

**KfW & FRANKFURT SCHOOL OF FINANCE & MANAGEMENT**

**FRANKFURT FORUM 2008: RESPONSIBLE FINANCE**

**February 21, 2008**

**WHY DO WE CARE ABOUT RESPONSIBLE FINANCE?**

**Keynote Address**

**Michael Chu**

Distinguished guests, our kind hosts from KfW and the Frankfurt School of Finance & Management, friends and colleagues:

It is a pleasure and a great privilege to be here with you to explore together the subject of *responsible finance*. The timing could not be more appropriate. In past years, we have come together in this venue to discuss the possible intersection of development finance -- the application of money to change lives --- with commercial finance --- the capital markets that represent the savings of the world. Today, we meet when the two have crossed, not as a reflection of vision, theory or daring imagination, but of hard, incontrovertible reality. In 2007, an institution that was born as an expression of development finance, and does nothing *but* development finance, went to the capital markets to sell its shares. In an IPO,<sup>1</sup> Banco Compartamos of Mexico, a microfinance bank with over 700,000 clients, offered 30% of its shares to the investors of the world. The issue was 13 times oversubscribed and it was 80% allocated by choice to US and European institutional investors. The IPO valued the ownership of Compartamos at \$1.5 billion. On the first day of trading, the price of the stock jumped over 30%. Today, the market capitalization of Banco Compartamos is over \$2 billion and a few weeks ago its listing was officially incorporated into the index of the Mexican Stock Exchange. This spectacular success of commercial finance had its origins in a \$6 million dollars investment of pure development finance in 1998.

The reaction of the capital markets was prompt, predictable and identical to all occasions when a new area of outstanding opportunity is discovered. In Mexico, there has already been a second IPO of a financial services company sailing under the microfinance flag. Some of us old-timers in development finance may not immediately recognize this vessel as part of the microfinance fleet, but the IPO was certainly a success. In the developed markets of the US and Europe, the “early adopters” have begun to apply themselves to acquiring knowledge of this new field. My phone has been ringing with callers from private equity funds and hedge funds. Commercial finance is doing what comes natural to it: seeking out and analyzing areas of opportunity promising above average returns.

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<sup>1</sup> Initial public offering, the first time a private company sells its shares to the public through a listed stock exchange

On the other hand, the reaction in developmental circles has been anything but business as usual. Once it actually happened, the long awaited intersection of development finance and commercial finance brought forth an intense polarization. Two examples illustrate the extremes of the reaction. The winner of the 2006 Nobel Peace Prize, Muhammad Yunus, has stated publicly:

*I am shocked by the news about the Compartamos IPO. Microcredit should be about helping the poor to get out of poverty by protecting them from the moneylenders, not creating new ones. A true microcredit organization must keep its interest rate as close to the cost-of-funds as possible.*<sup>2</sup>

On the other hand, in one of its publications, another microfinance pioneer, ACCION International, wrote:

*More than a new phenomenon, the IPO represents the culmination of an ongoing strategy within microfinance to enlist the private sector...: 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.*<sup>3</sup>

Accordingly, clarity of thought --- rigor and discipline in formulating our positions --- at this time is critical. If we get it right, development finance will be a positive force in harnessing the savings of the world as a tool for the poor. If we get it wrong, development finance will, at the least, be an impediment that slows the process, and, at the worst, serve as the intellectual foundation of mistaken government policy and development aid.

So, what is *responsible finance*?

This conference poses the fundamental question and then seeks to answer it at the micro level in terms of products, (i.e., the uses to which capital is applied) and funding (the way that capital is raised), and at the macro level (the financial system within which the sources and uses of capital come together).

The daunting opportunity given to me is to contribute to launch this exploration in a way that will catalyze the wisdom present at this conference. I believe I can do this best, not by trying to provide an overview, but by exposing my own thoughts, fallible and controversial as they might be.

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<sup>2</sup> Microcredit Summit E-news, Volume 5, Issue 1: July 2007.  
[http://www.microcreditsummit.org/enews/2007-07\\_suppcomment1.html](http://www.microcreditsummit.org/enews/2007-07_suppcomment1.html). Last viewed August 8, 2007.

