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Impact Investing as a Supplement to Nicaragua's Traditional Microfinance

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Abstract

There are too many good ideas in this world that go ignored and underfunded. By giving the less fortunate access to credit, microfinance has allowed millions of borrowers to fund their ideas for microenterprises. However, the impact these microenterprises have had may not extend very far beyond the individual borrower. Studies indicate that by investing in small and medium sized enterprises, more social impact would be generated. The purpose of this article is to suggest a new securities exchange that would facilitate the flow of capital from individuals globally to small and medium entrepreneurs in developing countries. In this article, this new securities exchange is applied to the case of Nicaragua.

I. Introduction

The world is becoming more globalized every day. However, with each step towards globalization, there seems to be an increase in the disparity between the "haves" and the "have-nots." Traditional microfinance has attempted to assuage this discrepancy by making financial services available to the poor. Yet, it is apparent that the rich are getting richer and the poor are getting poorer. Using Nicaragua as a case study, this article conveys the need to reform microfinance and propose a reform using impact investing that will change the vicious circle of contemporary microfinance into a virtuous cycle of financial sustainability.

Following this introduction and a brief literature review, the article provides some background on Nicaragua's economic history and the concepts of microfinance and impact investing. The article will then address some of the flaws in Nicaragua's microfinance infrastructure and propose an alternative method of debt financing that will alleviate some of the negative symptoms without undermining microfinance entirely.

II. Literature Review

While there is little literature available that quantifies the impact of microfinance on Nicaragua, there are many publications that debate the merits of contemporary microfinance on a global scale. The principles discussed in this literature will later be applied to Nicaragua in an effort to demonstrate the need for an innovation in microfinance.

In a study published by Kobe University of Japan, Imai, Gaiha, Thapa and Annim (2010) discuss the importance of microcredit. Their econometric analysis concluded that a country that has a higher gross loan portfolio held by microfinance institutions, has lower poverty (all other things held constant). The study found that an extremely high correlation exists between an increase in the number of active borrowers and an increase in gross domestic product (GDP) per capita. With regards to Latin America and the Caribbean (LAC) region, Dr. Imai and colleagues found that despite having a relatively high concentration of MFIs the LAC region has a very low concentration of active borrowers compared to other regions.[1] This low volume of borrowers is likely a contributing factor of LAC's poverty.

Richard Rosenberg (2010), who is Supervisor for the Consultative Group to Assist the Poor (CGAP), states that while econometrics may be used to indicate the help that microfinance provides to people living in poverty by raising their income, it still remains uncertain as to how much microfinance actually relieves poverty. For example, if a borrower of a small loan from a microfinance institution pays the loan back, then takes out another loan of a similar size, is she/he really better off or is she/he just dependent on a new financial institution for his income? To this Rosenberg (2010, p. 4) replies that the extremely low default rates on microcredit loans suggests "a strong presumption that microfinance is not over-indebting large proportions of its clients." Rosenberg suggests that we should instead look at some of the other impacts that microlending has rather than just fiscal impacts.

This notion of other impacts is corroborated by another CGAP article by Christen, Rosenberg and Jayadeva (2004), which discusses the notion of financial stability versus financial growth and argues that the former is a better indicator of poverty relief. The problem is that the borrowers of microfinance loans often continue to reuse microfinance after their first loan. There is a strong argument that, due to high interest rates, the borrowers are becoming dependant on the microfinance institution rather than becoming financially sustainable.

So how can we make microfinance more financially sustainable? In a presentation at the World Bank Conference on *"Small and Medium Enterprises: Overcoming Growth Constraints"*, Allen N. Berger and Gregory F. Udell (2004) discuss how the success of small and medium enterprises (SMEs) has a more measurable impact on poverty. SMEs, also known as small-growth businesses, create jobs and opportunities for more than just the entrepreneur and are much more financially sustainable than the microenterprises traditionally financed by microloans. However, Berger and Udell (2004) discuss numerous barriers and constraints that limit the flow of foreign capital to these enterprises. These barriers include financial institution structure and lending infrastructure, government regulations, and the lack of a discernable relationship between potential investors and entrepreneurs.

[1] Imai, Gaiha, Thapa and Annim (2010), p. 10.

