOs, and all profits accruing to those shares will remain in the NGOs, supporting their pro-bono work. We don't think there has been an inappropriate leakage of donor grants into private pockets.

Assumed competition would restrain profit motivations

CGAP Focus Note, CGAP Reflections on the Compartamos IPO, June 2007 (page 15)

Link: *www.cgap.org/p/site/c/template.rc/1.9.2440*

We at CGAP ask ourselves whether we bear any responsibility for this situation. Our 1996 grant of $2 million to the Compartamos NGO included no covenants about future interest rates or profit levels. Such covenants would probably have been inappropriate or impractical for several reasons, but in truth, we never gave much consideration to the possibility that Compartamos would be charging such interest rates, and generating such profits, 10 years later, after private investors had been brought into the picture.

We thought the motivations of the early leaders, or at least eventual competition, would keep things in reasonable bounds. We still hope—indeed expect—that competition will reduce rates and profits in the sector, but it is taking a long time.

More generally, since our founding in 1995, CGAP has been vocal about the need for interest rates that are high enough to cover costs, but we have been less emphatic about the loss to clients when interest rates are driven by inefficiency or exorbitant profits. We never made concrete predictions about how quickly competition would fix these problems, but we were probably too optimistic on this score. The Compartamos IPO gives all of us an opportunity to take another look at these questions.

Topic 6:

Are free-market forces (e.g., competition) sufficient to reduce interest rates or should the industry look at promoting codes of ethics, transparency efforts, and/or some forms of regulation?

Overview of this section

One commonly-stated theme throughout the discussions is that Compartamos has operated in a low-competition environment that has allowed Compartamos to set high interest rates and generate high profits. Microfinance experience in other countries, such as Bolivia, does demonstrate that as supply increases, competition can eventually drive down interest rates and profit margins. There was extensive discussion on the question of whether free market forces such as competition are sufficient to drive down interest rates – and how long that might take – or whether the industry should promote other means to accelerate the reduction on prices charged to the poor. This discussion continues, more than a year after the IPO, and has evolved into various conferences and action-plans.

Time to discuss our "next steps"

MFP/DFN Discussion

12 July, Chuck Waterfield (CEO, MFI Solutions)

Link:finance.groups.yahoo.com/group/MicrofinancePractice/message/7301

As I see it, we have many entities in microfinance whose mission is to "protect the interests" of *potential commercial investors* by rating MFIs and publishing data on profitability, etc. Sadly – and ironically – we have not a single entity whose mission is to "protect the interests" of the *microentrepreneurs* of the world. I firmly believe that the biggest need in microfinance is not – as we've been told over and over for a decade – to attract in commercial capital. Rather, it to establish Consumer Protection efforts. It is time to protect the poor from ourselves. We are guilty for not having done so years ago. It is late, but it is not too late.

I believe that *both* parties – the poor who need financial services and the wealthy that invest their money for a financial return – can jointly "win" if we agree to move forward with ethical behavior, transparency in our actions, honesty with our clients, and practicing a serious commitment to the challenges of reaching a double-bottom line. However, that joint process needs some restraints imposed on the monopolistic behaviors that tempt us when we work in unregulated free markets. Yes, eventually, competition usually comes in and forces us to behave, but the poor suffer in the meantime. And with a market of some 4 billion poor, the pressures of competition to enforce decent products and prices will take quite some time to work in the favor of the poor. That simply is not fair, and it is not necessary.

We can take actions to reduce the negative impact on the poor that come from monopolistic finance businesses. I personally don't think those actions require government intervention and interest rate caps. I think there are many other actions we can do, but they take efforts on our part. They take coordination and planning and time and resources. But I believe we need to step forward and do this now. The roots of microfinance come from those of us who became involved out of social concerns. The future of microfinance is in danger of losing those roots.

12 July, Beth Rhyne (Senior VP, ACCION)
Link: www.microfin.com/dfnpostings6

Chuck is absolutely right on this, and ACCION is interested in participating actively in this kind of work. While DFN and MFP have been good vehicles for surfacing ideas, progress from here is going to require other kinds of sessions, including some face to face.

I know that there are a number of different people starting to work on these issues. Certainly Consumer Protection is an idea that has been simmering for some time and perhaps this debate will give it the traction it needs to move forward.

