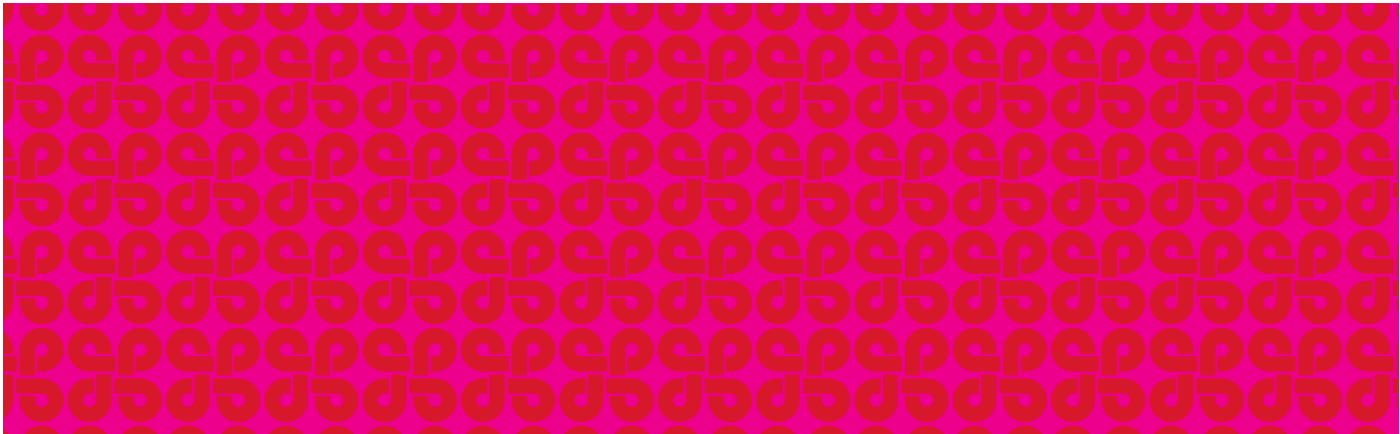


Social Impact in a Changing Microfinance Sector

Social Performance Report 2017



Luxembourg Microfinance
and Development Fund



In collaboration with



LMDf has been granted the LuxFLAG Microfinance Label



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Acronyms

ACP	African, Caribbean and Pacific Group of States	OECD	Organisation for Economic Cooperation and Development
ADA	Appui au Développement Autonome	PAMF	Première Agence de Microfinance
ATM	Automated Teller Machine	PhD	Doctor of Philosophy/ Philosophiae doctor
BCEE	Banque et Caisse d'Épargne de l'Etat	PIIF	Principles for Investors in Inclusive Finance
BIL	Banque Internationale à Luxembourg	PPI	Progress out of Poverty Index
bn	billion	RIM	Risk Management Initiative in Microfinance
CEO	Chief Executive Officer	RMGM	Risk Management Graduation Model
CERISE	Comité d'Echanges, de Réflexion et d'Information sur les Systèmes d'Épargne-crédit	RoA	Return on Assets
DAC	Development Assistance Committee of the OECD	SDG	Sustainable Development Goals
EIB	European Investment Bank	SEA	South East Asia
EMA	European Microfinance Award	SICAV	Société d'Investissement à Capital Variable
e-MFP	European Microfinance Platform	SIGI	Social Institutions and Gender Index
ESG	Environmental, Social and Corporate Governance	SIMFI	Web-based Simulation of Microfinance Institutions
FAO	Food and Agriculture Organization of the United Nations	SKS	SKS Microfinance Ltd., now Bharat Financial Inclusion Ltd.
GDP	Gross Domestic Product	SMEs	Small and Medium-sized Enterprises
HDI	Human Development Index	SPI	Social Performance Indicators
HEFF	Higher Education Finance Fund	SPI4	4th version of Social Performance Indicators developed by CERISE
HIV	Human Immunodeficiency Virus	SPTF	Social Performance Task Force
HR	Human Resources	SSA	Sub-Saharan Africa
IDG	International Data Group	TCX	The Currency Exchange Fund
ILO	International Labour Organization	UN	United Nations
IPO	Initial Public Offering	UNDP	United Nations Development Programme
IPR	Inteant Poalroath Rongroeurng	UNESCO	United Nations Educational, Scientific and Cultural Organization
KPI	Key Performance Indicators	UNICEF	United Nations Children's Fund
KYC	Know Your Customer	UNPRI	United Nations Principles for Responsible Investment
LAC	Latin America and Caribbean	USD	United States Dollar
LMDF	Luxembourg Microfinance and Development Fund		
LUXMINT	Luxembourg Microbank Intermediary Scheme		
MENA	Middle East and North Africa		
MFI	Microfinance Institution		
MTX	Microfinance Currency Risk Solutions, Inc		
MIMOSA	Microfinance Index of Market Outreach and Saturation		
MIVs	Microfinance Investment Vehicles		
mn	million		
MSME	Micro, Small and Medium-sized Enterprises		
NAV	Net Asset Value		
NBFI	Non-Bank Financial Institution		
NGO	Non-Governmental Organisation		
ODA	Official Development Assistance		

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Juana Rocha in her flower shop// Nicaragua



LMDF - Investing for social change

LMDF's first Social Performance Report was issued in 2015. Much has changed in the microfinance sector since then, and the Fund has shown that it is well positioned to adapt to changing circumstances while holding to its core agenda.

As the microfinance sector matures and the larger MFIs find new sources of finance, other microfinance funds are turning to emerging microfinance institutions in the Tier 2 category which has always been the focus of LMDF's investment strategy.

The increasing maturity of the sector coincides with a powerful global movement in awareness at all levels of business and society of the importance of non-financial goals.

Despite this additional competition, coupled with the challenges of an extended period of lower interest rates, LMDF continues to grow steadily, building what is now recognised as a credible track record and attracting new investors.

The increasing maturity of the sector coincides with a powerful global movement in awareness at all levels of business and society of the importance of non-financial goals (exemplified in the UN's Sustainable Development Goals). Money managers and advisers are slowly beginning to realise that, as a result, that there is an ever-growing body of investors who wish to dedicate at least some of their resources to achieving social impact. LMDF's shareholder structure, which is designed to respond to the demands of investors who share an interest in social or impact investing but have differing expectations in terms of financial risks and rewards, can serve as a model to meet the expectations of this growing investor population.

Demonstrating social impact in a reliable manner is, however, still challenging, as its measurement has not yet reached the maturity of financial measurement and reporting. This report concludes that the gathering and analysis of standardised data for social performance measurement is showing progress, but much remains to be done, for example in the areas of building social performance into the decision-making processes of both investors and MFIs themselves, and encouraging the MFIs who are seeking funding that the social performance data that investors will soon demand can only come from increased attention on their part to producing that data.

This second edition of our Social Performance Report seeks to present some background on the microfinance sector and LMDF, comment on some key social performance measures, review LMDF's track record against these measures and draw conclusions on LMDF's past performance and guidance for the future.

Kenneth Hay
Chairman

Social performance in a changing microfinance sector



The world is undergoing a period of significant change. New technologies, new political risks and new emerging economic forces are changing the dynamics of numerous industries. In a period of such changes, it is essential to ensure that those at most risk in societies are not left behind. As a Fund, we focus on providing opportunities to such people. This report looks at the data which we have collected over the history of the Fund and examines how effective we have been at supporting these groups and how the Fund and microfinance institutions have adapted to the changing global backdrop.

We revisit this journey and look at the evolution of the Fund which launched just 8 years ago and now exceeds EUR 30 mn in size, has made more than 100 transactions and has supported 155,000 microentrepreneurs across the globe.

LMDF's Social mission and history (Chapter 1)

This first section revisits the Fund's vision and mission. Although the global backdrop has changed, the core goals have remained constant. LMDF's vision is to contribute to the alleviation of poverty by supporting organisations that empower people and stimulate entrepreneurship, with a particular focus on the most excluded. Nonetheless the Fund has evolved considerably over the course of its history. We revisit this journey and look at the evolution of the Fund which launched just 8 years ago and now exceeds EUR 30 mn in size, has made more than 100 transactions and has supported 155,000 microentrepreneurs across the globe. Such growth has been supported by the broader development agenda, and we consider how the SDGs and

microfinance come together. We also look at the partners and investors who have been key to the development of the Fund.

How LMDF works (Chapter 2)

The second section of the report considers the infrastructure of the Fund. In order to be ready to adapt to a changing environment, the fund needs to have strong processes in place. In many of these areas, LMDF works together with its NGO partner ADA. The work conducted by both organisations, as part of the investment process, supports the development of MFIs so that they can be ready to face the developments in the microfinance world. The role of both ADA and LMDF is highly complementary. By having both an NGO and a for profit organisation working together, a unique dynamic has been constructed, allowing MFIs to benefit from funding and from technical assistance. Considerable emphasis is placed on the long-term sustainability of the institution, through local currency financing solutions, long-term partnerships and social performance support. This section examines these core areas and how LMDF has built up mutually beneficial long-term partnerships with MFIs.

LMDF's social performance achievements (Chapter 3)

This section considers LMDF's mission and how successful it has been at reaching these targets. As the external environment continues to develop, it is important to continually monitor whether the Fund has been able to achieve its desired impact. The results are encouraging; despite change, LMDF is still able to reach those most in need with 75% of investments located in the countries belonging to the bottom half in terms of development. When



Members of the women group Nyéléni during their weekly meeting // PAMF, Burkina Faso

considering the rural communities, the women and the younger micro-entrepreneurs, we not only examine statistics, but also success stories and case studies. This enables us to understand more about the best models to use to alleviate poverty and will hopefully provide encouragement for similar models to be rolled out further across the globe.

From this analysis, it is clear that the Fund's social vision and mission translate into higher social performance across all 6 dimensions and 19 indicators compared to the overall sector.

LMDF's social performance compared to others (Chapter 4)

Finally we consider LMDF's performance relative to its peers. LMDF in no way operates in isolation and in an increasingly interconnected world, we need to consider how we fit in relative to our peers in order to maximise our social impact. From this analysis, it is clear that the Fund's social vision and mission translate into higher social performance across all 6 dimensions and 19 indicators compared to the overall sector. This section is also evidence

of the increasing focus on social performance measurement as a way to take better and more informed decisions. In previous years, such data has not been sufficiently comprehensive to enable such analysis.

Going forward, increasing amounts of data and improved technology will make social performance monitoring more accessible. We look forward to seeing this evolution occurring and to using this data to ensure that LMDF can maintain constant in its values, vision and mission as the external world continues to change.

Apricot Wilson
ESG Responsible



Chapter 1:

LMDF's social mission and history

Vision

LMDF aims to contribute to the alleviation of poverty by supporting organisations that empower people and stimulate entrepreneurship, with a particular focus on the most excluded. The Fund facilitates access to responsible finance by building sustainable links between investors, microfinance institutions and ultimate beneficiaries.

Mission

In order to realise its vision, LMDF

- Constitutes an attractive investment proposition by balancing stable financial returns to investors with the provision of responsible financial services to the poor.
- Specialises in facilitating the growth of promising emerging microfinance institutions which address the financial needs of marginalised communities and individuals in developing countries.
- Enables the development of micro-entrepreneurs in areas where unmet needs are largest, particularly among women, youth and rural populations.
- Is accessible to public, institutional and retail investors and is accountable for reaching both social and financial objectives, and transparent in its reporting.

The evolution of the Fund

The Fund celebrated its 8th birthday in October 2017.

Over the course of its history, LMDF has reached many milestones:

- On the 17th May 2017, it disbursed its 100th loan to a microfinance institution
- It has worked in 26 countries across the globe: one quarter of these countries are in the lowest Human Development Index Ranking
- Investment agreements have been signed with many of Luxembourg's leading financial institutions, including an investment finalised during the 2016 European Microfinance Week with the European Investment Bank

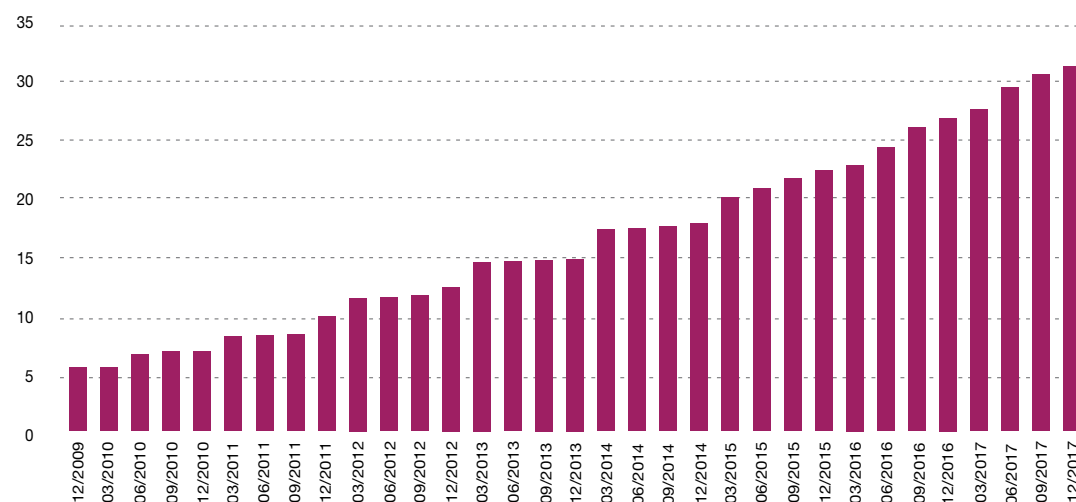
LMDF has seen a regular yet strong growth over the last years. Since its inception, the total net assets have increased by more than 20% each year. In 2017, the Fund's size exceeds EUR 30 mn for the first time. Its growth is a clear indicator for the interest in a social fund with a sustainable business model.

The Fund has grown and developed over its eight-year history yet the vision and mission of the Fund have remained constant. The Fund has always strived to reach the most excluded in society, be it through its investments, partnerships or thought-leadership initiatives. A full analysis of LMDF's efforts in this area can be seen in the Achievements section of this report.

LMDF has seen a regular yet strong growth over the last years.

However eight years is a long time in the microfinance industry and there have been considerable changes in the investment climate and needs of the sector over this time. When Symbiotics first conducted its Microfinance Investment Vehicle Survey in 2006, it identified 74 vehicles invested in microfinance; by 2016 this number had increased to 113. The combined Assets under Management of funds has increased over 10 years from USD 2.1 bn to USD 11 bn as of December 2015.

GRAPH 1.1:
EVOLUTION OF NAV (EUR MN)



Source: LMDF analysis, data as at 31/12/2017



Client of an Cambodian MFI in her bean field // Cambodia

ResponsAbility now reports that growth is slowing in the MSME financing sector, and the sector has reached a certain level of maturity.