<sup>3</sup> ACCION International, "The Banco Compartamos Initial Public Offering," *InSight*, Number 23, June 2007.

In this regard, the first question is: must there be a new and specialized definition of *responsible finance* for development finance?

If you look at anything under a microscope, singularity is exposed. In many ways, financing a multi-billion dollar M&A deal and a family home have many important differences; I know, I have done them both. But do these differences impact in any significant way what we would consider the basic principles of responsible behavior on the part of a financial institution engaged in both these activities?

Development finance has long crossed into commerce, the exchange of a good or service for payment. One of the great accomplishments of microfinance has been to prove that financing the needs of the poor is an integral part of the financial system. Let me suggest to you that the fundamental principles of responsibility in finance are the same for any financial activity, and development finance is no exception. What is different is how these principles are implemented.

But before we can define what those fundamental principles are, we must make a basic choice: should development finance operate under a *market system* or under a *command & control system*? This choice has nothing to do with regulation. Both are regulated, just in very different ways.

My own preference is for a market system. In a market system, while there are many attributes that are relevant, I believe three are fundamental:

- Choice: the ability to select from more than one provider of a good or service.
- The winners and losers are determined by the market itself, not by any other entity or process.
- All participants start on a level playing field. Advantages are the result of performance rather than other factors (such as collusion, privileged access to government or family connections).

Under a market system, I believe the principles of responsible finance are five:

- Transparency to the end customers: the terms and conditions under which a good or service is delivered is clearly known by the end-user.
- Transparency of the financial institutions delivering those goods and services with regards to the public, which include all the stakeholders, among them investors, regulators and policy makers.
- Compliance with the law.
- Compliance with the best practices regarding customer service, being faithful to the spirit rather than the text of codes of conduct.
- A regulatory framework (by which I mean the rules and the institutions to implement them) to ensure *all* the above, and the *solvency* of the financial institutions.

In the welcoming remarks today we heard references to the disastrous U.S. subprime mortgage crisis that has transcended borders to affect the world. Let me suggest to you that this came about as a result of violating these five principles:

- Because the holders of the mortgages were able to access them at such low initial down-payments, they were really holding options on their homes which were fine so long as prices increased but which had no value if prices declined; but all of them thought they had conventional mortgages.
- Many of the financial institutions involved carried their exposures in vehicles that were off-balance sheet.
- It is almost a certainty that laws were violated.
- The end customer was certainly mistreated.
- I believe history will show a failure of the regulatory bodies that should have known sooner and acted sooner.

Because I am proposing development finance under a market system, I am not advocating:

- Price caps
- Mandated targeted populations
- Mandated targeted regions
- Profit caps.

But why choose a market system over a command & control system?

Ultimately, one must choose where to place one's fundamental reliance: on the judgment of individuals who must be enlightened --- Plato's philosopher kings --- or on systems, and the behaviour that the structures of those systems elicit.

If your faith is on systems, then another way to pose the question of responsible finance is responsible systems versus irresponsible ones. Market systems without the five principles of responsible finance I referred to earlier are irresponsible systems. In case we forget, we need only go to very recent history and the former Soviet Union to remember that capitalism without regulation is the jungle, and in the jungle the predator is at the head of the food chain.

The reality of development finance is that it takes place in developing countries, where institutions and regulatory frameworks are weak and vulnerable, and so I understand the temptation to resort to command and control systems. I believe a major driver behind that temptation is the fear that in markets, especially imperfect ones, commercial behavior is inexorably driven over any other consideration to maximize profits through predatory practices.

This fear comes from a basic misunderstanding of two aspects of profits in market systems. The first is ignoring that the way in which profit is maximized is strongly determined by whether the protagonist is a one-time player or a long-time participant. If a

gambler comes into town in the morning stagecoach and plans to leave on the evening one, he may well have all the incentive in the world to stuff aces in his sleeve; but a gambler that comes to the poker table every day and plans to retire in the town serves his interests best when he is known as the most honest and fair man in the house.