Regulation, competition and the microfinance bubble

Tufts University Microfinance Dialogue, 2 November 2007 (Somak Ghosh, President of Corporate Finance, Yes Bank; Michael Chu, ACCION Board; Maria Otero, President, ACCION)
Link:http://fletcher.tufts.edu/ceme/past_events.shtml

Beyond providing savings and other services for the poor, the panelists argued for an improved regulatory framework within which microfinance can operate—a framework that would help standardize the industry and improve the protection of its clients. **Somak Ghosh** saw a powerful role for NGOs in this arena. In his view, NGOs could carve out a new niche, morphing from providers of cheap capital to major forces in the push for an improved regulatory and fiscal framework that would facilitate private sector participation.

This improved regulation, argued **Michael Chu**, should focus on three questions: How to protect (clients), how to promote (microfinance services), and how to draw the line on acceptable profit levels. An improved regulatory framework, added **Maria Otero** would help make microfinance part of the financial mainstream. This, in turn, would mean improved services for poor clients.

Lastly, the Dialoguers were asked if there was something that could burst the microfinance bubble. **Michael Chu** responded that it is likely that microfinance would follow a similar business pattern cycle as the rest of the private sector, complete with ups and downs. The cyclical nature of microfinance, however, was far less of a concern to Chu then a variety of other threats. Chu argued that misplaced government intervention could impede the growth of the sector, as well as decrease access to financial services for the poor.

When asked what she thought what might be capable of bursting the microfinance bubble, **Maria Otero** was clear: poor, misplaced government intervention. Referring to Bolivia, Otero argued that "populist" approaches to microfinance that make financial services for the poor unprofitable have the potential to "wipe out" the industry. Promoting competition, Otero argued, is the only real way to get prices down. And, ironically, the case in point for the impact of competition on prices is Bolivia itself. Regardless of the future ups and downs, however, Otero argued that microfinance clearly "is here to stay."

The need for checks-and-balances until competition develops

MFP Discussion
21 September, Rich Rosenberg (CGAP Consultant)
Link:finance.groups.yahoo.com/group/MicrofinancePractice/message/7814

An early entrant into the microcredit market in a given area is likely to find itself in monopoly position for some length of time, where its fees and interest charges are not restrained by competition, and potential profits are high. If such an MFI has private, profit-maximizing owners, the welfare of clients is not likely to enter very strongly into its pricing decisions.

If donors or socially oriented investors provide substantial funding to an MFI that's expected eventually to move to private commercial (i.e., profit-maximizing) ownership, how should they deal with this issue? One answer is to let things take their course, on the expectation that high profits during the monopoly phase will attract competition that eventually forces interest down to levels that more or less match the costs of efficient delivery.

It's too early to be sure, but my own impression is that the development of more advanced microfinance markets is looking pretty much like what standard competition theory would predict, with competition initially focused on product differentiation and then moving to price competition as the market nears saturation.

But this development can take a long time, leaving early pioneer MFIs in a near-monopoly position for as long as a decade or even more. There's an alternative approach that development-oriented funders might follow: requiring MFIs to which they provide major funding to keep a governance structure that is dominated by socially-oriented investors until such point as significant price competition develops. (Of course, having non-profit-maximizing owners is no guarantee that client welfare will be weighed heavily enough in pricing decisions, as the Compartamos experience suggests; but I think socially-oriented owners are in general less likely than commercial owners to charge whatever the market will bear.)

Would such an approach deprive MFIs of the equity capital they need to grow? Perhaps, but with the huge amounts of development-oriented investment funds out there hunting for MFIs these days, is this as a near-term danger?

21 September, Dave Richardson (*Senior Manager, WOCCU****)***

Link:finance.groups.yahoo.com/group/MicrofinancePractice/message/7817

I applaud Rich's idea of trying to create "checks and balances" into nascent microfinance markets funded by donors and other "do-gooders". The problem is that the term "socially-oriented investor" is too disarming for a naïve public who might think that such a person would *never* take advantage of the poor and the disenfranchised.

What would stop a social-investor from justifying huge profits with the caveat that such monies would be reinvested in similar activities consistent with their stated "mission" as we saw in the Compartamos case? I am left wondering if such profits can really be "sanctified" without damaging the moral integrity and authority of the social investors who created them. In other words, do the ends really justify the means?

A much more compelling approach would be to create true checks and balances into the system to keep the well-intentioned social investors from falling from grace into the temptation of profit maximization instead of a true double bottom line approach.

Here are some tried and true solutions from the boring cooperative brotherhood that really work:

1. Allow borrowers a voice and a vote on the Board of Directors to determine their own future.
2. Establish the practice of paying patronage refunds at the end of each year to all clients who have paid in interest. The refund amount would be determined, based on the current Basel Standards of capital adequacy.
3. Limit social investor dividends to a pre-determined maximum amount (i.e,. 6-10% or up to 2-times the inflation rate)
4. Allow client-borrowers the option to become stockholders of the MFI instead of

IPO investors with hyper-active salivary glands.