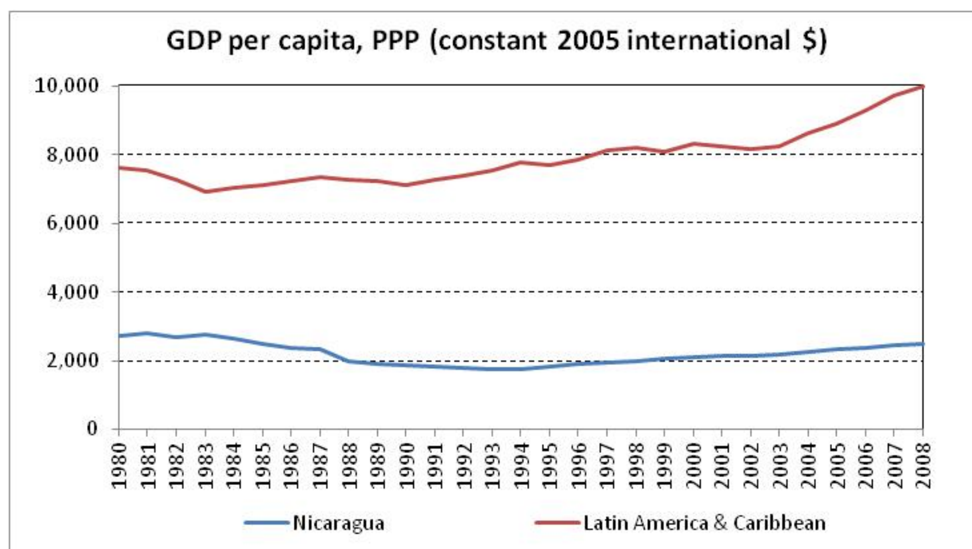
III. Background

III.1. Nicaragua's Recent Economic History

Despite some recent progress in terms of GDP per capita, measured in purchasing power parity (PPP) (see Figure 1), Nicaragua is the poorest country in Latin America (excluding Haiti in the Caribbean). Unlike the Latin American and Caribbean (LAC) region's income per capita, which caught up with its 1980 level by 1994, Nicaragua took 25 years to overtake its 1980 GDP per capita level. The country has longstanding widespread underemployment and poverty.

The Dominican Republic-Central America Free Trade Agreement (DR-CAFTA), signed by the United States on August 5, 2004, has expanded export opportunities for many of Nicaragua's agricultural and manufactured goods to the United States. Textiles and apparel account for nearly 60 percent of Nicaragua's exports. Ortega's promotion of mixed business initiatives, owned by the Nicaraguan and Venezuelan state oil firms, coupled with the weak rule of law, may negatively affect the investment climate for domestic and international private firms in the near-term.[2] Some also fear that recent increases in Nicaragua's minimum wage may erode Nicaragua's comparative advantage in the textile industry.

Figure 1: Per Capita GDP in PPP (in constant 2005 international dollars), 1980-2008



Source: Created by author based on World Bank (2010) *World Development Indicators* (as posted on the World Bank website; downloaded on April 10, 2011).

Nicaragua literally depends on international economic assistance to meet internal and external debt obligations. In early 2004, Nicaragua secured approximately $4.5 billion in foreign debt reduction under the Heavily Indebted Poor Countries (HIPC) initiative, but Managua still struggles with a high public debt burden. Most foreign donors have curtailed their funding in response to the November 2008 electoral fraud. Nicaragua has an Extended Credit Facility Program with the

[2] Adapted from CIA-The World Factbook: Nicaragua; available at: https://www.cia.gov/library/publications/the-world-factbook/geos/nu.html

International Monetary Fund (IMF), which is supposed to manage the government's targeted fiscal deficit during the 2011 election year. Furthermore, this program will encourage transparency in the use of Venezuelan off-budget loans and assistance. Nicaragua is progressively recovering from the current global economic crisis as increased exports drove positive GDP growth in 2010. The economy was expected to grow at a rate of about 3 percent in 2011.[3]

III.2. Background Information on Microfinance and Microcredit

Broadly speaking, microfinance is the notion of providing financial services to the poor. Microfinance institutions (MFIs) provide services ranging from insurance to loan brokerage. The loan brokerage aspect of microfinance is known as microcredit. Microcredit allows for low-income individuals with little or no collateral to gain access to debt financing. If managed correctly, microcredit can be a powerful tool for lifting people out of poverty. Originally, most microfinance and microcredit institutions were aimed largely at helping women gain access to capital and this trend continues today. The most famous MFI is the Grameen Bank of Bangladesh. Like most MFIs, the Grameen Bank was initially supported by donations. However, unlike most MFIs, the Grameen Bank's success has allowed it to become entirely self-sufficient and generate profits. This is however not the case yet in most other countries, including Nicaragua.