Yet eight years is a long time in the microfinance industry and there have been considerable changes in the investment climate and needs of the sector over this time.

These changes have been compounded by the low interest rate which has been prevailing in most of the developed world, and which has indeed begun to spread into the developing world. The increasing maturity of the sector is reflected in the size and form of many microfinance institutions today. A model providing a wider range of financial services is now common and MFIs often have a banking license. Many offer deposits and other money saving services to their clients and focus

their refinancing on growing this base. Authorities in many markets now effectively regulate the microfinance sector.

All these evolutions are a sign of success, that many aspects of the original vision for microfinance have been fulfilled. And we are proud that LMDF has contributed its small part to achieving these goals. Does it mean the job is done? What is the role for LMDF in this changing sector? This report takes stock of the guiding principle of LMDF's actions: How our social DNA translates into investment decisions and ultimately impact on the ground.

Brief history of microfinance and LMDF

1976

- Grameen Banking Approach developed in Bangladesh

1992

- BancoSol became the first microfinance NGO to transform into a licensed bank

1994

- ADA - Appui au Développement Autonome was founded

1998

- Luxembourg became the chosen domicile of the first registered Microfinance Fund

2009

- Microrate published its Cautious Resilience report – an analysis of the impact of the financial crisis on microfinance

**Launch of
LMDF**

2010

- Microfinance crisis in Andhra Pradesh
- Luxembourg government chose to exempt microfinance funds from subscription tax

2011

- Principles for Investors in Inclusive Finance developed

2012

- M-Shwari launched in Kenya allowing digital access to microsavings products

2005

- UN International Year of Microcredit
- First European Microfinance Award

2006

- The Nobel Peace Prize was awarded to Mr. Muhammad Yunus and the Grameen Bank
- ADA hosted its first Midi de la Microfinance
- LuxFLAG launched the world's first Microfinance Label

2007

- Banco Compartamos became the 1st MFI to hold an IPO
- Microfinance reached 100 mn of the world's poorest households
- M-Pesa mobile payments were launched in Kenya by Safaricom

2013

- From Microfinance to Financial Inclusion: Financial Inclusion 2020 Global Forum hosted in London

2015

- The Millennium Develop. Goals expired and the Development Goals were signed
- OECD launched their scoreboard on Financing SMEs and Entrepreneurs

LMDf's 5th Anniversary

2016

- The European Investment Bank launched partnership with LMDf
- Microlux was officially launched and became the first microfinance institution acting in Luxembourg
- 1st European Forum on Social and Solidarity Economy

2017

- LMDf completed its 100th transaction

Focus on emerging microfinance institutions

If you are starting a microfinance fund, you need to decide what sort of institution you want to invest in. There is quite a choice: large MFIs such as Compartamos and SKS have undergone initial public offerings- their shares are available for all to buy.

The majority of MIVs focused on large and mature MFIs, the Tier 1 institutions. However as a social fund, LMDF aims to support those with limited or no access to international finance.

Start-up organisations in highly underdeveloped economies may be very difficult for investors to access, but need capital to get into an expansion phase. Yet whatever direction you choose to take, you will have an impact on the micro-entrepreneurs underlying the microfinance institution.

LMDF was faced with this question when the fund

launched in 2009. It chose to concentrate on Tier 2, emerging microfinance institutions. The mission states that it “specialises in facilitating the growth of promising emerging microfinance institutions which address the financial needs of marginalised communities and individuals in developing countries.”

It chose this niche because:

1. The majority of MIVs focused on large and mature MFIs, the Tier 1 institutions. However as a social fund, LMDF aims to support those with limited or no access to international finance. This led it to look at the Tier 2 and Tier 3 sectors.
2. Emerging MFIs are likely to be found in regions less developed in terms of financial inclusion. More developed economies often have larger MFIs.

TABLE 1.2:
TIER DEFINITION AND LMDF'S FOCUS BY TIER

	Tier 1 MFI	Tier 2 MFI	Tier 3 MFI
Size	> USD 50 mio in assets	USD 5 - 50 mio in assets	No requirement
Sustainability	RoA > 0 during 2 out of 3 last years and all RoA > -5%	Positive RoA in 1 out of last 3 years and other > -5% OR positive trend in RoA and all > -5%	No requirement
Transparency	Regulated financial institution OR rated financial institution	Audited financial statements for at least 3 years	No requirement
Description	Mature MFIs; Highly saturated and competitive markets, 15% of market	Emerging MFIs; Market (niches) with high growth potential 25% of MFIs	Developing MFIs; Insufficiently developed business models 60 % of MFIs
Share of LMDF's Investment portfolio	2%	85%	13%

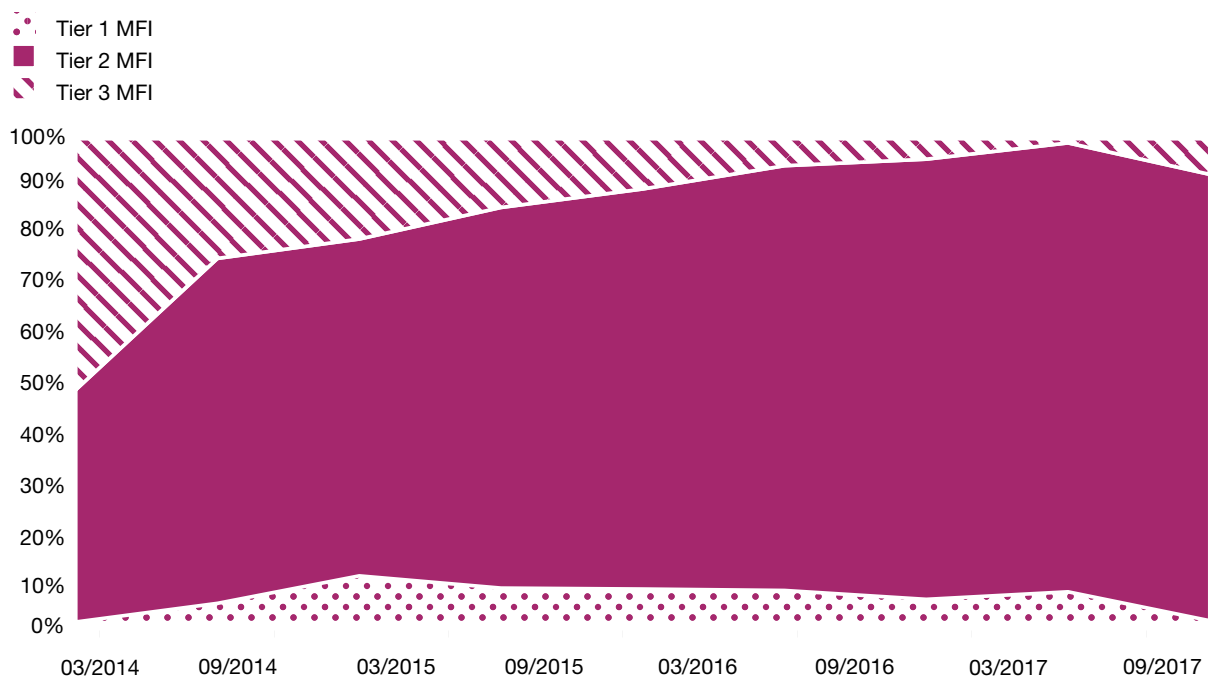
Source: Global microfinance institutions by Tier (in terms of number). Definition: e-MFP. Data source: Mix Market. LMDF analysis, data as at 31/12/2017.

3. The smaller size of Tier 2 and Tier 3 institutions is generally reckoned to be an advantage when it comes to targeting underserved populations.
4. The larger institutions have more of a tendency to focus on urban areas where there may already be a surfeit of financing solutions.
5. Tier 2 institutions have some form of track record. Their proven business models offer reassurance compared with the under-developed business plans of many Tier 3 institutions.

Yet markets are developing. Tier 2 institutions are now receiving more capital from established MIVs. Many Tier 2 can no longer be viewed as institutions with limited or no access to international finance.

Moreover the increase in investor interest means that yields have fallen. Although the number of Tier 3 investments has fallen back in recent years, the Fund now plans to target an expansion in this area.

GRAPH 1.3:
COMPOSITION OF LMDF'S PORTFOLIO BY TIERS (2014-2017)



Source: LMDF analysis

LMDF, microfinance and the SDGs

In 2015, 193 countries across the globe adopted the **Sustainable Development Goals**, part of the global development agenda which will be in place until 2030. Microfinance has a role to play in contributing to all of these goals, as LMDF shows through the examples below:

<p>1 NO POVERTY</p>  <p>Yembila Sorgho, Burkina Faso</p> <p>Yembila had been a successful farmer in rural Burkina Faso, but one evening his cattle were all stolen leaving him destitute. A loan from PAMF has allowed him to build up his herd and his livelihood once more.</p>	<p>2 ZERO HUNGER</p>  <p>Intean Poalroath Rongroeurng, Cambodia</p> <p>IPR focuses on rural lending and works in areas with strong potential for rice production; the MFI was founded to alleviate capital constraints of rice mill entrepreneurs who lacked access to credit to expand their production.</p>	<p>3 GOOD HEALTH AND WELL-BEING</p>  <p>Pro Mujer Nicaragua</p> <p>Pro Mujer Nicaragua does not view itself as a MFI, but instead as a Women's Development Organisation. As well as providing financial services, it also offers training and healthcare, and has provided 22,500 cervical cancer screenings in the past 2 years.</p>
<p>4 QUALITY EDUCATION</p>  <p>Victor Lemus, Guatemala</p> <p>Victor aims to complete two Masters and a PhD. He has been able to access university thanks to Génesis. Currently just 13% of young Guatemalans complete secondary education, and even fewer go further; those from poorer backgrounds are less likely to be able to do so.</p>	<p>5 GENDER EQUALITY</p>  <p>Asusu, Niger</p> <p>The literacy rate for girls in Niger is just 15.1% (compared with 34.5% for boys). Faced with this problem, ASUSU has developed incentives to encourage parents to keep their daughters in school by offering them uniforms and special educational savings accounts.</p>	<p>6 CLEAN WATER AND SANITATION</p>  <p>Pana Pana, Nicaragua</p> <p>The MFI works in an isolated region of Nicaragua where, access to safe water and sanitation is a real challenge. With two other organisations, they supported 800 families with rainwater recovery systems, perforations, wells and ecological sanitation.</p>
<p>7 AFFORDABLE AND CLEAN ENERGY</p>  <p>Fondesurco, Peru</p> <p>Fondesurco has been a pioneer in developing green products for its micro-entrepreneurs, including green credits for purchasing solar water heaters and energy efficient ovens.</p>	<p>8 DECENT WORK AND ECONOMIC GROWTH</p>  <p>Hadda Sebbai, Morocco</p> <p>Hadda Sebbai from Bouarfa in Morocco has been able to build up a successful tailor business with the support from Al Karama. She now has 5 sewing machines and offers training opportunities to young women.</p>	<p>9 INDUSTRY, INNOVATION AND INFRASTRUCTURE</p>  <p>ADA</p> <p>LMDF has an innovative partnership with the NGO ADA which acts as its investment advisor. ADA conducts investment research, and are also able to provide technical assistance enabling MFIs to increase their capacity and improve their infrastructure.</p>

<p>10 REDUCED INEQUALITIES</p>  <p>Boury Tamboura, Mali</p> <p>Boury is partially paralysed man and was not able to participate in the agricultural activities in which most of his community and family worked. However with support from PAMF and an NGO for the disabled, he managed to build up a successful rice milling business.</p>	<p>11 SUSTAINABLE CITIES AND COMMUNITIES</p>  <p>Marling Jimenez, Pro Mujer Nicaragua</p> <p>Marling – a single mother with 3 children – has run a shoe manufacturing company for many years, but a small loan has enabled her to grow her production 6 fold. She now employs 11 people, and hopes to be able to continue to grow to provide more jobs for her community.</p>	<p>12 RESPONSIBLE CONSUMPTION AND PRODUCTION</p>  <p>Prisma, Peru</p> <p>In a part of Peru where opportunities are lacking and many are driven to illegal activities as a source of income, Prisma offers other opportunities to farmers and encourages the sustainable cultivation of cocoa and coffee.</p>
<p>13 CLIMATE ACTION</p>  <p>Fundenuse, Nicaragua</p> <p>Among its many products, Fundenuse offers solar powered devices to its micro-entrepreneurs, helping to prevent the use of kerosene and other highly-polluting fuels, as well as reducing fuel costs for micro-entrepreneurs.</p>	<p>14 LIFE BELOW WATER</p>  <p>Pana Pana, Nicaragua</p> <p>Located in the North Atlantic Autonomous Region of Nicaragua, Pana Pana works with a variety of rural micro-entrepreneurs, including those running small-scale sustainable fisheries.</p>	<p>15 LIFE ON LAND</p>  <p>Fundap, Guatemala</p> <p>Fundap runs an environmental forestry programme, providing training, technical assistance and support, for those micro-entrepreneurs interested in projects involving the protection and sustainable use of forests.</p>
<p>16 PEACE, JUSTICE AND STRONG INSTITUTIONS</p>  <p>KIF, East Timor</p> <p>East Timor is the world's 4th youngest country, which became independent following serious clashes with the Indonesia. LMDF is pleased to be working with KIF, one of two microfinance institutions working to build opportunities in the new country.</p>	<p>17 PARTNERSHIPS FOR THE GOALS</p>  <p>LMDF, Luxembourg</p> <p>LMDF works with a range of institutions across the globe to support micro-entrepreneurs in developing countries. Working with NGOs, banks, individuals and the Lux. gov., the Fund has enabled nearly 140,000 loans to reach the poorest in developing countries.</p>	

A partnership for development

The Sustainable Development Goals, “a universal call to action to end poverty, protect the planet and ensure that all people enjoy peace and prosperity”, came into effect in 2016. The final goal, Goal 17, is Partnerships for the Goals. It recognises that the ambitions of the SDGs cannot be realised without cooperation between a broad range of institutions, from multilateral organisations, to NGOs, to individuals.

In preparation for the coming years, LMDF further developed its shareholder structure.

This is a philosophy which LMDF has adopted since its launch. Founded as a successor to ADA's LUXMINT programme, LMDF has continued to work closely with the Luxembourg State and with the NGO ADA. From the start, it has also partnered with many of Luxembourg's largest financial institutions. BIL, BGL BNP Paribas, BCEE, Banque de Luxembourg, CBP Quilvest, Banque Fortuna, Le Foyer and La Luxembourgeoise were among the founding shareholders and new partnerships with financial institutions continue to be forged to this day. In November 2016, LMDF announced new partnerships with the EIB and with Banque Raiffeisen.

