Not So Fast: The Realities of Impact Investing

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At the beginning of 2010, the Indian microfinance sector was a hotspot for impact investors. The promise of impact investing could be seen in the number of investors lining up to participate in the IPO of SKS Microfinance.

SKS had ballooned from 603,000 borrowers in fiscal year 2007 to 6.8 million in fiscal year 2010. Most were women in South Indian villages. The founder of SKS, Vikram Akula, had been saluted by Time and the World Economic Forum, and his Harvard-published memoir told the story of an "unexpected quest to end poverty through profitability."

But by 2011, the Indian microfinance sector was mired in bad press and political controversy. Newspapers accused lenders of putting poor villagers in debt and causing suicides. State-level legislation in late 2010 capped interest rates and scared away equity investors. Borrowers ceased to repay, and SKS's share price plummeted, dipping below 200 rupees in late August 2011 (from an IPO price of 985 rupees in August 2010). As summer 2011 ended, BASIX—a pioneering competitor of SKS-- very publicly searched for funding to stay afloat.

Both the achievements and challenges in India hold lessons for impact investors.

Impact investing has been widely touted, with microfinance as a leading example. The temptation to attract capital by promising macro-impact at a micro-cost is difficult to resist—and India continues to be one of the most important and innovative microfinance markets. But getting the equation right is more complicated than most advocates admit.

Here are seven lessons on challenges, risks and realities drawn from three decades of microfinance ups and downs.

Win-Win Possibilities are Enticing but Exaggerated

The early rhetoric around microfinance was heavy on "win-win." Investors would earn a profit, and poor customers would gain access to opportunities that were previously limited to richer folk.

Today, that rhetoric has been toned down in microfinance, and experts carefully note that for all its possibilities, microfinance is not a silver bullet. That's a start at realism, but a larger point is still under-appreciated: data fail to confirm that "win-win" investments are always most appropriate or most powerful. It may be necessary to accept bigger costs in order to generate bigger benefits. The impact investment proposition is based on achieving massive scale and multiplying the power of philanthropy through financial leverage. All the same, often the optimal proposition for someone interested in creating social change is not win-win. Instead it may be "lose-win;" i.e., tolerating a financial loss may be the best way to create the most meaningful social benefit.

In this light, it's notable that Muhammad Yunus has been leading the opposition to commercial microfinance in India. The Grameen Bank founder accused investors in SKS of being more interested in profit than social change.

"Poverty should be eradicated, not seen as a money-making opportunity," Yunus wrote in an op-ed for *The New York Times* in January 2011. "Commercialization has been a terrible wrong turn for microfinance." He went on to observe that it indicates a "worrying 'mission drift' in the motivation of those lending to the poor."

Yunus'motivation is partly to distance Grameen Bank from the public relations disaster in India, particularly given Grameen's own political troubles in Bangladesh. But his barbs reflect a longer legacy of concern that microfinance is abandoning the truly poor families that had been Grameen Bank's core focus.

Grameen Bank, in keeping with Yunus's vision, looks more like a non-profit cooperative than a traditional bank—and as such doesn't present much opportunity for a financial "win" by outside impact investors regardless of how you assess its impact

For-Profit Efforts Seldom Target the Poorest

Most microfinance customers, especially those served by commercially-oriented players in Latin America and Eastern Europe, are not rich, but neither are they poor as measured by the global $1.25-a-day poverty line. The typical commercial players do not focus heavily on women or the poorest borrowers, leaving low-profit segments of the markets to the NGOs. If the aim is to help meet the United Nations Millennium Development Goals through impact investing, microfinance yields few investments in the win-win sweet spot, especially outside of South Asia.

Benchmark data from the Microfinance Information Exchange, a donor-supported information clearinghouse, suggest that microfinance NGOs serve very different communities than do commercial microfinance banks.

We can get a rough measurement of customers' income by dividing an institution's average loan size by the gross national income per capita in the country. It's not a perfect measure, but it is indicative. Lower scores mean that loan sizes are smaller and suggest that the institution serves poorer customers on average. This proxy measure registers at 16 percent for NGOs, 32 percent for non-bank financial institutions, and 111 percent for commercial microfinance banks.