5. Establish a transparent methodology for setting loan interest rates, which cover all costs, including a fair return to equity capital.

Absent these types of mechanisms, I would remain very skeptical about any "double bottom line" rhetoric.

The Need for Pricing Transparency

MFP Discussion

25 June, Tanguy Gravot (Microfinance Expert, CAPAF)

Link:finance.groups.yahoo.com/group/Microfinance Practice/message/7143

One thing could make it clearer for clients: education on what is an Effective Interest Rate and mandatory disclosure of the effective interest rate calculated according to an agreed formula, for each and any loan proposal and contract, or advertisement. That would probably give back some decision and negotiation power to the client.

25 June, Del Fitchett (Rand Corporation)

Link:finance.groups.yahoo.com/group/Microfinance Practice/message/

Precisely a recommendation I made to the MFI authorities in Burkina Faso earlier this year. However, this decision might have to be approved at the regional central bank level before being implemented by the individual member countries. Such a rule could introduce more transparency into the financial markets. Actually, in Peru the Bank Superintendency publishes this information for MFIs on a web site.

25 June, Chuck Waterfield (CEO, MFI Solutions)

Link:finance.groups.yahoo.com/group/Microfinance Practice/message/

I couldn't agree more strongly about the need for transparency in product pricing. Most of the MFIs in the world hide the true cost of the loan product from their clients. Clients see a repayment schedule, yes, but that does not help clients understand the actual cost of the loan.

The US finance industry was disguising product pricing in the same way for decades – setting an attractive advertised interest rate, but then using manipulative interest rate calculation methods and up-front fees – to dramatically increase the real cost of the loan (what Tanguy calls the effective interest rate).

The US government got involved and passed the "Truth in Lending" legislation in 1967, requiring every lender to state prominently in the loan contract the APR (Annual Percentage Rate) which is exactly the formula we generally use in microfinance.

Many of us have been advocating that we need to lobby for these rules in the countries where we work, that the *true* cost of the loan is fully communicated to the clients. Sadly, we need to protect the clients from ourselves.

Targeting maximum ROE

MFP Discussion

24 April, Dale Lampe

Link:finance.groups.yahoo.com/group/Microfinance Practice/message/

I believe that when a NGO transforms into a for-profit, that the organizing documents should state some sort of maximum net income / ROE target that management is required to not exceed or else there's an automatic reduction in the interest rate. It might be helpful to think of it as a factor above that which debt holders receive. For example if the weighted average cost of debt is 12%, targeting ROE to 18%, or 1.5 times WACD might make it clear that what some might consider "excess" profits will be sacrificed back to the client. Note that I'm not saying that exactly 1.5 is the correct number here but just a representative idea. Board members might have to think of ways of rewarding increasing efficiency if an infinite profit possibility is taken off of the table.

DFN, 14 July, Dave Richardson (Senior Manager, WOCCU)
Link:finance.groups.yahoo.com/group/MicrofinancePractice/message/

I am not at all clear or comfortable about how anyone will define how much profit is "acceptable" in a for-profit institution, whether by yields, absolute amounts, or moral ethics. In a non-profit, there is no need to discuss this point since individuals can never profit individually.

Time for consumer protection efforts

SEEP Conference Presentation, 20 October, by Chuck Waterfield (CEO, MFI Solutions)
Link: www.microfin.com/SEEPConference

I honestly believe that the microfinance community is at a clear split in the road. We started 25 years ago as non-profits implementing short-term projects. We gradually evolved into social businesses pursuing the goal of sustainable services for the poor. And we now find MFIs – not just Compartamos, but others as well – charging the poor the highest rates they can, generating massive profits from the poor, and now extracting those profits for private gain. We are told that this is “social business” with a double-bottom line. We are told that this is the “future of microfinance.” I’ve honestly been trying to find a distinction between this approach I’ve just described and what moneylenders have been doing for centuries. Sadly, I’ve not yet come up with any significant distinction. We are progressively and rapidly blurring the lines between microfinance and moneylending.

To counteract this radical shift from the middle-ground of “social business” to profit-maximizing commercialism, I believe we need to move actively and even aggressively toward goals of increased **institutional transparency** and establishing serious **consumer protection efforts**. We’re told that market forces will settle things down. But is market competition sufficient to ensure genuine consumer protection for the poor? Do we wait patiently for competitive markets to be become fully saturated in order to drive down the profit margins before we can feel comfortable about what we are doing? And are we comfortable with some of our colleagues reaping windfall profits in the meantime? Or is there something else that we can, and should, be doing now? I think there are, in fact, many things we should have started doing years ago. And I believe that it is not too late to start. But we do have to start. And start now, and start with conviction and with serious efforts and resources.