The support from the Luxembourg State and ADA has also allowed other actors to become involved. The fund is structured so that Class A investors (public investors) and Class A_{bis} investors

(philanthropic investors) serve as first loss capital for private individual investors subscribing in Class C shares. This decreases the microfinance risk exposure for individuals and foundations, enabling them to invest and support LMDF's work overseas. Through this mechanism, organisations such as ETIKA, Œuvre Nationale de Secours Grande-Duchesse Charlotte, Fondation de Luxembourg and SOS Faim have been able to support LMDF and its investment philosophy. The structure has also allowed many Luxembourgish residents to buy into the Fund.

As the Fund has evolved, there has been increased interest from individual shareholders and foundations (Class C, Graph 1.4). The proportion of public money (Class A and A_{bis}) is also decreasing as a broader range of entities show interest in the Fund. It is this very mix of interested parties which will be the key to reaching the targets of the Sustainable Development Goals in the years to come.

In preparation for the coming years, LMDF further developed its shareholder structure. Class A_{bis} shares have been launched mid 2017. These shares are designed for the public and philanthropic sectors and will continue to provide first loss capital for C shares. They are differentiated from conventional Class A shares as they do not participate in the governance. This permits the Fund to be opened up to a broader range of philanthropic investors wishing to support the microfinance industry.

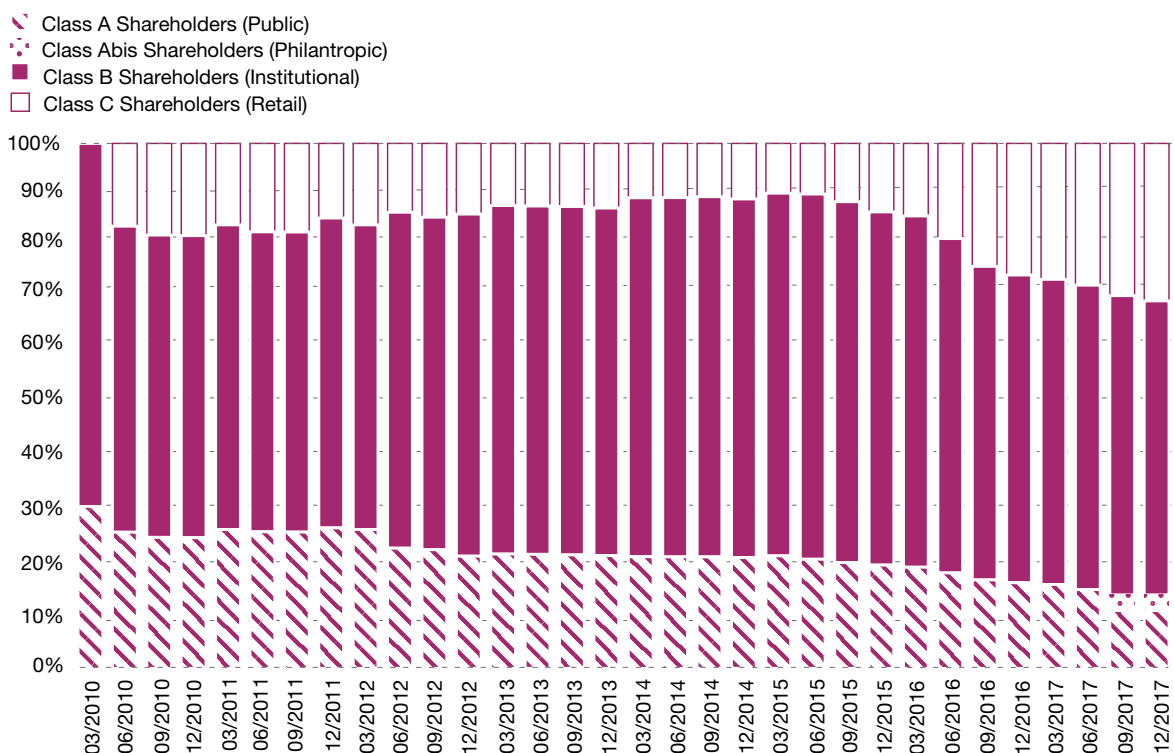
PARTNERSHIP WITH THE EUROPEAN INVESTMENT BANK

On 17th November 2016, during European Microfinance Week, LMDF and the European Investment Bank announced a new partnership. The EIB is providing EUR 5 million to LMDF in order to support its microfinance activities, with a particular focus on projects in the African, Caribbean and Pacific Group of Countries (ACP) region.

The EIB has a long heritage of supporting microfinance projects and as at December 2016 had a microfinance portfolio of EUR 974.1 million and worked with 80 intermediaries.

LMDF is delighted to work with a leading institution that has been at the forefront of microfinance investment.

GRAPH 1.4:
BREAKDOWN OF SHARE CAPITAL BY SHARE CLASS



Source: LMDF analysis, data as at 30/09/2017

KEY PARTNERS OF THE FUND



Private Investors' Expectations

LMDF's mission states that it "is accessible to public, institutional and retail investors and is accountable for reaching both social and financial objectives, and transparent in its reporting." A selection of our investors explain their reasons for investing in the Fund.

Patrick Bilbault



I have decided to invest money in 2016 in LMDF shares for my nephews aged 10 and 13 and for my godchild aged 16. As this is money that should be kept safe for up to 10 years until they need it for example to study at university, I was very happy to find out that Class C shares enjoy a special protection mechanism.

But I also wanted an investment I could use to explain to the children what a SICAV is and how one can invest and contribute to improving the world at the same time. The children are enthusiastic about helping poor people in Burkina Faso or Peru to open a business.

As I have been very interested in microfinance as a tool for helping people out of poverty for years, LMDF has proven the perfect vehicle for impact investment.

Doris de Paoli



I have been fortunate enough to be able to gather some savings, and I realise this is a luxury that very few people in this world have. As such, investing them in sustainable solutions, such as LMDF, seemed obvious to me.

There are many convincing arguments to do so - but two particularly appealed to me. First I want to know the destiny of my savings and second investing in LMDF allows microcredits to be given to the most deprived so that they can build a suitable income and support their families.

Personally, I have to find investments which provide benefits and have a double purpose.

As such, investing them in sustainable solutions, such as LMDF, seemed obvious to me.

Mark Uldall



I have been active in the financial markets for more than 20 years as an equity and bond trader. After the crisis of 2008, where my employer went bust, I steered my career towards private banking. This was a major change in my life and after many years of just growing the balance sheet of wealthy people I knew the time had come, I had to act and find out how I could help.

I wanted to contribute in a social manner, but not just by “giving away” my money, I wanted to empower people, privilege education, encourage entrepreneurship, allow people who have no access to regular banking services to be able to get a fresh start or make their dreams come alive. If this could be done in a sustainable way, with a little yield and a certain security for the investor, this would be perfect.

This is where LMDF came in, offering the possibility of supporting the poor financially, giving a regular decent yield, partly guaranteed by the Luxemburgish State and the priceless feeling.....Philanthropy.

I wanted to contribute in a social manner, but not just by “giving away” my money [...]



Esther Meyer, Fondation de Luxembourg

There are various aspects we have to take into consideration when we prepare the investment decisions for the foundations under our aegis, such as the lifetime of the foundation, the expected annual transfers of funds to projects, as well as our strong preference for sustainable investment solutions.

One of the most important criteria is the level of portfolio risk. In order to ensure a low level of risk, diversification across asset classes and of the underlying investments, is of utmost importance. For microfinance investments we trust the expertise of the LMDF team in regards to due diligence and the selection of the underlying microfinance institutions. The fund also provides sufficient liquidity, a low but stable return and, considering the guaranteed share Class, which excludes parts of the risks for the investor, we feel comfortable with the investment. For a foundation seeking coherence between its investments and the cause it supports, the social profile of the fund, its low level of risk and stable return are attractive features.

Beyond investing: Technical assistance to MFIs

Interview with Sarah Canetti



ADA acts as LMDF's investment adviser, and as Luxembourg's leading NGO specialising in microfinance, it brings much more expertise to the table.

In this interview Sarah Canetti, Manager of Investments at ADA, discusses the technical assistance work conducted

by the organisation and how this supports MFIs in LMDF's portfolio.

What technical assistance services does ADA provide?

ADA offers three main methods for delivering support to MFIs in four key areas. The diagram (Diagram 1.5) shows how this works. We have found that it is best to specialise in these key areas, as they are commonly requested by MFIs and as we have also built up considerable expertise in them. The first two methods of delivery (tools and training) are more generic. However the technical assistance packages have a strong focus on an individual MFI's needs; a consultant will visit the MFI and spend approximately a week on site with the MFI's staff. This will enable the MFI to address its own priorities. In general, a technical assistance session will focus on these priorities, but sometimes an MFI may have a specific need which falls outside our expertise.

Demand for our offerings really varies depending on the maturity of the MFI. Younger institutions tend to be more interested in our training and technical assistance packages while the larger institutions are often more interested in product development and governance training. Some institutions prefer

the more independent approaches through tools and training, while others prefer to receive a more intensive technical assistance package.

How does ADA leverage its knowledge of the microfinance industry to deliver technical assistance?

During its 23 years of operations, ADA has built up good networks across the globe. This regional knowledge and the connections that ADA has, enable the institution to deliver training appropriate for MFIs in all types of geographical contexts. Instead of building a wide range of technical assistance offerings, ADA has chosen to focus on key areas. This has allowed us to consolidate our expertise in these topics. Moreover each training delivered is also a lesson for us, and we can pass on the success stories and lessons learnt in future sessions.

Why is technical assistance so important for emerging and developing MFIs?

When a small organisation is growing fast and undergoing considerable change, which is certainly the case for many of the Tier 2 and Tier 3 organisations with which LMDF works, they need to have the structure in place to cope with the changes. Often this is not the case. It is absolutely fundamental to reinforce these structures before a period of fast growth. Risk Management and Financial and Social Performance training packages have been very helpful in supporting Tier 2 and 3 institutions as they tackle the challenges which come with growth. However it is not only the smaller institutions which can benefit from technical assistance.

As institutions grow and evolve, we often find an increased interest on Governance and Transparency and also on Product Development enabling a broader range of clients to be reached.

Where do you see the links between investing and the institutional development of MFIs?

There are so many links. As I outlined before, when institutions are on a fast growth trajectory, which those requiring funding normally are, then reinforcing their structures through technical assistance is absolutely fundamental. Providing financing without providing support for the growth infrastructure could almost be irresponsible in certain circumstances. Ensuring MFIs have the necessary support to go with financing is integral to our process.

Providing financing without providing support for the growth infrastructure could almost be irresponsible in certain circumstances.

The provision of assistance is thoroughly integrated into our team's investment process. When we look for potential partners for LMDF, we are hoping to build a long-term relationship with the MFI and this

should not just be a financing relationship, but a proper partnership. As such, we make sure that the provision of technical assistance is integrated into our due diligence process. When we go on a due diligence mission, we always conduct the SPI4 Alinus, a tool which helps us to understand an organisation's social performance better. We also explore any other areas in which the MFI could benefit from our support, be it governance training, product development or co-financing a rating.

We also use technical assistance as a tool for pipeline development. We often view institutions which are at a too early stage to receive investment or make a good portfolio proposal; they may be lacking some basic functions or need support to be prepared for further growth. Providing technical assistance can not only help the institution to resolve these issues, but also prepare it to be investment ready at a later date.

DIAGRAM 1.5: ADA - 3 WAYS OF PROFESSIONALISING MFIs



Source: ADA



Client of a Moroccan MFI in her hairdressing salon // Morocco

Chapter 2: How LMDF works

LMDF's unique partnership with ADA

ADA, Appui au développement autonome, is Luxembourg's leading NGO specialised in microfinance. It is a non-governmental organisation that is registered with and co-funded by the Luxembourg Directorate for Development Cooperation and Humanitarian Affairs and is under the High Patronage of Her Royal Highness the Grand Duchess of Luxembourg.

[ADA] has a much greater role than a conventional investment adviser. As well as providing investment recommendations, ADA is also active in the development of MFIs.

Over the past 23 years, ADA has been dedicated to increasing the financial inclusion of populations excluded from conventional banking channels in developing countries.

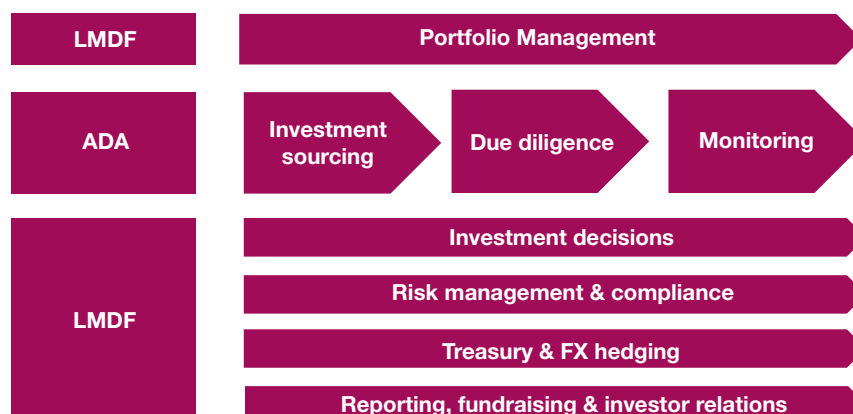
ADA's work consists primarily of empowering and supporting the growth of microfinance institutions, professional associations and networks. It also works

closely with governments to support and develop the regional and national microfinance sectors. It acts as the investment adviser to LMDF and has a team which is solely dedicated to the Fund.

Yet it has a much greater role than a conventional investment adviser. As well as providing investment recommendations, ADA is also active in the development of MFIs through its many offerings, including technical assistance. Together, LMDF and ADA have built an eight step screening and proprietary due diligence methodology encompassing business, governance, financial and social aspects.

LMDF was born out of ADA's LUXMINT financing programme and has worked closely with the NGO since this time. Its main aim is focused on emerging microfinance institutions with a strong social mission and a great potential for development. Maintaining and developing this relationships has been key to achieving the Fund's financial and social goals.

DIAGRAM 2.1: PARTNERSHIP OF ADA AND LMDF



Source: LMDF

Social and financial performance in the investment process

DIAGRAM 2.2: SOCIAL PERFORMANCE IN THE INVESTMENT PROCESS



Source: LMDF

A microfinance institution which is seeking financing is analysed through an eight steps process to evaluate financial risks and social impact. At each step of the investment process, LMDF and their partner ADA focus on integrating social and financial metrics.