III.3. Background Information on Impact Investing

Impact investing can be defined as "actively placing capital in businesses and funds that generate social and/or environmental good and at least return nominal principal to the investor" (see Freireich and Fulton (2009), p. 2). Impact investing is seen as an evolution beyond the notion of "socially responsible investment" in which investors avidly avoid investments in companies perceived as socially or environmentally harmful in an effort to encourage more ethical corporate practices. Impact investors are actively placing capital in the hands of those who need it most in a manner that instigates development in much more demonstrable fashion than "socially responsibly investment" or philanthropy. Some investments only expect the return of nominal principal while others will negotiate a low interest rate or the purchase of some equity to compensate for the opportunity costs associated with investing.

Currently, high net-worth individuals, through investment vehicles such as pension funds, hedge funds and mutual funds, are the primary practitioners of impact investing. This article proposes an impact investing vehicle that allows the average investor, someone not necessarily wealthy enough to place money into an impact-focused hedge fund, to also participate in global development. Furthermore, the way most impact-funds are currently set up, their investments go through an intermediary, like an MFI, who then disperses the capital. The investment vehicle proposed in this article will facilitate direct impact investment by which the capital goes directly to the borrower without the need of an MFI.

[3] Adapted from CIA-The World Factbook: Nicaragua; available at: https://www.cia.gov/library/publications/the-world-factbook/geos/nu.html

III.4. Microcredit and Impact Investing in Nicaragua

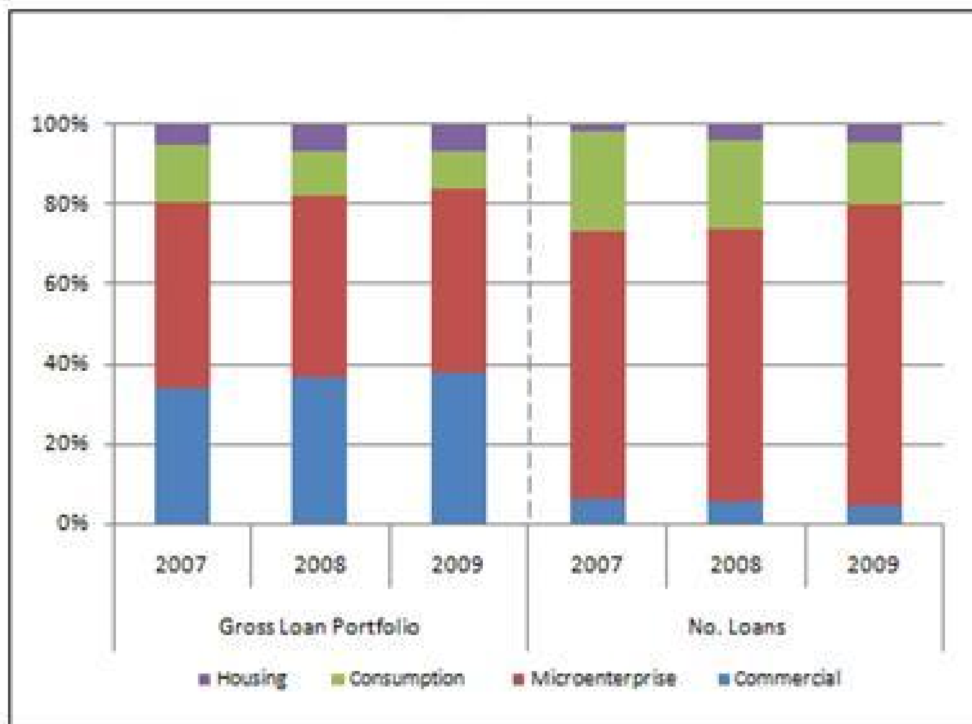
As of 2009, there are 32 active MFIs in Nicaragua. According to Mix Market (2010), these 32 institutions had 391,375 active borrowers in 2009. While precise historic data for the number of active borrowers in Nicaragua is not readably available, the research by Imai, Gaiha, Thapa and Annim (2010) indicates that the increase in GDP per capita corresponds with an increase in the number of active Nicaraguan borrowers. The data on impact investment in Nicaragua is even more difficult to obtain, but based on the worldwide increase in the popularity of impact investing, it can be assumed that it has grown recently in Nicaragua.

