

KfW & FRANKFURT SCHOOL OF FINANCE & MANAGEMENT

FRANKFURT FORUM 2008: RESPONSIBLE FINANCE

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CLOSING COMMENTS

Michael Chu

Yesterday, I stood between you and the start of highly stimulating panel discussions. Today, I stand between you and the cocktail reception. I will try to use this precarious position to share with you three thoughts.

The first one is that development finance brings out the best in us as humans. Even the most commercial of us are touched by knowing that we serve the poor. This creates a great danger: ideological standards and conclusions taking the place of rigor and discipline in our analysis. That this can do damage is clear. Those of us who are old-timers in microfinance will remember the harm done when a lobbying group in the U.S. defined that “microfinance ended at \$300 per loan.” Today, the downside is even greater, as the large socially responsible investing sector and institutions like TIAA-CREFF are coming into development finance.

Let me point out some examples of this that have appeared in the last two days:

- It’s been reported that Muhammad Yunus stated recently that microfinance institutions should never price more than 10% above their cost of funds. Yet this does not take into consideration average size of loans, the stage of development of the organization, the country or the size of the portfolio. For example, at four million clients, perhaps the margin should not exceed 5%.
- It’s been implied that anything above a ROE of 14% reflects bad microfinance practices, yet analytically ROE is not a good proxy for any of that. In fact, all good practitioners of microfinance share similar attributes: knowledge of its clients, provision of a high value-proposal, control of late payments, etc. This can be true whether the ROE is 5%, 14% or 50%.
- There’s been a lament that the “purity” of microfinance is being lost, that some newcomers and new products somehow do not deserve to be at this conference. Let me suggest that the meaningful delimitation of microfinance is not what makes sense in our eyes but in the eyes of the poor.
- That brings me to the propensity at the conference to view consumer loans as bad and microenterprise loans as good. Let me propose that this is meaningless and that it is more useful to divide loans into “good credit” and “bad credit”, and consumer loans or microenterprise loans can fall into either category. Good loans

first fulfill the Hippocratic oath of doing no harm. Secondly, if they are microenterprise loans, they allow the borrowers to grow their assets; if they are consumer loans, they enable the borrowers to come a little closer to fulfilling their human potential by accessing choice. In other words, they do not cripple because they are backed by well-analyzed sources of repayment.

The second thought is that we are dogged by a misunderstanding of the dynamics of profits and their role in development. Let me point out three things:

- Profit maximization is a function of profits x time x the business model. Development finance is not like Sotheby's, where the model is selling one unique Van Gogh painting at the one moment in centuries it is put up for sale, and getting \$35 million instead of \$20 million determines success. Our model is more like a supermarket, which depends on multiple small operations with customers that return day after day, where profit maximization depends on delivering a good value proposition for a long time.
- Mission drift as a result of profit-seeking is a red herring. Our moderator reminded us yesterday that the highpoint of conventional banking in the last cycle was ROEs in the low 20%*s*. Without much effort, I can think of a long list of strong MFIs which are generating ROEs from the mid 20%*s* to the 50%*s*. So, if you are a successful MFI, why would you want to go upscale? And, could you? All the strengths of a MacDonald's apply to fast foods, none of them are relevant for fine French cuisine.
- But most importantly, profits are fundamental for development. A strong balance sheet is a necessary condition to be able to attract the resources necessary, be they from the capital markets or from savings.

The third thought is that responsibility cannot be defined independent of duty, and duty defines expectations. Development finance seeks to be an agent of change. The deeper the change, the more disruptive it will be. It follows that there can be no expectation that successful development finance can avoid causing pain and casualties. If you, like me, see development finance in a market setting, it is important to remember that Adam Smith's invisible hand is a clumsy one. As microfinance advances, the process will be uneven and painful. Competition will no doubt bring with it the risk of over-indebtedness and its wake of "dead and wounded." But ultimately competition will ensure that prices drop, product variety rises and customer service improves.

If you are tempted by the command and control system, you should remember that history shows its "dead and wounded" are often higher than those of the market's clumsy hand. In Latin America, we know that interest rate caps only shift the funds away from the poor to those whose average loan sizes can be larger. And will profit caps really lead to lower prices for the poor, or to more lavish head offices?

Microfinance cannot be expected to be the silver bullet to end poverty. The complexity of poverty means that no single intervention can solve it, but I think those of us who have been doing development finance for some time would agree that the set of high-impact

interventions that constitute the essential arsenal in the war against poverty is not that extensive: together with microfinance, they include access to health care, education, housing, and basic services such as power and water. For me, the great lesson of microfinance is that it is possible to bridge the gaps between the poor and those goods and services through commercial means. Let me suggest that the same conditions that allowed microfinance to emerge as an activity capable of high financial returns while delivering high social impact exist in all these other key interventions.

I believe in this so much that I have voted with my wallet and my commitment. This last June, together with my friend Alvaro Rodriguez, we have launched and are raising funds for the IGNIA Fund, dedicated to investing in commercial enterprises that will bring that arsenal of goods and services to the poor while delivering superior financial returns.

So I urge all of us to go forward after this conference, humbled because development finance cannot win the war alone, but with renewed commitment and enthusiasm because our work, while not sufficient, is a fundamental pillar that will allow the world to vanquish poverty.