The investment process is complemented by a quarterly monitoring, partially on-site to ensure that MFIs are progressing in the right direction. All parts of this procedure will be explained hereunder.

Step 1 - Identifying an opportunity

The process begins with the analysts from ADA having identified a MFI in need of financing to grow their activities. ADA verifies that a potential investment fits in LMDF's target bracket, by conducting an initial review, focusing mainly on financing, size and social mission. If this looks promising, the investment goes forward to the next step.

Step 2 - Internal confirmation of an opportunity

ADA analysts launch a further screening and consider the outreach of the MFI; factors related to a more thorough review of finances and operating efficiency is also conducted. If this analysis indicates that the MFI is in keeping with the vision and mission of the Fund, LMDF will recommend that a due diligence mission goes ahead, contingent on the findings of the country analysis. This is internally called the "Level 2" assessment.

Step 3 - Analysing country risks and development needs

After the Level 2, LMDF will conduct in depth country analysis, considering both the economic profile and risks of a country and the need to reach those with least access to conventional financial services. These two areas can often be in conflict and so LMDF carefully examines four key areas: Politics,



LTR: Michel Haas, Raoul Stefanetti, Gilles Franck, Thomas Lammar, Miguel Maeztu, Olivia Fechner, Kaspar Wansleben, Btissam Dardari, Olivier Selis, Jennifer Urbain, Laura Foschi, Daniela Laforteza, Sarah Canetti, Saad Menjour // Investment Committee LMDF and teams at ADA and LMDF

Development, Economy and Financial Inclusion. After the analysis of the perceived risks and benefits of an investment is completed, LMDF recommends a certain allocation to the country.

Step 4 - Due diligence process on site

Once the country limit has been approved, ADA analysts will set out for a full due diligence mission to an MFI. ADA will have the chance to meet all the key staff and also visit branch offices and clients. During this visit, ADA's key priority is to verify that the institution does indeed meet with the vision and mission statement of the Fund. The obtained information is included in a detailed report which is reviewed by LMDF and subsequently by the Investment Committee.

At each step of the investment process, LMDF and their partner ADA focus on integrating social and financial metrics.

Step 5 - Negotiating terms and conditions

Towards the end of the mission, if the analysis is going well, the ADA analyst will also begin negotiations with the MFI on the terms and conditions of a potential transaction.

Besides financial covenants, regarding debt to equity, portfolio at risk and foreign exchange, social covenants are negotiated helping the MFI to support and strengthen its social performance.

Step 6 - Presentation to the Investment Committee

ADA and LMDF present full due diligence reports and country research to the Investment Committee. This last one will review and consider the extent to which files comply with the Fund's vision and mission. According to this, a decision will be taken as to whether an investment should go ahead.

Step 7 - Complete Know-Your-Customer and contracts

By this time, covenants are confirmed and contractualised, documentation is reviewed, funds are prepared (if possible in local currency). Constant communication is maintained with the MFI so that any queries may be answered promptly and the process can run as smoothly as possible.

Step 8 - Monitoring process

The process in no way stops once an investment has been disbursed. Quarterly investment reports are produced by ADA and reviewed by LMDF in a quarterly Portfolio Risk Committee meeting. These reports focus on the MFI's social and financial performance and their compliance with the covenants. On an annual basis, ADA also tries to visit the institution, to maintain a good relationship and to monitor progress.

Besides monitoring the loan, ADA also investigates whether any technical assistance could help the MFI as it continues to grow and develop.

The country selection process

A recent improvement to the investment process saw the introduction of a country and regional assessment of risks and opportunities. The process results in a macro allocation of the portfolio following criteria of LMDF's risk appetite and social mission.

LMDF incorporates to its country analysis two important categories that assess development and financial inclusion [...]

LMDF performs a top down analysis on countries where investments are in place or where the Fund would like to start investing. Such analysis is performed in four equally-weighted dimensions: politics, economics, development and financial inclusion. Each one is punctuated to deliver a final score that will correspond to a specific limit (as a % of net assets). This limit will be proposed to the investment committee, which ultimately will make a final decision. Consequently, LMDF incorporates to its country analysis two important categories that assess development and financial inclusion, thus including in the macro asset allocation process key social performance information.

Integrating social aspects in the country selection

Regarding development levels, LMDF performs an analysis by individually looking at a country's indicators and by comparing it to its peer group. The aim is to determine whether the country has seen positive development in recent years, and what the current level of development is. The optimal outcome is that of a country which has been achieving some development due to conducive government policies in recent years but remains underdeveloped or less developed. In terms of investment impact, this results in LMDF being supportive of this development trend and even contributing to a multiplier effect by making an investment in social MFIs. Key indicators that help assess the development level of a country are for example its HDI (Human Development Index), its presence on the OECD's DAC List of ODA Recipients, the category it falls in (low, medium, high...), and more detailed information such as literacy rate,

education levels, life expectancy, median age or rural population.

Furthermore, as a Fund which considers progress in terms of gender equality a priority, gender relations are also analysed in order to identify the level and areas of inequality between men and women (Graph 2.3). The analysis also compares a country with its peers, because it is important to understand the development level of a country in its regional context. For example, Kenya, a medium HDI country will be assessed firstly against itself by looking at its development trend since 1990. Secondly it will be assessed against the average values for other medium HDI countries, the Sub-Saharan region, and similar countries such as Cameroon and Tanzania. Finally, it will be assessed in terms of a deeper analysis of where individual indicators stand at today, such as the aforementioned literacy rate or life expectancy.

In terms of financial inclusion, LMDF analyses the broader subject that it represents. Data will be extracted from World Bank's Findex, a database that incorporates information about financial penetration in a country. The data contains for example the percentage of the population with accounts at a financial institution, mobile banking or credit card ownership. The information is then broken down between the overall country average, women, rural population, and youth. This allows LMDF to assess the global situation of the country. If the data shows little financial penetration in the country, it will be supportive of a higher score in the category.

The importance of good regulation

In order for an investment to have the maximum positive impact in the country and its population, the Fund looks for a solid and encouraging regulatory framework, which would give a higher scoring for the country. LMDF will also assess any crisis or turmoil that might have happened in the microfinance industry in recent years, or at a broader level in the financial sector. This could be a sign of industry instability, and if the reasons causing such crisis have not been addressed, it could play against the



country. Two examples could be the “No pago” crisis in Nicaragua resulting from client over-indebtedness, or the Ghanaian microfinance crisis due to insufficient regulation and management practices. Finally, market competition and saturation will also be studied. The MIMOSA index, developed in order to put a score on market saturation, will be included to support the analysis.

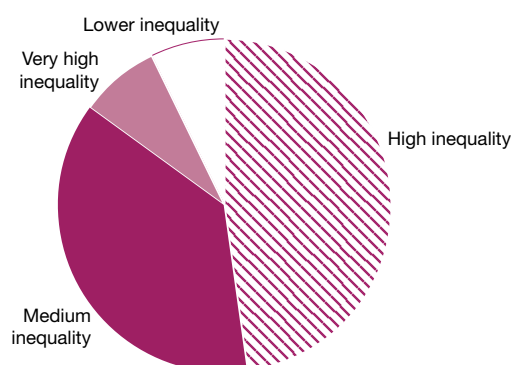
Half of the portfolio is invested in countries where gender inequalities are at their highest, underscoring LMDF’s gender lens investing.

It is in line with the vision and mission of the Fund and permits us to quantify and incorporate the social and developmental aspect of a country into the

optimal exposure of the portfolio. This report allows LMDF to incorporate social measurements into its top-down analysis of a country.

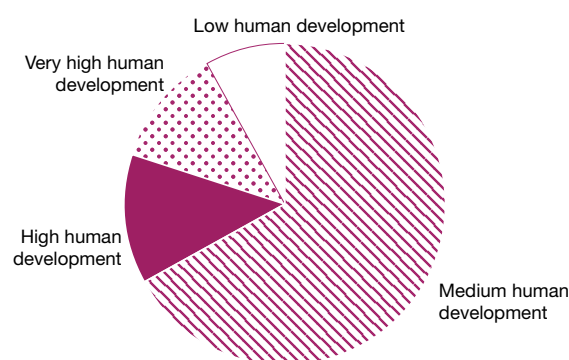
The following two graphs illustrate the countries in which LMDF invests, grouped by the level of human development and the level of gender inequality. The Gender Inequality Index measures gender inequality, such as participation of women in the labour force or their underrepresentation in the parliament. Half of the portfolio is invested in countries where gender inequalities are at their highest, underscoring LMDF’s gender lens investing. Likewise, the LMDF portfolio is clearly tilted towards countries with medium and lower levels of human development with a special emphasis in medium Human Development countries, such as Honduras or South Africa.

GRAPH 2.3:
LMDF’S INVESTMENTS IN COUNTRIES IN
TERMS OF GENDER INEQUALITY



Source: LMDF and Human Development Report

GRAPH 2.4:
LMDF’S PORTFOLIO COUNTRIES CLASSED BY
HUMAN DEVELOPMENT INDEX



Source: LMDF and Human Development Report

LMDF's use of social covenants

Social performance is a key topic for debate. At nearly every impact investment conference, discussion will break out about how it is best monitored and measured. This report is LMDF's best effort to measure social performance within the Fund and to monitor the progress our investees have made. However every institution the Fund works with is different. Each one has its own specific needs, strengths and weaknesses, particularly when it comes to social performance processes.

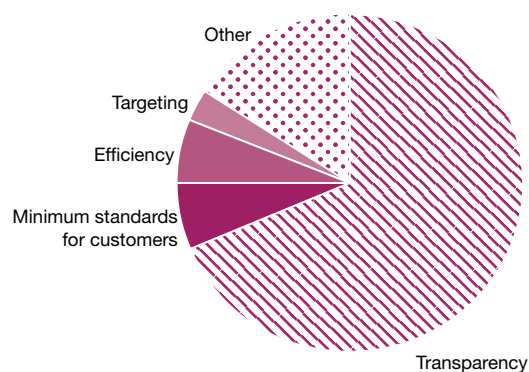
In most instances, the Fund's main concern is improving transparency regarding social performance.

For this reason, the Fund tailors the social covenants, i.e. the conditions it includes in each financing contract, to the needs of each individual MFI with which it works. For institutions that still need to work on client protection, we may recommend the implementation of a covenant foreseeing a client protection certification. Sometimes operational

systems may not be in order, meaning that the loan disbursement process is not optimal and clients may incur additional costs. In such cases, efficiency covenants may be recommended so that the MFI improves processes for its clients. In some of the less-sophisticated, smaller MFIs, basic processes may not be fully formalised, such as full contractualisation for clients. In these cases, the Fund has minimum standard clauses, to bring processes in line with good practice.

Such covenants are required in a minority of cases. In most instances, the Fund's main concern is improving transparency regarding social performance. For this reason, in over two thirds of cases the Fund requires a PPI, SPI4 or social rating as the social covenant. These social performance tools enable the MFI to monitor their own social performance, but can also be useful for investors trying to understand the impact of their financing.

GRAPH 2.5:
USE OF SOCIAL COVENANTS IN
LMDF'S CONTRACTS



Source: LMDF analysis



LMDF'S TRANSPARENCY REQUIREMENTS

PPI- THE PROGRESS OUT OF POVERTY INDEX

The Progress out of Poverty Index (PPI) is a poverty measurement tool for organisations and businesses with a mission to serve the poor. The PPI can readily be implemented by socially motivated MFIs to measure their commitment to poverty alleviation. Through 10 questions about a household's characteristics and asset ownership, MFIs can identify the clients who are more likely to be poor and track changes in clients' poverty levels over time.

SPI4

The 4th version of the Social Performance Indicators (SPI4) is a social audit tool, launched by CERISE (Comité d'Echanges, de Réflexion et d'Information sur les Systèmes d'Epargne-crédit), which evaluates MFIs' abilities to achieve their social missions by allowing them to measure the level of implementation of the Universal Standards on Social Performance Management.

SOCIAL RATINGS

Social ratings are an external assessment by a professional evaluator of the social performance of an MFI. Today most financial ratings in microfinance incorporate "social risks" caused by insufficient social performance management.

The original sin of microfinance (hard currency lending)

Microfunding to small entrepreneurs in unstable developing countries in U.S. dollars or Euros has been referred to as the 'Original Sin' of microfinance. Original sin because it goes against the very founding principle of microfinance: To provide fair and affordable financial products which make the lives of small entrepreneurs better. A loan in dollars or euros may work well... until that week when the local currency devalues by 30%, or 40% or 50%...

If microfinance institutions lend in hard currencies, they expose their clients to huge risks.

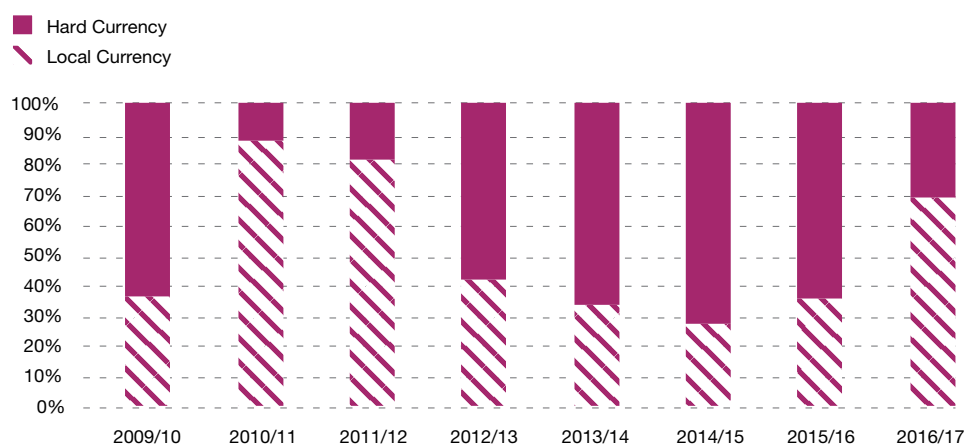
The reality of micro-entrepreneurs is to operate in local currency. The fishermen at the market in Dakura, Nicaragua are using córdobas. At the coffee collectives in the region of Apurimac in Peru, women are being handed soles. In the island of Sumatra, Indonesia, the ladies shopping at their local greengrocer are using rupiah. In the small city of Banfora, Burkina Faso, the lady running a tailor's shop asks her clients to pay in West African francs... When these micro-entrepreneurs need to buy

supplies, sewing machines, boats, fruit, vegetables, seeds, they pay for them in local currency.

If microfinance institutions lend in hard currencies, they expose their clients to huge risks. Because they receive funding in hard currency, they are tempted to lend in hard currency to their clients. But do the fishermen, coffee pickers, greengrocers or tailors really understand the risks this entails? And if so, what can they do about it? Hedge themselves? And if micro-entrepreneurs can't take the currency risk who should? The MFIs? The microfinance investment funds? The investors in the funds?

