CHAPTER 9:

Governance, Transparency, and Accountability in the Microfinance Investment Fund Industry[1]

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Introduction: Improving Fiduciary Practice

Fiduciary governance of the microfinance investment fund (MFIF) industry is at a crossroads. Best practice and fiduciary governance require serious improvement to win the trust of an entirely new class of institutional investors. A new breed of managers have become "swing funders" of microfinance, increasingly able to influence interest rate movements, while investors are kept in the dark about the true nature of this asset class, its risk levels and the "social hazards" imposed upon them.

This paper proposes practical ways to address these problems. In combination with the glossary at the end of the book, it examines the two sides of fiduciary governance: exogenous factors affecting investment professionals, such as its poor regulatory environment, and the importance of defining this new asset class on the basis of a clear risk/reward profile; and endogenous factors related to the daily practice of fiduciaries and how they meet the contractual expectations of investors.

The exogenous dimension includes the confusion surrounding the whole microfinance asset class, which is undermined by social hazards that weaken fiduciary practice and threaten its credibility among institutional investors. The asset class remains unclear, blurred by factors that make it difficult for outside investors to determine risk levels. Microcredit investment is essentially conducted over-the-counter (there is no exchange or liquid market as yet) for both fixed-income and equity securities of microfinance institution. Some managers claim microfinance investment is a "money market plus" product (providing a yield equal to the money market rates *plus* some additional percentage or a dual objective investment seeking a financial return *plus* development impact). Others say that it is much closer to the least efficient markets of private equity, showing an enormous performance gap exceeding 10 %. If it is mission-oriented, it is impossible to determine how much investors "leave on the table" in the form of development im-

pact rather than financial return. This ambiguity is deepened by the uneven standards applied to microfinance institutions (MFIs) by rating agencies. Some ratings are credit driven, while others have a fiduciary focus, with no common denominator of risk or risk measurement for funders, whether financial or social.

The endogenous case arises from the fair to poor fiduciary practice by fund managers. The lack of performance valuation and presentation standards makes it virtually impossible for investors to compare funds by their risks and rewards. Furthermore, some emerging MFIF professionals do not seem to distinguish the wide risk disparity between equity and fixed income (that is, debt) management. Fiduciary practice includes fund structure, risk control systems and compliance, investment processes, price setting, quality of reporting, integrity and comparability of data. These variables are the most critical components of the three key concerns of any serious investor: governance, transparency and accountability. Until these conditions meet generally accepted and recognised fiduciary practice (GARFP) standards, the level of trustworthiness and reliability will not trigger the flood of capital that so many people hope for.

The explosive growth of the MFIF industry since 2002 on the fixed income (debt) side and the current trend towards much greater leverage might expose or create fiduciary problems that could reduce investor interest for some time to come. To strengthen the credibility of the MFIF industry, this chapter recommends to bilateral and multilateral organisations five major lines of action: defining the asset class, defining the fiduciary risk, setting key assumptions, setting fiduciary practice, and measuring fiduciary risk. In addition, it prescribes fiduciary rating for all management firms offering microcredit investment funds, and advocates a charter of fiduciary rights (Annex).

Setting the Context: External and Internal Fiduciary Causes for Concern

Risk management is rapidly evolving in fiduciary practice. Formerly, it focused strictly on the investment portfolio, based on quantitative measurement against market benchmarks. Risk management practice gradually moved upstream during the late 1990s to identify the major sources of high and low performance by asset managers within the fund industry, recognising that people and systems could not be divorced from overall governance, checks and balances, risk control, fund raising and compliance. The nascent MFIF industry, hardly more than 6 years old, is emerging from a start-up phase. It is attracting institutional money, especially from pension funds. The better-managed MFIFs have experienced meteoric growth, with assets under management more than trebling since 2001. This creates concern about how the industry will cope with such rapid growth without improvements in fiduciary practice. While fiduciary practice has progressed, it has yet to become fully credible in the eyes of mainstream institutional investors. Rapid changes are required.