The Jewish theologian Rabbi Abraham Heschel said: “only some are guilty, while all are responsible.” We may not be guilty, but I think we should all feel responsible. This happened in our industry, with our support and our personal and professional investments. And it will happen again. We are not guilty, but we **are** now responsible to make efforts to restrain the negative impacts that our industry can and will have on the poor.

We need to hold our industry to the standards of *building* assets and wealth *for* the poor, and not be found guilty of practices that *strip* assets and wealth *from* the poor. We need to move toward *positive* actions that balance out and restrain the *negative* actions that happen when private interests enter into what started as a public-spirited effort to develop sustainable ways to serve the poor.

Topic 7:

What implications might high-profit commercialization have on public perceptions about microfinance and on potentially increased government regulation of the microfinance industry?

Overview of this section

As demonstrated in Part I, the public media has found the issues of profits and the poor to be quite newsworthy. Many in the industry have argued that the issue of high profits generated by high interest rates charged to the poor can have a marked influence on the public perceptions of the microfinance industry and can potentially lead to increased government regulation. The discussions below address some of the implications of this. This issue is far from resolved, implications are still to be determined, and government reactions likely will be influenced by the issues raised in the previous six topics highlighted in this paper. Therefore, this is a suitable topic to bring our discussion of the implications of increased commercialization of the microfinance industry to a close.

The fallout of negative publicity

MFP Discussion, 19 June, John De Wit (Managing Director, SEF, South Africa)

Link:finance.groups.yahoo.com/group/MicrofinancePractice/message/

The IPO will bring to the attention of those who are wary of microfinance that there are actors in microfinance who are willing to charge the poor 100% while making exceptional profits for themselves. The question is then will they extrapolate this way of operating to us all?

Will the IPO add considerable fuel to the fire of those who claim that microfinance is not about poverty alleviation or economic growth but is simply about a new market, which is relatively unregulated, in which exploitation and indebting of the poor is common? And will this lead to more and more negative publicity and eventually encourage the politicians to bring in controls and interest rate caps in country after country? And will this scare away social investors and other investors who won't want to be associated with an "undesirable" industry?

Is the IPO good or bad for the microfinance industry?

CGAP Portfolio Newsletter, June 2007

Link: cgap.org/portal/site/Portfolio/Jun2007Lead/

The concern about interest rates and private enrichment has obscured some of the clear benefits of the IPO. The buyers of the shares were almost all truly commercial mainline investors, who represent a much larger long-term funding source for microfinance than the socially-motivated investors who are buying most MFI debt and equity at present. The huge success of the Compartamos IPO will no doubt make it easier for MFIs to raise mainline funding in the future, and help microfinance be regarded as a serious business by the financial systems of the countries where it operates.

While the Compartamos IPO may stimulate investors' interest in other MFIs, it may also have less fortunate results for some MFIs in Latin America and elsewhere. A number of countries are seeing a strong backlash against high microcredit rates from populist governments and politicians. This populist critique conveniently ignores the fact that rates for tiny loans have to be higher – sometimes much higher – than normal bank rates even when the MFIs are efficient and profits are reasonable. But the public example of Compartamos, where interest rates and profits look surprisingly high even to a fair-minded observer, seems likely to add fuel to the flames.

The Mexican microcredit market is still far from saturated, so it may be a while before Compartamos is forced to lower its prices to levels that produce a normal profit margin on its loans.

Super-profiting off the poor adds grist to the political mill

MFP, 28 April, Narasimhan Srinivasan (Microfinance Consultant, India)

Link:finance.groups.yahoo.com/group/Microfinance Practice/message/

What one is shocked at is applauded by another. An NGO-led microfinance outfit going public at a premium is a dream for many MFIs. But is it a dream or a nightmare for those who paid heavy interest charges and look on with disbelief at the institution which harvested such high interest charges is also harvesting premium from the investors. Will the MFI return a part of the interest paid by the borrowers? For, after all, these high interest charges are what bring in the premium on the share equity issue.

MFIs with super-profits add grist to the political mill and could make MF heavily regulated. That would be the end of innovations. The donors and lenders to such MFIs have a clear role to play. If they fail then can they justify their investments in MFIs as being in public interest?

What do you tell your acquaintances you do for a living?