MFIs have a range of options to manage foreign exchange risks. They can have back-to-back loans- a loan received in a hard currency is deposited in a local bank; this local bank then provides the equivalent local currency amount for the loans in local currency MFI's use. Alternatively MFIs can raise local currency savings to shield them from the effects of fluctuating exchange rates. In some markets they have access to derivative financial instruments able to mitigate foreign exchange risks.

GRAPH 2.6:
PROPORTION OF HARD CURRENCY AND LOCAL CURRENCY LOANS DISBURSED BY LMDF



Source: LMDF analysis



Client of the MFI Fondesurco selling her merchandise at her stand at the local market // Peru

Yet, one of the best ways for MFIs to mitigate currency risk is to receive funding in local currency. This means funds such as the Luxembourg Microfinance and Development Fund must take on such risk. But LMDF's mission is to finance entrepreneurial activities and not to speculate on currency movements.

This is where the microfinance sector has created a powerful collective solution, MFX Currency Risk Solutions (MFX) which provides access for microfinance investment funds and large microfinance institutions to hedging solutions with commercial banks or The Currency Exchange Funds (TCX). TCX is a Dutch based global fund which offers hedging solutions for over 70 currencies of developing and frontier countries.

LMDF is a unit holder in MFX since 2009 and has been able to offer local currency financing to MFIs for eight years. Through MFX, LMDF has access to a range of derivative instruments to mitigate currency risks including cross currency forwards and cross currency interest rate swaps. This allows LMDF to offer local currency funding to MFIs in almost all global currencies.

This is not without its challenges. Providing local currency loans can be difficult in areas where there are currency restrictions or it may be extremely costly. Graph 2.6 shows the proportion of local currency loans which LMDF has provided each year.

Interestingly the periods in which a higher proportion of loans are disbursed in local currency are years considered risk off (years when investors tend to avoid riskier assets as a result of increased concern regarding markets). This suggests that microfinance institutions, just as many other investors, are reacting to the heightened risk environment. However their reactions are the inverse of most investors, who tend to retreat to the relative safety of hard currency. In the context of microfinance institutions this does make perfect sense. The main risk which they face is not being able to pay back the hard currency loan, following the depreciation of the local currency in which they receive the majority of their revenue. By ensuring that exposure to hard currency is minimised in difficult times, the institutions are more likely to be able to repay their loans.

Local currency financing for MFIs is still not the norm in all markets. Yet the industry has made great progress in providing concrete solutions. LMDF is actively contributing to enable more in financing in local currency.

Did you know that LMDF's Executive Director has played an active role in the development of MFX Solutions by being a board member for five years and contributing to the development of its risk management framework?

The importance of long-term partnerships

Change takes time. The deep-rooted problems in the societies of the majority of low income countries can in no way be solved overnight. For real societal change and real progress on the alleviation of poverty, investors need to wait for improvements to take their course. This is why the Fund asks investors to invest for a period of at least three years. It is also why LMDF tries to build up long-term relationships with the entities it finances. Significant time and effort is invested in analysing the potential of new partnerships.

For real societal change and real progress on the alleviation of poverty, investors need to wait for improvements to take their course.

Table 2.7 shows the total number of MFIs which LMDF has ever financed. Out of the 114 institutions the Fund has ever worked with, an average of 56% remained in the portfolio as of 31/12/2017. This means that long-lasting financing relationships have been maintained with over half of the institutions with which the Fund has ever worked. This means,

a stability has been achieved in the relationship established with the entity, which has overcome the incidents that may have happened in the country and / or have been readjusted to both parts to the needs of the moment.

Such a long-term view makes sense given the type of institutions that LMDF is financing. Institutions typically receive investments at a relatively early stage, when they might not previously have received external financing. At this stage, organisations have a long growth path ahead of them. It is important that they have consistent support during this early stage, so that they can grow and reach a broader pool of clients. In addition to the vision of experience that the Fund can provide and the technical assistance provided by ADA.

As well as providing long-term support on the financing side, MFIs also need other forms of support to help them in their growth. As a long-term investor, LMDF looks to ADA to provide technical assistance packages which suit the needs of the institutions as they continue to develop.

TABLE 2.7:
LONG-TERM PARTNERSHIPS WITH MFIs
SINCE 2009

Invested in year	MFIs	Still being financed
2009/10	18	11%
2011	9	11%
2012	10	10%
2013	12	42%
2014	15	47%
2015	17	94%
2016	12	92%
2017	21	100%
Average		56%

Source: LMDF analysis, data as at 31/12/2017

Social performance initiatives

LMDF is one of 1,682 entities worldwide and 28 entities in Luxembourg which are signatories to the United Nations Principles for Responsible Investment (UNPRI). These principles reflect a commitment from investors to ensure that the well-being of society is part of their investment process.

In 2016, the Fund was awarded an A for the third year running.

Each year, LMDF participates in an assessment from the UNPRI. This assessment monitors a Fund's adherence to the Principles for Investors in Inclusive Finance (PIIF), a sub-segment of UNPRI. In 2016, the

Fund was awarded an A for the third year running. The Fund showed particular strength in its commitment to Transparency and Standards (encouraging a range of collaborative initiatives), but fell down slightly on Responsible Investment as more work needs to be done to thoroughly integrate environmental issues into the investment decision making process.

This year the Fund also participated in the Strategy and Governance Assessment. In this assessment, the Fund received the top score of A+.

PRINCIPLES FOR INVESTORS IN INCLUSIVE FINANCE

As investors or fund managers investing in inclusive finance, we have a duty to act in the long-term interests of our clients- private and institutional investors. While upholding our fiduciary responsibility, we will commit to adhering to and promoting the following principles:

1. Range of services

We will actively support retail providers to innovate and expand the range of financial services available to low-income people in order to help them reduce their vulnerability, build assets, manage cash-flow, and increase incomes.

2. Client protection

We believe that client protection is crucial for low-income clients. Therefore we will integrate client protection in our investment policies and practices.

3. Fair treatment

We will treat our investees fairly with appropriate balanced contracts, and fair processes for resolving disputes.

4. Responsible investment

We will include Environmental, Social and Corporate Governance (ESG) issues in our investment policies and reporting.

5. Transparency

We will actively promote transparency in all aspects.

6. Balanced returns

We will strive for a balanced long-term social and financial risk-adjusted return that recognises the interests of clients, retail providers, and our investors.

7. Standards

We will collaborate to set harmonised investor standards that support the further development of inclusive finance.

Source: UNPRI

Chapter 3: LMDF's social performance achievements

Working towards common goals

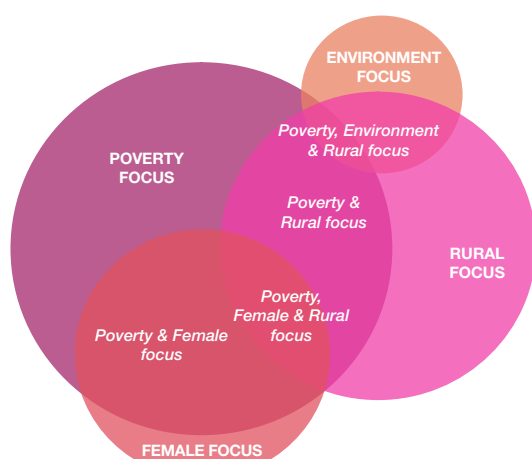
LMDF's strong social mission

The vision and mission statement of LMDF formulates the Fund's priorities: To contribute to the alleviation of poverty by supporting organisations that empower people and stimulate entrepreneurship. The Fund particularly addresses the needs of marginalised communities and individuals in developing countries and focuses on areas where unmet needs are largest, particularly among women, youth and rural population.

What are our MFIs looking to achieve?

A similar analysis was conducted on all of LMDF's partner MFIs. Taking all the vision and mission statements of the partner institutions (translated into English) we searched to see which words came out most often. Unsurprisingly "financial", "economic" and "microfinance" were among the main words used. The social missions of the MFIs also come across very

DIAGRAM 3.2:
VISION AND MISSION THEMES



Source: LMDF and MFIs visions and mission statements

TABLE 3.3: MAIN AREAS OF FOCUS OF MFIs IN LMDF'S PORTFOLIO

% of MFIs explicitly focusing on this in vision/mission	
Poverty	61%
Rural	42%
Women	22%
Environment	11%

Source: LMDF analysis

clearly. "Quality" and "sustainable" are among the key words for partner institutions. The words "rural", "social" and "women" also stand out, which is very encouraging given the Fund's work in these key areas.

On more rigorous analysis, we went through the vision and mission statements of all our institutions to see what their main areas of focus were. As might be expected, given the role of microfinance institutions across the globe, many explicitly focused on poverty.

In accordance with LMDF's vision and mission, a considerable proportion (61%) of the MFIs also had a particular focus on rural areas (42%) and women (22%). However the Fund was disappointed to find that, although many of the MFIs do offer products for young people or educational products, none explicitly stated this in their mission statements.

Although MFIs highlight philosophies very much in-line with LMDF's mission, it appears many focus on only one particular aspects of poverty alleviation. Although there is some overlap between the entities which focus on rural areas and on women, this is limited and no MFI has both an environmental focus and a focus on female entrepreneurship (Table 3.3).

Working where needs are highest

LMDF mission is to “enable the development of micro-entrepreneurs in areas where unmet needs are largest.” As its name suggests, the Fund’s aim is to contribute to a larger development agenda expressed through the 2030 Sustainable Development Goals.

Since its foundation in 2009 LMDF has worked in countries which belong to the less and least developed on this planet. Graph 3.5 illustrates the level of development of all countries LMDF works in or has worked in the past. The three groups clearly stand out:

- Least developed countries with a low human development and which include many African States (Niger, Burkina Faso, Mali, Ivory Coast, Togo, Benin) but also Haiti, the poorest country in the Western hemisphere.
- Less developed countries with a medium level of human development and which include many Central American, Southeast Asian (Indonesia, East Timor, Philippines, Cambodia) and some African countries (Kenya, Morocco, South Africa) but also Kyrgyzstan in Central Asia.
- Developed countries which include many South American countries (Peru, Colombia, Ecuador, Uruguay) and Central Asian countries
- Highly developed countries (only Argentina).

Graph 3.4 shows the share of each category of human development in LMDF’s portfolio. The vast majority of the Fund’s financing are deployed in less developed countries (with a medium HDI). Less and least developed countries account for 75% of LMDF’s total financing.

Less and least developed countries account for 75% of LMDF’s total financing.

The Human Development Index provides an indication of the development state of a country. But the HDI works with average data for each country. These averages may mask very significant inequalities with regards to income levels, access

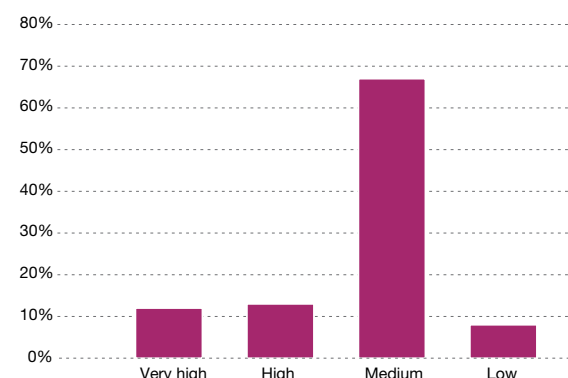
to education, health care, gender, rural and urban populations and youth. This explains why LMDF works in a country such as Argentina which on average is very developed. Yet pockets of poverty also exist in Argentina, particularly in the case of migrant workers from bordering countries. Microfinance in Argentina often specialises in providing financial services to these marginalised groups.

[...] all countries in which LMDF works have made progress in terms of human development.

A second important message is that all countries in which LMDF works have made progress in terms of human development from 2009 (launch of LMDF) to 2015 (latest HDI data available). And some of the least developed countries have seen the largest progress, including Niger, Mali and Morocco in Africa and Cambodia in Southeast Asia. Graph 3.5 shows the development level of all countries by HDI illustrating a universal upward trend.

This is encouraging and puts our provision of access to capital and other financial services in a context of general progress with regards to human well-being.

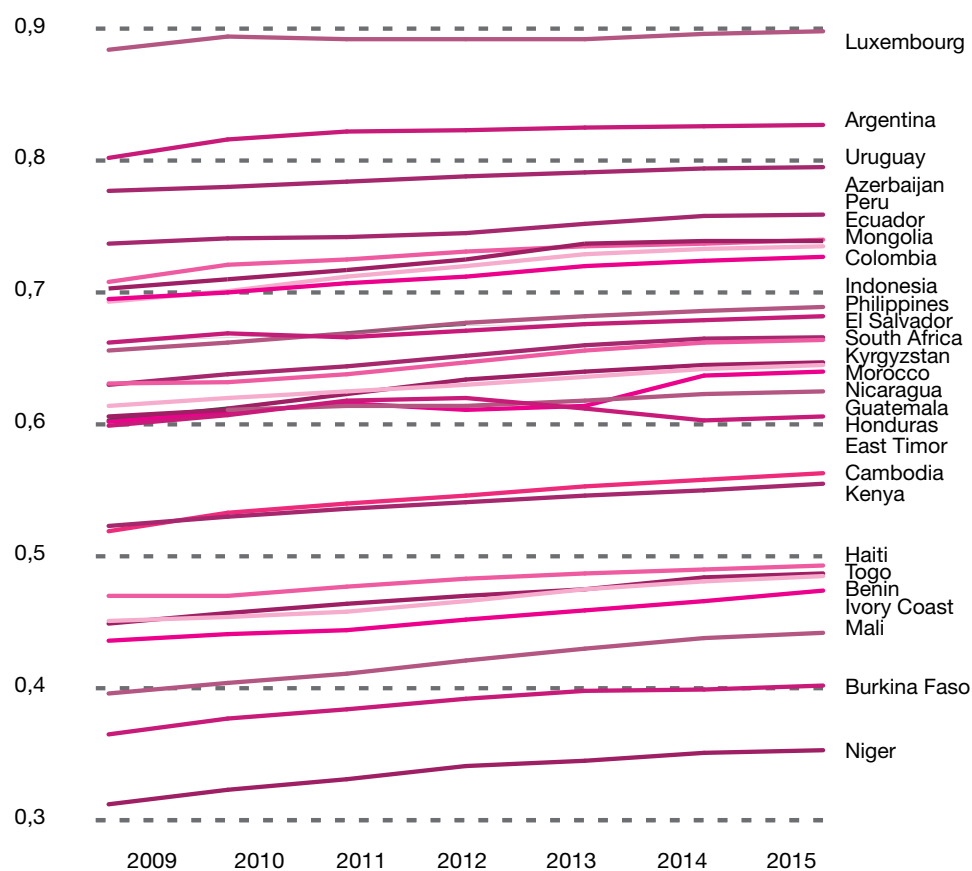
GRAPH 3.4:
LMDF’S PORTFOLIO BY HUMAN DEVELOPMENT



Source: LMDF analysis as at 31/12/2017, UNDP



GRAPH 3.5:
HUMAN DEVELOPMENT BY COUNTRY 2009-2015



Source: UNDP

LMDF's impact map

The map on this page illustrates the approximate number of loans provided by LMDF to micro-entrepreneurs across the globe. Over time, 155,461 loans have reached micro-entrepreneurs.