When I did leveraged buyouts in the U.S. and took on large mountains of debt, why did I repay? That certainly did not maximize returns. I'd like to think that at the end of the day I would have done so because my mother worked hard to instill honesty in her son, but long before that became relevant, I had repaid because I wasn't there just for that one deal, but for the next one and the one after that.

The second misunderstanding lies in the role of profit in development finance. Through history we have come to associate profit with greed and serving the poor with sacrifice. Accordingly, it is difficult for us to celebrate a person that went to the slums and spent every day delivering exactly the same loving care as Mother Theresa if she arrived in the mornings in a Rolls Royce. So now that development finance has shown that it can perform as well or better than conventional finance, a part of the development community is confronted with an anxiety engendered by this cognitive dissonance. But in focusing on the by-products of serving the poor, they've taken their eyes off poverty itself.

The fundamental objective of development finance is to roll back poverty. In order to succeed against poverty, and not just alleviate its symptoms, I believe four key attributes are needed:

- The first one is massive scale. We all know that there are 3 billion people that survive on \$2 or less a day. If we deploy an intervention that reaches 100,000 people, we will have failed in relation to the problem at hand.
- The second is permanence. Our intervention must serve the poor of today, and their children and their children's children. This war will not be won in one generation. Accordingly, our intervention must survive the finite career span of its current champions.
- The third is continuous efficacy, by which I mean a model that gets better and better through time.
- The fourth is continuous efficiency, by which I mean a model that gets cheaper and cheaper through time.

The only thing I know that can deliver these four consistently and simultaneously is business --- not through one firm (companies are born, prosper and die) but through an industry. And to create an industry you need two things: an economic activity and above average returns.

This has been the great achievement of microfinance: to show that something of high impact for the poor can be delivered with a profitability high enough to create a whole industry.

But how high does that profitability need to be? And here we return to Banco Compartamos and responsible finance. In the years since its establishment as a finance company, Compartamos has generated ROEs of 50%. We have all read the emails and the blogs following the IPO. In my opinion, the overwhelming bulk of these communications have been emotional outbursts, but there is a criticism driven by analysis, exemplified by the work done by Rich Rosenberg of CGAP. He argues that Compartamos could have charged meaningfully lower interest rates and still produced financial returns commensurate with the average of Mexican commercial banking. His work is thoughtful and certainly worthy of serious consideration.

However, let me present an alternate reading. Banco Compartamos serves 700,000 clients, out of an estimated 7 million potential families that can be helped by microfinance. What is more important for development finance: to bring an immediate benefit to those that are currently served or to reach those unserved, as completely and as rapidly as possible? The outstanding success of the Compartamos IPO has drawn extraordinary attention to microfinance in Mexico. Conventional banking and new entrants are rushing in to provide financial services to the poor. Competition in Mexican microfinance is exploding as we speak. And we know from experience that it is competition that assures that the benefits of successful microfinance continue to flow not only to investors but to the poor. In Bolivia, since competition rushed in, microfinance interest rates have continuously dropped, with no end in sight. Today, it stands at 19%. It wasn't too long ago that such rates were accessible only to the cement or the beer company. Product variety has proliferated: BancoSol went from a situation of virtual monopoly and monoprodukt to a product mix today of 14 products, spread over credit, savings, remittances and insurance. Customer service has never been better, all because there are several world-class microfinance institutions competing to serve the poor. BancoSol last year earned a ROE of 37% because it has learned to drop costs faster than price.

In advocating for market systems, I would be remiss if I left you with the impression that I favor *laissez-faire*. I absolutely do not. Of course all of us present --- civil society, financial institutions, developmental agencies, government --- should be proactive in pursuit of development finance. The challenge is to do so in ways that strengthen the market rather than weaken it. For example, if we wanted to promote development finance in a particular region, we should not provide subsidies that favor anybody for just being there. We could, instead, provide an income tax rebate, which would benefit most those who are the most effective and efficient.

And so, with these thoughts in mind, I look forward greatly to this conference, where we will help each other to tap into our collective wisdom to ensure that responsibility is preserved and strengthened, just as the intersection of development finance and commercial finance are finally opening the doors of the savings of the world to the poor.

Thank you.