MFP Discussion, 27 April, John De Wit (Managing Director, SEF, South Africa)

Link:finance.groups.yahoo.com/group/Microfinance Practice/message/

Once upon a time, when I met someone in South Africa who was not a microfinance insider and they asked me what I did, I proudly told them about our work to reach the very poor and to give them loans to build or start enterprises. The audience was generally quite enthusiastic and appreciative.

Then there was a change in the law in South Africa which removed all interest rate caps for loans under about US$1500. Within months a huge, for-profit, consumer lending industry exploded into our economy and onto our streets. Everywhere there were signs for "Quick Cash" and "Cash While You Wait". And the interest rates – 30% per month, yes, per month – became the most common rate around.

Of course the general public hated this. We are all brought up to loath loan sharks and Shylock. Then followed the stories of poor employees having so much debt that when this was deducted from their salaries they went home with nothing at all. Eventually this got so bad that the government stopped consumer lenders from having access to payroll deductions on the salaries of all government employees. By now the public had do doubt, microfinance was evil.

As you know politicians have two challenges, one they're just average human beings, and two, they pay so much attention to what the public thinks. So as average human beings they were always at least suspicious of lending to the poor and now as populists it didn't take them long to pick-up the vibe that microfinance was the scum of the earth. So it is no secret that our Minister of Finance doesn't see a difference between "good micro-finance" i.e. micro-finance which at the very least has an enlisthment objective, and legal loan-sharking.

So the calls to outlaw microfinance came. Somehow we were saved and instead have regulation that caps interest rates. But the caps are rather high, so who knows what the next episode there will be.

Now when I go to parties and people ask what I do I really have to search for words and shuffle my feet. One thing I know for sure is that the word "microfinance" will not pass my lips but the words "Nobel Peace Prize" will have to.

Conclusion

The material summarized in this paper is a small – but representative – portion of the material related to the Compartamos IPO that has appeared in the past year. Clearly the event has attracted a great deal of interest, has stimulated vigorous discussion and debate, and that discussion still continues.

Now, a year after the IPO, much discussion has transitioned beyond the specifics of the Compartamos IPO and is focusing more in the issues of future IPO trends, the implications of new, profit-maximizing investors entering the industry, and various possible action steps in the area of consumer protection that should be explored and implemented.

Our hope is that this paper helps to stimulate continued discussion of the implications of increased commercialization of the microfinance industry. Most do argue that commercialization is on the inevitable increase. Therefore, if this consensus view is correct, the microfinance industry is entering a new phase of its life cycle. We would argue that we are all obliged to seriously analyze the implications of this change on the future of the industry. What we in the industry have dedicated ourselves to create and build over the past several decades is on the cusp of change, and the implications of that change have not yet been fully analyzed or articulated. We should do so now.

Suggestions on using this paper

We envision many ways that the material presented in this paper can be effectively used to advance and continue dialogue on these issues. Among them are:

- **Personal study:** Readers can formulate positions on these points by going carefully through this material topic-by-topic. Readers can go into further depth by following the provided hyperlinks that lead to more thorough information.

- **Case study material in academic classes:** The material and structure of this document are well-suited for use in classroom settings. Lectures and student discussion sessions can target specific topics raised in the paper. Students can be assigned to argue for or against various positions raised in this paper.

- **Presentations and discussion groups at industry conferences:** In a similar fashion, this material can be used to engage practitioners in discussion of the topics raised. If time is limited, it is likely more effective to concentrate attention only on one or two of the key topics addressed in the paper.

- **Core material for internet conferences:** Internet conferences can give an opportunity to practitioners to probe more deeply and thoroughly into the material and to discuss and share their views. Participants can be requested to read a section each day or every few days prior to entering into moderated web-based or email-based discussions of the topics.

ANNEX 1: Sources used for this paper

Official CGAP sources

CGAP Focus Note, CGAP Reflections on the Compartamos IPO, June 2007

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Official Compartamos sources

Shortly after this paper was completed, Compartamos published a “Letter to our Peers” placed on the home page of the www.compartamos.com website. Presently this letter is only available in English.

MicroFinancePractice(MFP)/DevFinance(DFN) Discussions

Various contributions to Listserve discussions coming from: John De Wit, Del Fitchett, Ruth P. Goodwin-Groen, Tanguy Gravot, Sarah Haig, Lauren Hendricks, Dale Lampe, Calvin Miller, Paul Rippey, Beth Rhyne, Dave Richardson, Rich Rosenberg, Narasimhan Srinivasan, Chuck Waterfield

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