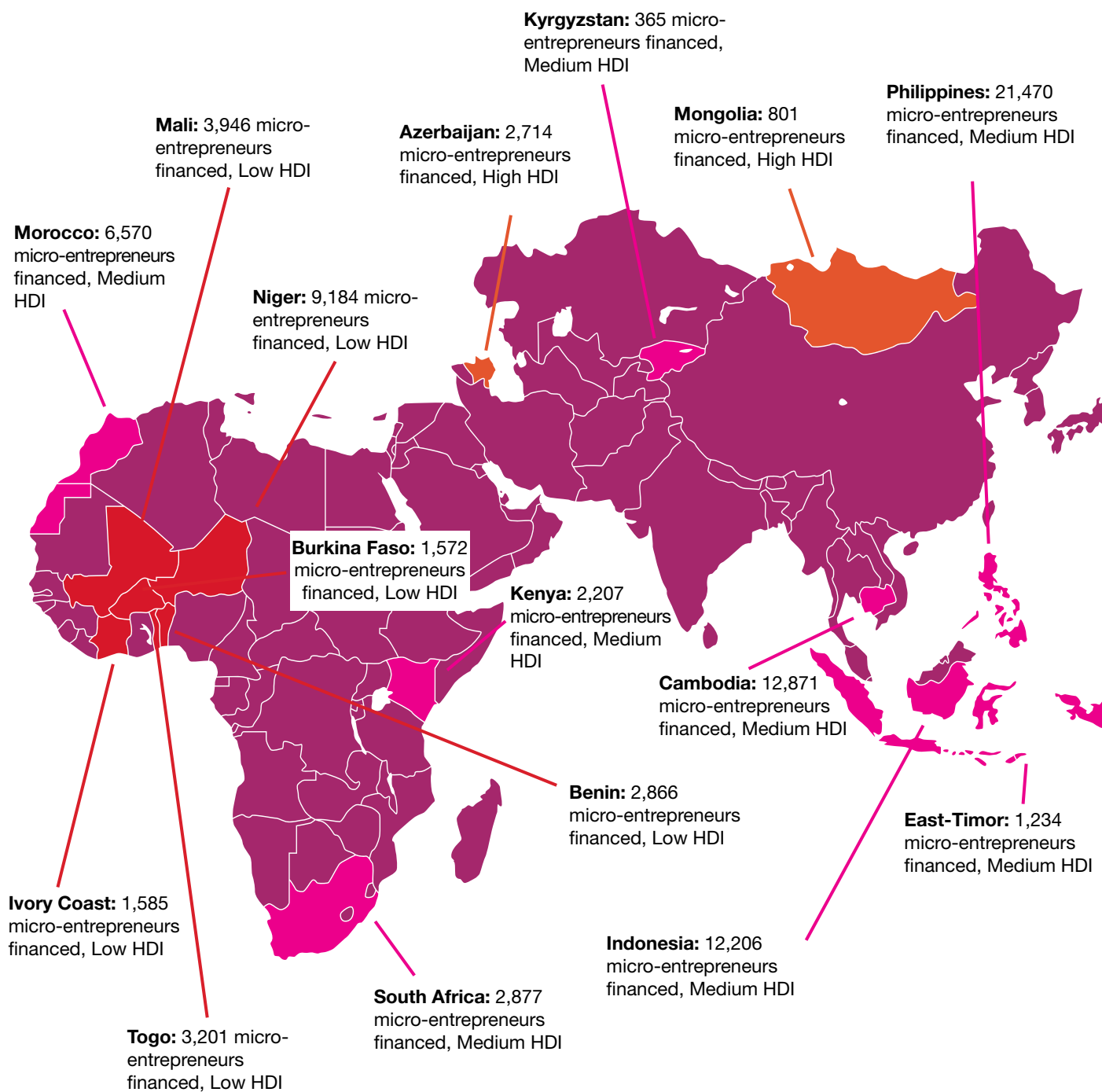
The map has been colour-coded to show the Human Development Index (HDI) status of all the countries in which LMDF has worked to highlight the Fund's work in less and least developed countries (low and medium HDI, 2015 data).



Colour Codes:

■ Low HDI ■ Medium HDI ■ High HDI ■ Very high HDI

Source: LMDF analysis



Who are micro-entrepreneurs financed by LMDF? Data from Ecuador

In this section, LMDF presents socio-economic data collected by one partner institution in Ecuador on their clients. This data provides an interesting insight into the lives of micro-entrepreneurs.

Family and Home

The average micro-entrepreneur's household size is 3.5- this is significantly less than the provincial population average household size of 3.8 and 4.2.

The majority of micro-entrepreneurs live in their own houses, but a minority do live in crowded conditions. Nearly a quarter of the households have cars and nearly a quarter have internet, which is in marked contrast with the provincial averages.

Attitudes

Although there is no benchmark for this data, the micro-entrepreneurs appear to be satisfied with their work, health, education, home, free time, family and community participation. Their main concern appears to be the government, but even here 60% are content.

Income

Data on revenue streams shows that micro-entrepreneurs have quite a diversified source of revenues, although salaries and micro-businesses are the principle sources of income. Nearly half of the households have a salary and the average salary size is greater than the average monthly income for micro-entrepreneurs' households suggesting that, where it exists, it is a very significant source of funds.

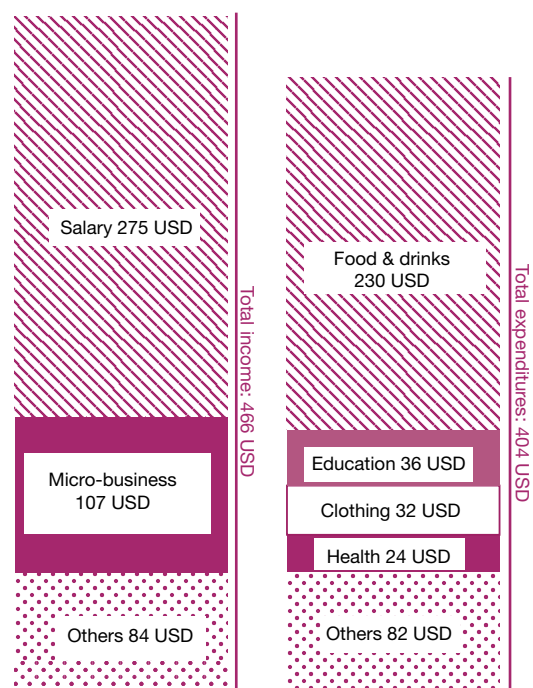
Data on revenue streams shows that micro-entrepreneurs have quite a diversified source of revenues [...]

Unsurprisingly, nearly all households have a micro-business, but revenues from this are limited. It is also surprising to find that foreign remittances, which have declined in recent years, form such a small proportion of household revenues. The average loan granted amounts to 4.4 times average income.

Food and drinks are by far the largest expense for these micro-entrepreneurs. For those who need to pay rent, this is also a very significant cost. Healthcare forms a small portion of monthly outgoings. Further studies conducted by the MFI found that confidence in public health services was low and therefore only 36% of micro-entrepreneurs made social security contributions to healthcare (below provincial averages).

This data suggests that incomes exceed expenditure by an average of USD 62. Yet this does not include loan repayments. From the excess money, part is reinvested in the business and part is saved. In the past year, however, it was found that only 14% of

GRAPH 3.6:
INCOME AND EXPENDITURES OF MICRO-ENTREPRENEURS IN ECUADOR



Source: LMDF analysis of data provided by a partner MFI

households contributed to their savings. From those who did save, banks and cooperatives were the preferred places to keep savings. Nonetheless over a quarter of micro-entrepreneurs still preferred to keep their savings at home. The MFI considers that those who keep savings at home expect them to be needed in the near future and believe it to be best to keep them accessible. 41% of micro-entrepreneurs reported having loans besides those offered by the MFI. These overwhelmingly came from banks or cooperatives.

[...] providing enough food is by far the largest expense of poor households. This is followed by expenses for education and health.

The Business

Commerce and agriculture dominate as occupations for micro-entrepreneurs. The study also found that 88% of micro-entrepreneurs would prefer to keep their business running in the sector they are currently in, while 11% would prefer to change their focus.

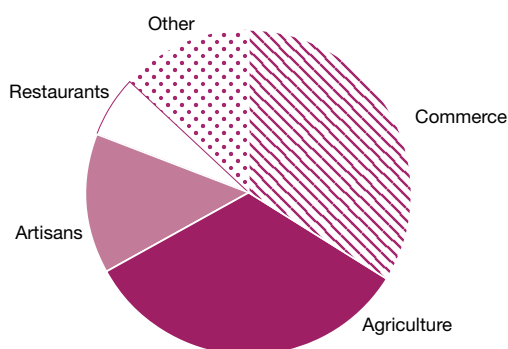
Given the precarious nature of micro-businesses, it was surprising to find that over 50% of the micro-

businesses that the MFI supports are over 5 years old and over a quarter were over 15 years old. This compares with the MFIs that LMDF works with in Ecuador which were founded in 1998, 1991 and 1980. However a slightly less encouraging statistic came from the state of growth of the business. Only 12% consider their business to be growing while 27% consider them to be decreasing in size.

What the data tells us

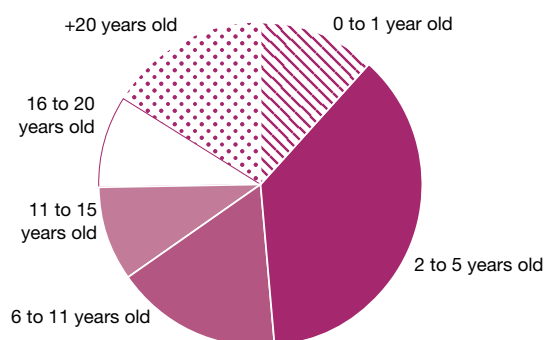
The example from Ecuador may not be representative for micro-entrepreneurs in other parts of the world, yet it highlights some important elements. The first insight is that households of micro-entrepreneurs engage in a range of activities and receive a variety of income next to their business. Employment, even if it is irregular and precarious constitutes an important source of income. The second insight is that providing enough food is by far the largest expense of poor households. This is followed by expenses for education and health. The provision of food at fair prices and the accessibility of public and private health and education services are key determinants in the economic live of low income households.

GRAPH 3.7:
TYPE OF MICRO-BUSINESS



Source: LMDF analysis

GRAPH 3.8:
AGE OF MICRO-BUSINESS



Source: LMDF analysis

Financial inclusion of women

Women: exclusion from financial services

There are many groups whose access to financial services remains limited. LMDF focuses on women, youth and those living in rural areas. Graph 3.9 shows the difference between women and men who hold accounts at financial institutions in the countries in which LMDF invests. In nearly every instance, the proportion of men with accounts is noticeably higher. It has been estimated that, in developing countries as a whole, only 50% of women have bank accounts.

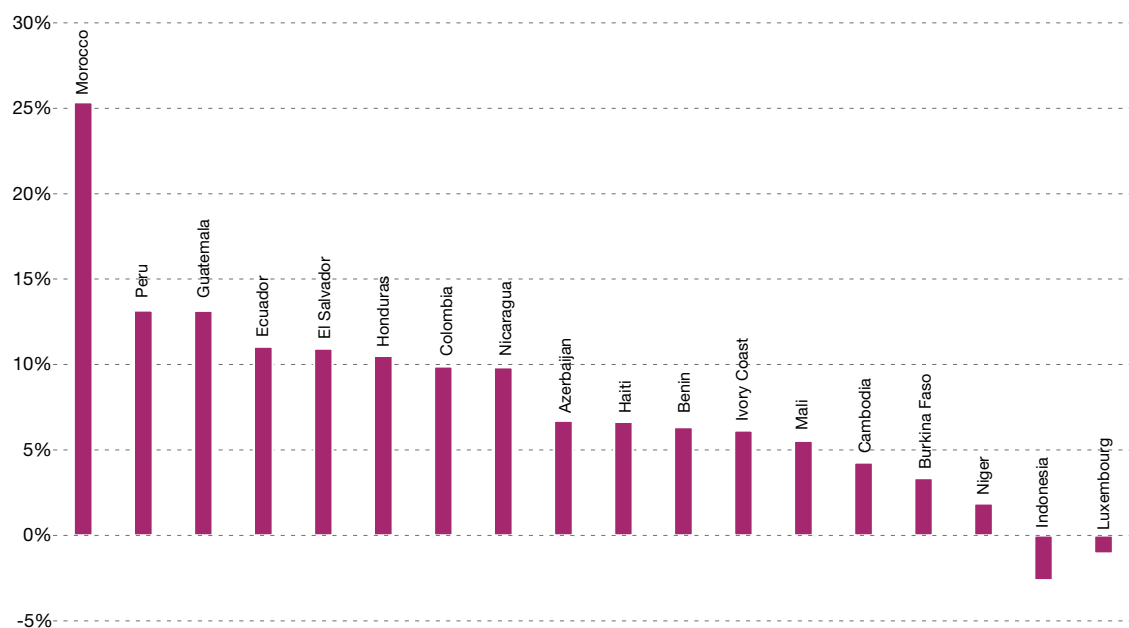
Since 2010, LMDF has every year provided a larger share of its financing to women compared to its competitors.

The same can be seen when it comes to borrowing money: there is a considerable disparity between the amount of men and women borrowing funds. This has a particular impact on small and medium-size enterprises lead by women. The UN estimates that 70% of female owned small and medium sized

business in developing countries are underserved by the finance system.

Yet the benefits of providing access to financial services to women have been shown to be prodigious. As well as accessing those most excluded from conventional financing, loans to women have ripple effects allowing a broader community to be reached. A World Bank study found that 90% of women's earnings are invested back into their families and communities. Women appear to spend more money than men on food, healthcare, and schooling for themselves and their children. Benefits spread to the whole community. McKinsey has calculated that breaking down the gender gap has such potential that many countries could see their GDP (Gross Domestic Product) increasing by more than 10%. McKinsey's research suggests that this can add USD 12 trillion to global growth.