In other words, the typical institutions most open to impact investors (the commercial microfinance banks and non-bank financial institutions) look very different from the typical institutions (NGOs) that are most focused on poor communities. You can't count on investing in the former and reaching the customers of the latter.

It's Not So Easy to Find Investment Opportunities

Even when going "up-market," it may be hard to find appealing deals from a financial standpoint. The microfinance rating agency MicroRate conducts an annual survey of microfinance investment vehicles, finding $4.7 billion invested in microfinance by 80 funds in 2010. About three-quarters of this amount is concentrated in Latin America and Eastern Europe. But the survey also revealed another $1.7 billion held by the funds but not invested in microfinance, presumably waiting for investment opportunities.

"Quite frankly, impact investors are sitting at the end of an oil pipeline, waiting for the riches to gush out, but they are finding few deals," said Felix Oldenberg, Ashoka's Europe and Germany director, in a conversation with Nilima Achwal on NextBillion.net: "The most common complaint from impact investors is the low deal flow in their industry, since there are so few social enterprises that meet their (often narrow) requirements for investment." Experience suggests that part of the problem is the win-win assertion that you can expect to achieve meaningful social impact for next to nothing in foregone income.

Impact Investment Doesn't Banish the Need for Subsidy (It Often Requires It)

It's natural to imagine that social enterprises get funded solely by social investors, just as commercial enterprises get funded by commercial investors. The reality, however, is more complicated.

Most microfinance institutions are funded by a range of different kinds of investors. Some funding comes from foundations; others from government grants. Some comes from social investors happy with below-market financial returns. And, on the margin, some funding originates from pure commercial funders simply seeking profits. Financial statements reveal business models built on funds from multiple sources, together with revenues earned from doing business with customers.

Since money is fungible, some of the grant funding and some of the social investment necessarily is used to attract (and pay for) the commercial funding. Some social investors, seeking to attract commercial capital, are aware of and perfectly happy with this arrangement. Others, however, may not be so happy to think that their social investments are subsidizing the returns of commercial investors. But that is the reality whether they realize it or not. While the commercially-minded wing of the microfinance sector has at times been fiercely anti-subsidy in its rhetoric, this misses the point. First, social investments usually entail opportunity costs (that is, they generate lower financial returns than comparable investments with no social component), and this amounts to an implicit subsidy that is just as real as a traditional philanthropic grant. Second, social enterprises in microfinance often get subsidies from governments and foundations in addition to commercially-oriented social investment. It is those subsidies that allow social enterprises to generate the returns (and lower the risks) for commercial and "near-commercial" investors.

This isn't a criticism of microfinance and its funding. Instead, it's simply a recognition of how hybrid business models have helped build the sector and how prevalent they remain.

Social Returns Are Hard to Measure

The ultimate goal of impact investing is to improve the world in some way. That is premised on whether the intervention makes meaningful changes in customers' lives. While meaningful changes may be occurring, microfinance researchers have had a hard time quantifying them.

Microfinance grew by providing a compelling narrative about social impacts and economic market failures, coupled with inspiring success stories. Those success stories were cherry-picked to sell the idea, rather than reflect typical experiences. Social enterprises may work in the sense that they attract paying customers, but that doesn't answer the big question on social impacts.

When researchers measure impact, they aim to quantify changes that would not have otherwise happened. It's a challenging, but absolutely essential approach. Here, having a credible control group is the key. A study is only as good as the control group.

The latest research departs from the impressions given by success stories. An MIT evaluation of the introduction of microfinance to slums in south India found, for example, that while access to loans increased, average monthly expenditures failed to rise after a year. Households with existing businesses did invest more in durable goods and did see profits rise, but there was no measurable impact on health, education, or women's decision-making power. In sum: a mixed bag of results. Some customers gained in terms of measured outcomes, others did not.

This is only one small, short-term study in a specific group of slums in a competitive microfinance market. We can't generalize from it. Nevertheless, the evidence is similar to other studies in failing to find the widespread transformations that Muhammad Yunus and others have long described.