IV. Discussion and Proposal

IV.1. Reaction to Literature and Data

From the literature it has become evident that while there are many criticisms of microcredit, two main problems make its impact debatable: extremely high interest rates for borrowers and the profile of the borrowers. The high interest rates are in place to compensate for the lack of collateral on the loan. While in theory this may seem fair, it can lead to the borrower becoming dependent on the MFI due to a need for refinancing and continued borrowing. While Rosenberg (2010) points out that low default rates indicate that there are only a few over-indebted borrowers, they are still far from financially independent.

Figure 2: Portfolio Structure and Number of Loans by Credit Type of all MFIs

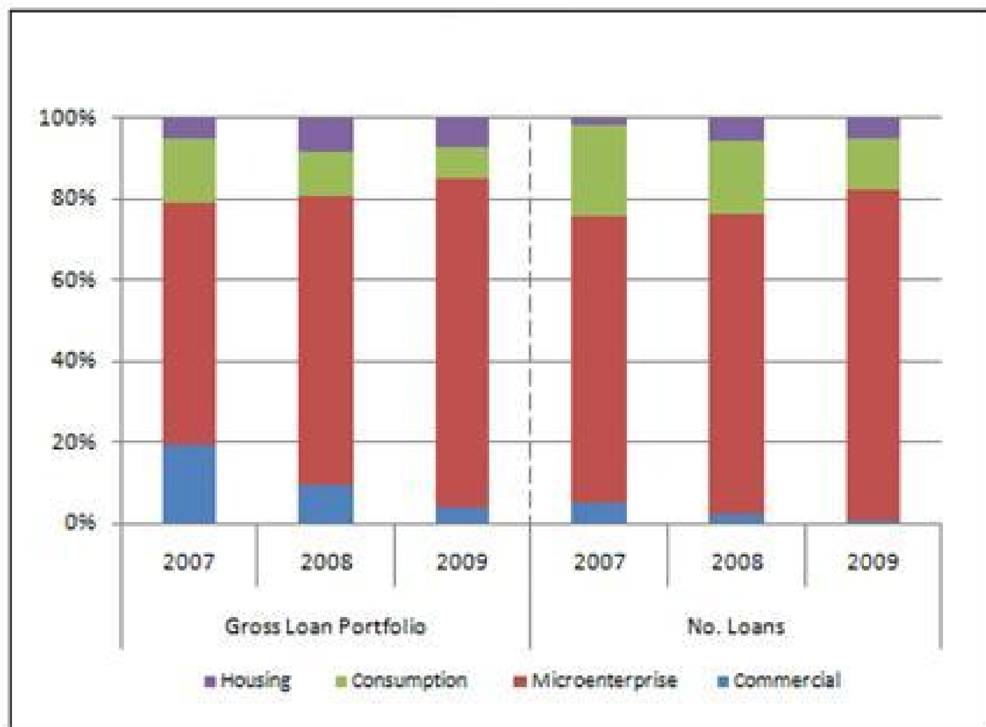


Source: MIX Market (2010) *Microfinance in Nicaragua*, Graph 1
(as posted on the MIX Market website; downloaded on April 13, 2011).

With regards to the profile of the borrowers, most MFIs issue loans to micro-entrepreneurs (who only need relatively small amounts) or to commercial borrowers (who need very large amounts). While this alone is not a detrimental matter, the allocation of nearly all capital to very small, micro-business makes it hard, if not impossible, for entrepreneurs trying to start with small or medium sized business to get loans. These SMEs often go underfunded because their entrepreneurs require a loan too large for a micro-loan yet too small for a commercial loan. As the literature indicates, these SMEs are essential in stimulating growth in a developing economy. As impact investments become a larger proportion of available capital in developing countries, it is imperative that these investments be funneled directly into these SMEs rather than traditional MFIs.