GRAPH 3.9:
DIFFERENCE BETWEEN MALE AND FEMALE OWNERSHIP OF BANK ACCOUNTS IN %



Source: Global Findex (Global Financial Inclusion Database), as at April 2015

Does the Fund reach female micro-entrepreneurs?

Given the benefits of investing in women and their relative financial exclusion, the Fund pays particular attention that loans granted by MFIs financed by LMDF reach women. Throughout its history, women have constituted a large majority of all clients served. The Fund has consistently provided more than 70% of its funding to women.

But is LMDF unique in its focus on women? An annual survey of microfinance funds conducted by Symbiotics, has found that overall in the microfinance sector, just over two thirds of loans go to women. Since 2010, LMDF has every year provided a larger share of its financing to women compared to its competitors (Graph 3.10).

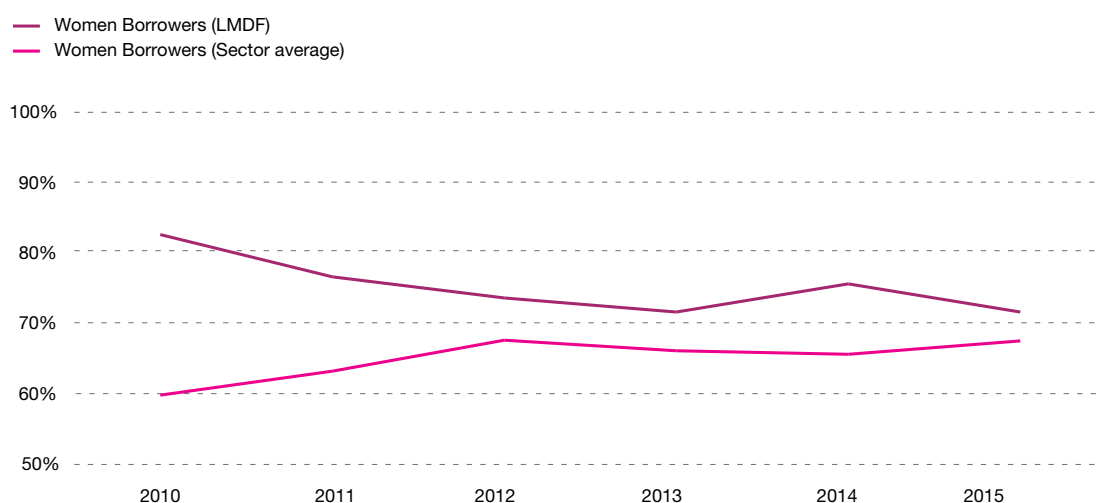
The distribution of female micro-entrepreneurs varies quite widely in the portfolio countries. Although there

is little correlation between the proportion of female micro-entrepreneurs helped and the gender equality in each country, one trend does stand out. In the countries classed as having a low ranking in terms of gender equality, a smaller proportion of women are helped.

Taking a gender lens to microfinance institutions

Even if the projects on which the Fund focuses do succeed in reaching women, a secondary question arises as to whether MFIs have the right structure, product and services in place to support women. To ensure that products are suited to their clients, their needs to be a sufficient concentration of women throughout the business. Although many MFIs have a female focus when it comes to their end users, having female staff throughout the institutions is an area in which MFIs often struggle.

GRAPH 3.10:
WOMEN BORROWERS REACHED



Source: LMDF analysis and Symbiotics Survey Data



A Malian market vendor selling basic crops // Mali

When LMDF investigated the correlation between the number of female clients and the number of female employees or the number of female senior managers, it found close to no correlation (0.05 and 0.19) respectively. Those entities which explicitly mentioned their focus on women in their vision and mission statements were more likely to have a greater number of female employees, yet this may just be a coincidence resulting from a small sample size.

Although the proportion of women reached by microfinance institutions is promising, it is clear that a lot more work is needed to ensure that women are included within the MFIs.

The higher proportion of women in female focused MFIs vanished at the director level. Women are highly under-represented at the director level across the board with women making up just 25% of directors, regardless of the gender focus of an MFI (Table 3.11).

Although the proportion of women reached by microfinance institutions is promising, it is clear that a lot more work is needed to ensure that women

are included within the MFIs. Nonetheless this is by no means a problem limited to MFIs. The Harvard Business Review has found that only 15% of Fortune 500 Board Directors are female and the Fund itself struggles with female representation on its committees and board.

TABLE 3.11:
PROPORTION OF FEMALE CLIENTS & STAFF IN
MFIS SUPPORTED BY LMDF

	% female clients	% female employees	% female directors
Andean Region	51%	66%	13%
Central America and Caribbean	58%	54%	33%
North Africa	57%	48%	13%
Southeast Asia	88%	25%	31%
West Africa	44%	59%	18%

Source: Simple average of data provided by MFIs without weighting LMDF's financing.

“Through LMDF I discovered
the power of gender-lens
investing – the ‘Women Effect’”

Hedda Pahlson-Moller, Investor

Products for financial inclusion of youth

Challenges for the young

The integration of a growing and mainly young population in labour markets is a key challenge in many countries LMDF works in. In every country, the youth employment rate is substantially lower than the average employment rate (Graph 3.12). In 2016, the ILO found that the youth unemployment rate was on the rise for the first time in several years.

The developmental challenge for youth from low income households may be articulated around two closely linked issues: access to quality education and opportunities in the formal labour market and through self-employment.

Out of thirty MFIs most recently financed by LMDF, 30% offer educational products.

What MFIs can do to enable access to education

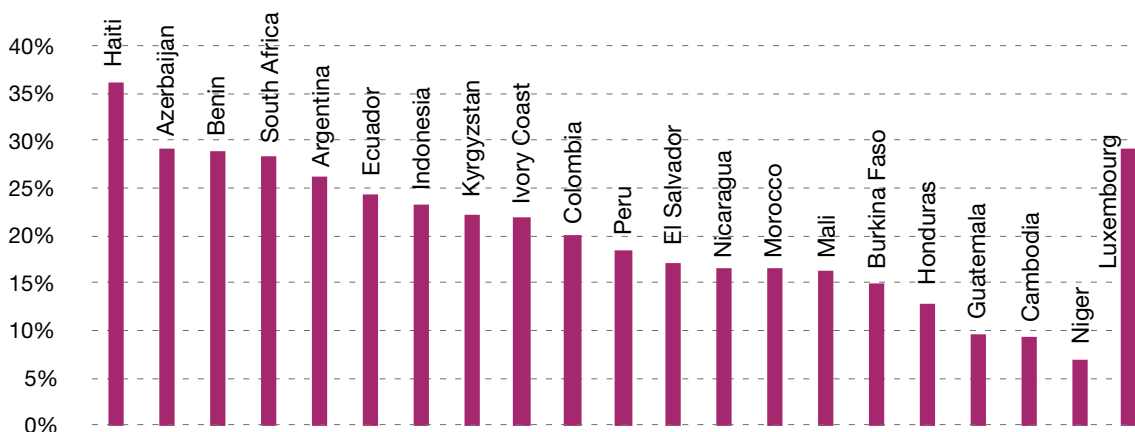
Education can help young people to reach career opportunities which would otherwise not be open to them. And the benefits of education go beyond pure employment advantages. It has repercussions on all areas of life, from health to childcare to empowerment. Each year of schooling increases an individual's earning power in future years by up to 10% and researchers

estimate that if every child learned to read, around 170 million fewer people would live in poverty. Education also has a dramatic impact on infant and maternal healthcare and increases the awareness and prevention of life threatening diseases such as HIV and Malaria.

Yet the finances of many of the countries in which LMDF works are insufficient when it comes to supporting education initiatives. Although many governments in developed countries spend nearly 6% of their budget on GDP, governments in the majority of LMDF's partner countries fall well short of this measure. Moreover, many of these countries have a large young population and a skills shortage at the same time.

UNESCO has calculated there is a USD 26 bn funding gap for the financing of basic education. This rises to a USD 38 bn funding gap when taking into account lower secondary education. What funding there is, does not necessarily target those most in need. UNICEF found that about "half of all public education resources are allocated to 10% of students that are most educated. Resources to the wealthiest quintile of children are up to 18 times larger than those to the poorest quintile." Agencies beside the public sector are needed to address the financing gap and ensure that finances reach those most in need.

GRAPH 3.12:
GAP BETWEEN AVERAGE AND YOUTH EMPLOYMENT RATE



Source: International Labour Organization, 2017

This presents both, a challenge and an opportunity for many MFIs. Education falls out of the remit for conventional products offered by MFIs. The longer funding cycle means that MFIs need to create particular products suitable to the needs of those pursuing studies. MFIs also need to focus on products which meet the individual challenges in different markets. Out of thirty MFIs most recently financed by LMDF, 30% offer educational products. Although these tend to form a small proportion of an MFI's portfolio, they make a significant difference to the young people who benefit from them.

The following pages contain five promising examples of specific products and strategies MFIs may use to strengthen access to quality education - both from demand and supply side - to benefit their clients and the children of their clients.

TABLE 3.13:
EDUCATION DATA FROM LMDF PORTFOLIO COUNTRIES

Country	Population with some secondary education	Net enrolment ratio Primary	Net enrolment ratio Secondary	Gross enrolment ratio Tertiary	Primary school dropout rate	Pupil teacher ratio	Public expenditure on education (% of GDP)
Guatemala	23%	86%	47%	19%	33%	26	2%
Honduras	27%	94%	49%	21%	30%	34	-
El Salvador	40%	93%	70%	25%	16%	24	3%
Nicaragua	39%	97%	49%	-	52%	30	4%
Peru	61%	93%	78%	41%	26%	18	3%
Ecuador	40%	95%	83%	41%	11%	19	4%
Haiti	29%	42%	-	-	-	-	-
Av. LAC	37%	86%	63%	29%	28%	25	3%
Azerbaijan	96%	95%	88%	20%	2%	12	2%
Mongolia	85%	95%	81%	62%	9%	28	6%
Indonesia	45%	90%	75%	32%	11%	19	4%
East Timor	-	97%	52%	18%	16%	31	5%
Philippines	65%	96%	67%	28%	24%	31	3%
Cambodia	16%	95%	38%	16%	36%	47	3%
Av. Asia	61%	95%	67%	29%	16%	28	4%
Morocco	25%	98%	56%	16%	11%	26	7%
Burkina Faso	2%	67%	21%	5%	31%	46	3%
Ivory Coast	22%	75%	-	9%	27%	41	5%
Benin	19%	96%	42%	12%	47%	44	5%
Niger	5%	61%	16%	2%	31%	39	4%
Mali	4%	59%	35%	7%	38%	41	5%
Av. Africa	13%	76%	34%	9%	31%	40	5%
Luxembourg	100%	93%	85%	20%	-	8	-

Source: HDI 2015 / World Bank - most recent available data



Student pursuing his studies thanks to the educational loan from the Fundación Génesis Empresarial // Guatemala

Products for the inclusion of youth in specific markets

HEFF, Costa Rica and Fundación Génesis Empresarial, Guatemala

Problem: Although access to primary and secondary education has improved over the past decades in Latin America, tertiary education enrolment still lags behind in some countries. Financing remains one of the main issues and those from poorer families have trouble accessing this level of education which is essential for joining many of the more lucrative career paths.

Microfinance solution: The Higher Education Finance Fund – “HEFF” seeks to mobilise student loans for low-income populations in Latin America. The fund lends money and provides technical assistance to microfinance institutions so that these institutions can, in turn, use HEFF’s financing for their student loan portfolio. HEFF currently works with 7 MFIs across Latin America, and, to date, has financed over 5,080 students.

ASUSU, Niger

Problem: Niger is one of the countries with the worst educational attainment levels in the world: youth literacy rates are only 35% for young men and 15% for young women; only 59% of children are expected to finish primary school. Although many countries have made a considerable impact on improving access to basic education, this remains a fundamental problem in West Africa.

Microfinance Solution: ASUSU focuses on ensuring more girls have access to basic education; to date, it has helped over 10,000 young girls to go to school. Given the very low rates of school completion, ASUSU offers various rewards to parents if they have a certificate showing their daughter has regularly attended school. These rewards include clothes, helping to relieve the financial burden of equipping a girl to attend school. The MFI also has a system of providing a child with a first savings account with a small deposit if she attends school regularly. If she continues saving, she can build up the money in her account, allowing her to continue her studies in future years.

PILARH, Honduras

Problem: Many young men in Honduras leave their homes in rural areas to find work in towns, leaving rural regions populated predominantly by senior citizens, women and children.

Microfinance Solution: PILARH provides savings products that help women acting as heads of household to manage their finances, become entrepreneurs and provide their children with access to education. In this context, PILARH offers two savings accounts to promote education. The first is the “school savings account” which focuses on children from 6 - 12 years old and the second is the “educational savings account” for 13 - 17 year olds. These accounts give incentives, in the form of school supplies, to promote the habit of saving from a young age.

Chamroeun, Cambodia

Problem: The educational context in Cambodia is very challenging. The Khmer Rouge regime which fell in 1979 left behind it a dearth of educated young people: there are 45 pupils per teacher and 5,000 people to each doctor in the country. Educated young people will be fundamental for rebuilding Cambodian society.

Microfinance Solution: Chamroeun, an MFI based in Phnom Penh, does not finance education directly, but invests part of its net profits into a scholarship programme which supports poor and vulnerable young people in their endeavours to access education. Any MFI client who has a child studying at primary school, secondary school or university can apply for the scholarship programme. Successful applicants receive a bicycle and package of study materials. In 2015-2016, Chamroeun received 586 applications and 96 were successful.

Access to quality education: what microfinance can do

Interview with Roshaneh Zafar, CEO of Kashf, Pakistan



It is not only on the demand side that innovative products are needed. Schools themselves also receive insufficient funds to create an environment conducive to quality education. Yet providing loans to educational institutions falls outside the expertise of most traditional microfinance institutions.

Some institutions are beginning to focus on the best ways to support educational establishments. One such is Kashf, an institution based in Pakistan, and, following LMDF's nomination, the winner of the 7th European Microfinance awards in 2016. Roshaneh Zafar, CEO of Kashf, explains more about the institution's unique approach in the challenging operating context of Pakistan.

Whilst designing our programme, we quickly realised that to liberate children from household chores and burdens and get them into schools, there must first be an increase in women's contribution to household income.

Conventionally microfinance companies have focused on supporting individual families rather than supporting schools. Why have you chosen such a different approach?

Developing a programme to promote quality education undoubtedly has both supply side and demand side dynamics. Whilst designing our programme, we quickly realised that to liberate children from household chores and burdens and get them into schools, there must first be an increase in women's contribution to household income. This is where microfinance came in.