This kind of evidence has been humbling to the sector but constructive. It has led innovators to look for ways to improve impacts by adding other interventions like vocational training and health education. Perhaps more important, it has helped shift attention away from a narrow focus on business profits and toward more modest ends, including ways that finance can help families deal with ups and downs of income, save, and simply manage their money better.

The microfinance sector has come to impact evaluations slowly and reluctantly, but today rigorous impact evaluations are in process around the world.

The impact investing world can learn from the microfinance experience, especially given how central the "impact" part is to "impact investing". The recent 2011 IRIS Data Report of the Global Impact Investing Network (GIIN) and the Impact Reporting and Investment Standards (IRIS) initiative reflects an important step in presenting more and better data. But the report falls short of reporting anything resembling an "impact" (if we understand impact, as we should, as a net social or economic difference created by the intervention). Instead readers get numbers on scale, outreach, costs and revenues.

If impact investing is to evolve as a mature development strategy, investors need to find ways to measure (and be accountable for) true net impacts. "Performance" measures and impact measures can and do diverge big-time.

Investing Changes Incentives

Yunus's worry about mission drift is echoed by Elisabeth Rhyne, the head of the Center for Financial Inclusion in Washington, DC and one of the most thoughtful advocates of commercialization in microfinance. While Yunus and Rhyne have been on opposing sides of arguments, they're surprisingly aligned when evaluating the Indian microfinance crisis. Rhyne argues that "Investors must also swallow a big spoonful of blame because they paid dearly for shares in the [microlenders], they need fast growth to make their investments pay off."

The investors surely had good intentions and social commitments, but balance was lost. There's often good reason to think that impact investments can bring a world of good, but it's dangerous to ignore the flip side of the coin. There are times when investors can help turn something good into something risky for customers, as in India.

There, the explosive growth of microcredit has been singled out as the cause of sloppy loan-making and aggressive loan collection practices. The need for speed also explains the push to make ever-bigger loans to customers in order to reap economies of scale -- but at the risk of creating untenable heaps of debt for customers.

There's another way that investors change incentives, a focus of my recent research with Jonathan Conning, an economist at Hunter College of the City University of New York. The basic insight is that diligence and prudence are helped by having something at stake. Thus, maintaining incentives often requires having "skin in the game" to use the finance phrase.

Once investors are the ones whose money is mostly at stake, there has to be a way to ensure that microfinance managers and staff members work hard and take prudent risks, rather than simply pushing growth and scale as fast as possible. It's especially difficult to monitor management when investors live in a distant city – or another hemisphere.

The bottom line is that while social enterprises may simply be hungry for capital, those with capital often require more than a promising investment idea. Investors also need a way to deal with the incentive problems that accompany investment, and that means having good governance mechanisms, including ways to adjudicate conflicts, monitor managers and rein them in if needed.

Talking about the governance of social enterprises is far more dull than talking about the life-changing outcomes that social enterprises hope to achieve, and who wants to dwell on potential conflicts? Still, the lesson from microfinance in India and elsewhere is that governance is ignored at real peril.

Beware of Over-Selling

Hype can help inspire people, but we eventually need clearer language and clearer expectations. With microfinance, the claims and expectations have at times been so unrealistic that the inevitable mistakes and failures get amplified. So too does the negative coverage of statistical evaluations that yield less-than-stellar findings. Example: the MIT study was called, somewhat tauntingly, "The Miracle of

Microfinance?" harkening back to a phrase used often by microfinance proponents during its rapid rise in the impact investment consciousness.

We saw the backlash in the Indian microfinance crisis, which spilled over to the front page of the New York Times and was amply covered by the Wall Street Journal and The Economist (and most importantly continues to get lots of attention in the Indian press.) One result is that in a MicroRate survey, "negative publicity on microfinance" received 23 percent of the votes for why microfinance investment slowed down in 2010. Some of the negative publicity reflects real problems and can't be ignored, but much of the international coverage is an explicit reaction to inflated claims.

Social entrepreneurs are giving investors new ways to make a difference, and that's surely making the world a better place. But, in return, investors carry the responsibility to demand clear evidence and to make sure that the tough questions are getting asked.

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