Unfortunately, there is no available recent data reflecting the concentration of small and medium enterprises within the Nicaraguan economy. However, Figure 2 and Figure 3 display where loans from microfinance institutions are going. The figures indicate a general trend towards investing in microenterprises and away from investments in housing, consumption and commercial loans for all MFIs (both regulated and unregulated) in terms of number of loans issued. Contrarily, in terms of gross loan portfolio (the left-hand side of Figures 2 and 3), only unregulated MFIs are actually investing a growing percentage of their money in microenterprises.

Figure 3: Portfolio Structure and Number of Loans by Credit Type (Unregulated MFIs)



Source: MIX Market (2010) *Microfinance in Nicaragua*, Graph 2
(as posted on the MIX Market website; downloaded on April 13, 2011).

Regulated MFIs are largely comprised of government-backed banks and publically funded international finance organizations. Therefore, it is reasonable that they would keep a large

percentage of their investments in less risky, commercial loans. Unregulated MFIs are privately held institutions that range from international lending corporations to pension funds anchored in the United States or Europe. These institutions have more freedom to lend to slightly more risky entrepreneurs. While this data is encouraging and depicts a greater investment in Nicaraguan entrepreneurs, impact investing is primarily aimed at SMEs and not microenterprises, because SMEs have a greater impact on their communities and therefore have a more demonstrable social return on the investment. As stated by the literature, a higher concentration of SMEs receiving loans would probably benefit the economy in the long run.

Hence, Nicaragua is the perfect country to begin discussing the potential for direct impact investing. Not only is it one of the poorest countries in the world, its lack of a middle class will make it possible to measure the direct results of impact investments. Furthermore, Nicaraguan entrepreneurs are faced with all of the barriers discussed by Burger and Udell (2004): (a) poor financial institution structure and lending infrastructure, (b) inefficient government regulations, and (c) a lack of a relationship between potential investors and entrepreneurs.

a) ***Poor financial institution structure and lending infrastructure***
   Obviously, something is wrong if the people who will help the aggregate economy the most have the hardest time gaining access to capital.

b) ***Inefficient government regulations***
   A detailed analysis of the legal framework surrounding Nicaraguan microcredit is not important for this article, but it should be noted that the laws are extremely convoluted. There are five different categories that MFIs fall into and each of them has their own set of exceedingly complicated laws (see MIX Market, 2010).

c) ***Lack of relationship between potential investors and entrepreneurs***
   This is largely a marketing problem. When people think of the Nicaraguan economy, they think of the many problems related to Nicaragua's poverty rather than a place where a difference can be made. Also, due to a lack of capital, SMEs have no way of contacting potential investors, both domestically and abroad.

IV.2. The Proposal: Direct Impact Exchange (DIX)

To overcome these barriers, this article proposes a new kind of securities exchange that only deals with impact investments. The exchange would be called the Direct Impact Exchange (DIX), and would encourage facilitation of the flow of capital from developed nations to developing or least developed countries by selling impact bonds to investors. DIX would be a virtual exchange, meaning that it would take place entirely online.

Investors would log into the exchange and view a list of entrepreneurs in need of a small business loan. The lender would then choose which entrepreneur she/he would like to lend to and makes a loan in any amount. Other lenders will log in and do the same and eventually the entrepreneur will have enough small loans to comprise the large loan she/he initially wanted.

The bonds sold by the SMEs would be valued similarly to the way bonds are currently valued for other companies using return versus risk analysis. Global Impact Investing Rating System (GIIRS) is an organization that uses an econometric system to calculate and quantify the projected social or environmental returns of a given SME. Since the borrowers of SME loans in developing countries usually do not contain much collateral, GIIRS meets directly with the SME to attempt to

gauge its level of sustainability. The proposition is that GIIRS' ratings actually become company ratings that would behave similarly to the way companies are currently rated on the New York Stock Exchange. However, these companies would have a quantifiable social/environmental return in addition to a financial return.

Depending on the competency of the entrepreneur and the social value of their proposed enterprise, the GIIRS would assign a rating that would be used to value bonds sold by that entrepreneur. The less sustainable the SME, the more expensive the subsequent bonds would be for the issuer. Furthermore, GIIRS currently offers nonprofit consulting to entrepreneurs to hedge some of the risk in investing. This consulting could be expanded upon and substantially reduce poverty in Nicaragua.

Moreover, the terms of the bonds would be highly favorable for the SME to ensure a high rate of approval. An example of a favorable stipulation would be that the SME did not have to pay any interest for the first two years, though interest would accrue. As with any security, there would also be a secondary bond market for impact investments. This would allow for investors to sell their impact bonds to other investors and would minimize the liquidity premium of the bonds.

As evidenced by recent increases in impact investing, foreign investors are indeed willing to take a smaller financial return in exchange for a quantifiable social/environmental return. This grants SME entrepreneurs access to capital at a cheaper rate than a commercial bank loan and allows them to become financially self-sufficient.

The notion of taking a smaller financial return has been demonstrated by microlending websites like Kiva where lenders make $25 loans with no interest and no collateral. However, this exchange would be substantially more efficient than organizations like Kiva, because Kiva does not directly give its donations to the entrepreneurs. Instead, Kiva bundles up the $25 donations and transfers them to a MFI that in turn loans them to its constituents at a normal microloan's rate. Kiva merely facilitates microfinance; it does little to improve its effectiveness. DIX however, would cut out the middleman and the rate of return the investor receives will be nearly identical to the rate the borrower pays (there would inherently be some flotation costs as with any security). These rates will be far lower than normal microfinance rates because of the GIIRS rating each entrepreneur will have.

Additionally, with a Kiva-like interface, DIX will solve the problem of only large investors being able to partake in impact investing. By allowing for any amount to be lent, any interested investor can participate in global development. The pension and hedge funds could still invest through their normal channels, and with large amounts it might be more profitable for them to do so, but impact investing would be a concept more omnipresent than derivatives or futures.

IV.3. Potential Problems

In addition to the large capital expenditure it would take to set up DIX, the largest potential problem for the exchange is the opportunity for abuse of the GIIRS ratings. To avoid a scandal like that of the 2008 credit-crunch caused by the exceptional overvaluing of mortgage-backed securities, GIIRS would have to be audited by another agency. To avoid the auditor becoming infiltrated by those who would abuse the power, the auditing agency should be comprised of an international committee with no one country having a greater weight than another.

Another problem could be that competition for impact investment opportunities will dilute the quality of the SMEs. To compensate for this potential pitfall, GIIRS' metrics would have to be enumerated clearly and remain static for a long period of time. This would ensure that an 'A' rating today would be equal to an 'A' rating five years from now. It is improbable that there will be fewer novel entrepreneurial ideas in the future than there are today, so there should always be a steady flow of SMEs at all levels of the GIIRS spectrum.

IV.4. Long Term Impact

By developing Nicaragua's middle class, there will be increasing employment opportunities available for the poor, and the severity of poverty will decrease. As the severity of poverty decreases, Nicaraguans will begin to accumulate assets and before long will possess their own collateral to offset the ridiculously high interest rates of microloans. As these Nicaraguans begin to take out loans, loans will also become cheaper for those without collateral and microlending will become more sustainable.

Furthermore, impact investing and GIIRS sets up the foundation for an extremely virtuous cycle. Soon not only will SMEs have GIIRS ratings, but every company worldwide will have a GIIRS rating of some sort. Companies that partake in more ethical practices would have higher GIIRS ratings and will attract more investors. Eventually, companies will be competing for impact investing opportunities. DIX combined with contemporary impact investing will quickly achieve the reform that socially responsible investing set in motion.

V. Conclusion

The Direct Impact Exchange (DIX) will be a revolutionary facilitator of global development. There are many countries around the world with similar economic climates to Nicaragua that will benefit greatly from the DIX implementation. While microfinance has helped millions, its long-term effects continue to be debated by macroeconomists. Impact investing will better allocate capital to entrepreneurs who will have a more comprehensive effect on relieving poverty. However, it is important to make the distinction that DIX would not replace contemporary microfinance, but rather supplement it. Impact investing, with a focus on small and medium enterprises, will yield immense social returns that will allow microfinance to facilitate the poverty relief it was intended for. Impact investing is going to change the way financial transactions occur all over the world. With the execution of the Direct Impact Exchange, people of all means can participate in demonstrable social change.

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