However we also felt that in some ways, our clients' ability to pay for a better education had improved over the years. Our focus was therefore on improving the supply-side dynamics of education provision. We had already seen that some of our loans had been used by clients to set up small tuition centres in their homes which had later grown into small scale schools.

While we were considering the best action to take, a report was published on the state of education in Pakistan which revealed that 30% of school enrolment was in low cost private schools across Pakistan and that the academic results of these schools were somewhat better than public schools. All these factors made it clearer to us that it was important to develop a better understanding of the financing and other requirements of low cost private schools. In 2012, we examined over 300 low cost private schools and discovered that along with financing, they also had major quality gaps related to school management, teacher quality, infrastructure and safety.

We therefore developed a holistic approach to improving the capacity of such schools, by not only providing them access to finance, but also the skills sorely needed: intensive training on school management aimed at the owners and teacher training programmes. Additionally, we have also developed a financial education curriculum for nursery up to grade 8, which is currently being delivered across the network of 1,000 Kashf supported schools. This has given us the opportunity to prepare children from a very young age to understand good financial practices and also hopefully enable them to become job creators rather than job seekers!!!

Why have you chosen to prioritise education for girls?

There is no doubt today that investing in girls reaps



both economic and social benefits in the long term. As is often stated, it is simply smart economics. It is important to emphasise that, other than in a small number of communities, the demand for girls' education has grown in Pakistan. The critical factor now is access: distance to schools has become a primary indicator of school retention of girls. Our low-cost school model works to counter this as most of these schools are located within communities and have been organically grown. Another interesting feature we saw within this particular market segment was that over 60% of such schools are run by women, thus offering the twin benefits of education for girls and viable career paths for women. There are, of course, other cultural challenges that young girls face which make education a challenge, not least the general perception that girls are seen as a liability rather than as an asset by the family. However we hope that this perception is also changing.

There is no doubt today that investing in girls reaps both economic and social benefits in the long term. As is often stated, it is simply smart economics.

What operational challenges have you faced operating in Pakistan?

Like any other product the first challenge is really understanding the dynamics of the segment and designing a product that adds value and meets the needs of the client. This was our first challenge and even now our product is a work in progress and we are still learning how to improve its features.

The second operational challenge was to train existing staff to leave their comfort zones. The low-cost private school client has a different set of demands from those of a female micro-entrepreneur; a different marketing approach and maintenance of a solid credit portfolio is important.

The third challenge was to determine the right operational mix in terms of managing risk and returns. Since our staff had not made such large loans prior to this (our average loan size is USD 350, as opposed to USD 1,500 for the school product), we needed to invest a great deal in the capacity of our staff to enable them to assess such loans and also to improve their understanding of the education sector and its needs as a whole.

However, none of these aspects were or are insurmountable, provided one has an eye and ear open to innovation! The other aspect that is challenging is twinning the non-financial aspects with the delivery of financial services and also ensuring that this is sustainable and impactful over time. The role of Kashf's school development officers has been critical to taking the training aspects of the programme forward. However, there is room to improve, particularly in terms of training content and training delivery.

A final important aspect we included in the programme is the regular checking of the quality of school services through a quality monitoring framework; again this is time intensive and more effective techniques need to be put into place to make this entire process more impactful.

Financing rural development

Microfinance is commonly associated with commercial activities and takes often place in densely populated areas. The global increase in urban populations has probably helped the sector development. Yet this does not mean that rural areas do not matter. Rural development in many less and least developed countries remains a key challenge to ensure food security and find a balance between human needs and ecological sustainability.

Since inception, LMDF has paid special attention to MFIs operating in rural areas. LMDF commonly uses the proportion of loans destined for agricultural activities as a way of reporting on the rural communities which it reaches (Graph 3.14). In recent years, around 30% of all financing provided by LMDF is used for agricultural activities, mostly by smallholder farmers.

80% of the thirty most recently funded MFIs have some form of agricultural loan product. This might simply be a product that allows bullet repayment at the end of a crop cycle, or a more complex product which fits in with the precise needs of a farmer growing a certain product such as coffee or cocoa.

Since inception, LMDF has paid special attention to MFIs operating in rural areas.

Yet entrepreneurship in rural areas extends beyond agriculture. Many of those who are working in rural areas are running small businesses which are not related to agriculture, but which are crucial for infrastructure in remote areas. Not all MFIs collect such data on such businesses. However, from the data which is available, 57% of the loans disbursed by portfolio MFIs reach those in rural areas. This amount is ahead of the sector benchmark (Symbiotics Survey), which found that 53% of borrowers were located in rural areas.

From LMDF's perspective, it is important to continue the focus on rural areas as these are places disproportionately affected by extreme poverty and which have less access to conventional financing. The FAO estimates that 75% of those classed as living in extreme poverty reside in the countryside. The disparity

between rural and urban areas also comes across very clearly when looking at data from LMDF's portfolio countries. In all the portfolio countries, urban poverty rates are considerably lower than rural ones. As Graph 3.15 shows, this disparity is particularly clear in Latin America and Africa, but less pronounced in Asia. Similar disparities can be seen when looking at access to financial services.

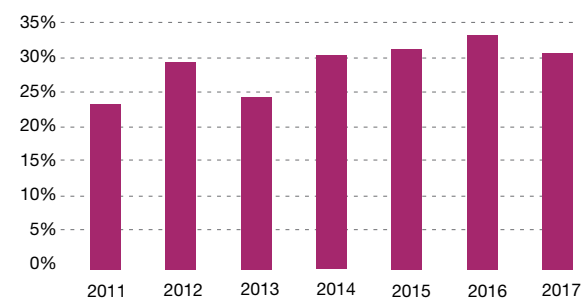
The will to prioritise rural funding can also be seen in the missions and visions of the portfolio MFIs. Out of the MFIs financed by LMDF:

- 15 out of 36 with data specifically mention that they aim to target those in rural areas;
- 10 out of 35 with data have increased their proportion of rural entrepreneurs over the past 3 years;
- MFIs explicitly stating a focus on rural areas show 70% of micro-entrepreneurs supported are in rural areas.

Microfinance institutions have proved to be particularly adept at accessing rural communities. Conventional financing providers may have viewed rural areas as too expensive to access or have been worried about the risks of providing predominantly agricultural products.

This has left opportunities open for microfinance operators which, with their local knowledge, are at an advantage when it comes to promoting funding in rural

GRAPH 3.14:
MICROCREDIT FOR AGRICULTURE GRANTED BY
LMDF (IN %, 2011-2017)



Source: LMDF analysis of data submitted by MFIs



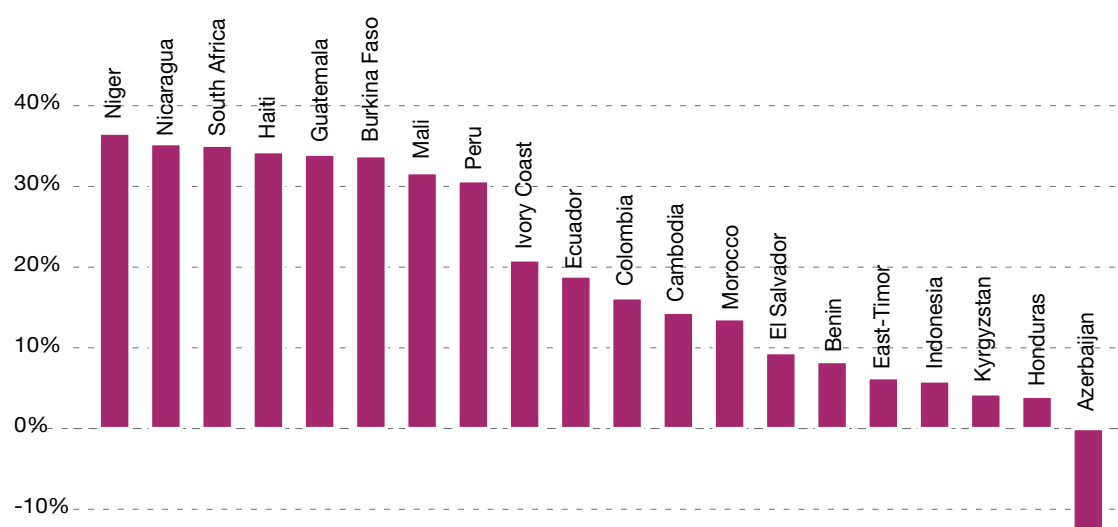
and remote areas. Moreover the smaller sizes of loans needed by many of those working in the countryside, for example to smallholder farmers, are more readily provided by microfinance organisations than by mainstream financial institutions.

Microfinance institutions are also well-positioned to provide support through training initiatives. Education and training programmes for farmers can have a considerable impact on yields, contributing both to business profitability and to food security. By delivering such programmes, microfinance firms can improve livelihoods in the local community while increasing the

probability of loan repayment.

Exciting opportunities are now opening up for institutions operating in rural areas. Digital financing is beginning to bridge the gap, allowing previously underserved rural communities to access financial services. The population with digital accounts is in many instances higher in rural areas than among the wider population. The numbers with digital accounts remain very low, but growth and development in this area is prodigious and further change should be expected in the coming years.

GRAPH 3.15:
DIFFERENCE BETWEEN RURAL AND URBAN POVERTY



Source: World Bank - most recent available data

“PAMF’s objective is to provide adapted and accessible financial services, for both credit and savings, to people excluded from the traditional banking system, in order to reduce their vulnerability, increase their incomes and reduce their social and economic exclusion.”

Birame Kane, CEO of PAMF Burkina Faso

Chapter 4: LMDF's social performance compared to others

LMDF compared to the CERISE database

The previous section describes the outcome of the key elements of LMDF's social performance derived from the Fund's vision and mission. It allows to assess to which degree the Fund's investments correspond to its social goals (a relation commonly referred to as social performance).

However, the previous section does not allow to position LMDF compared to other funds and the wider microfinance sector. The last social performance report published by LMDF for the years 2010 – 2015 measured the Fund's social performance. It compared LMDF to sector benchmarks where data was available, for example the percentage of women financed. Because comparable data was scarce, the report did allow to draw only very limited conclusions about LMDF's positioning in relation to other funds and actors. In 2012, after a long consultation process with a wide range of sector actors, the Social Performance Task Force (SPTF) published the Universal Standards for Social Performance Management. These standards define what we understand by social performance management. The Universal Standards cover six principle areas:

1. Define and monitor social goals
2. Ensure Board, Management and Employee commitment to social goals
3. Design products, services and delivery channels that meet client's needs and preferences
4. Treat clients responsibly
5. Treat employees responsibly
6. Balance financial and social performance

Since 2012 a number of tools have been developed to assist microfinance institutions to measure where they stand with regards to the six dimensions of the Universal

Standards. A French organisation, CERISE, has developed a social audit tool, the Social Performance Indicators (SPI) to enable MFIs a comprehensive review of their social performance. The tool is now in its fourth version, normally referred to as SPI4. The use of SPI4 by a range of MFIs allowed CERISE to build a database and sector benchmarks.

LMDF compared to the benchmark

A close collaboration between ADA and CERISE has allowed to compare the social performance data of MFIs financed by LMDF to a peer group (Table 4.1). The criteria used for the selection of the peer group were:

- MFIs in regions in which LMDF operates (Latin America, Sub-Saharan Africa, Southeast Asia and North Africa)
- MFIs with comparable legal forms (excluding the MFIs with a banking license)
- Scale (measured as gross loan portfolio)

TABLE 4.1:
COMPOSITION OF LMDF'S PORTFOLIO AND
CERISE BENCHMARK

Region	Number of MFIs LMDF	Peer Group (CERISE)
Latin America and Caribbean	13	75
Sub-Saharan Africa	3	64
Southeast Asia	2	26
Middle East and North Africa region	1	11
Total	19	176

Source: LMDF & Cerise Database

The benchmark compares the average score of MFIs financed by LMDF (all 19 for which the SPI4 data is available) to the benchmark across the six principle and 19 sub-elements of social performance.

The overall result of the benchmark illustrates that MFIs in LMDF's portfolio perform better socially in all six areas and in all 19 sub-elements compared to the peer group. The outperformance proves the positive impact of the principles and strategies pursued by LMDF.

The overall result of the benchmark illustrates that MFIs in LMDF's portfolio perform better socially in all six areas and in all 19 sub-elements compared to the peer group.

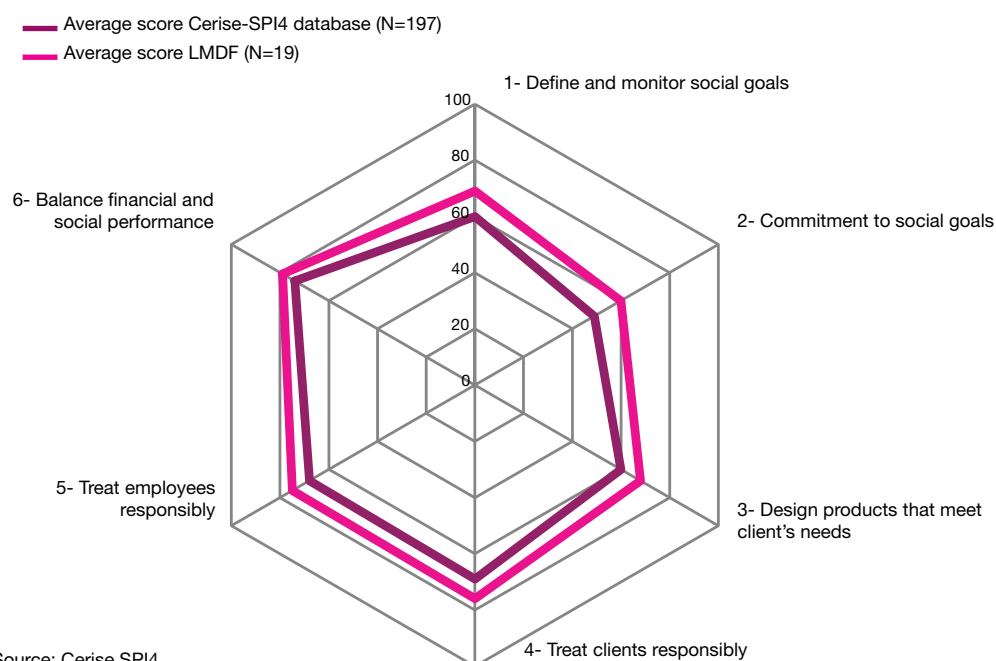
It is worth noting that the highest performance of LMDF's portfolio compared to the peer group is in dimensions 1 – define and monitor social goals, 2 – commitment to social goals and 3 – design products that meet client's needs. While dimensions 4 – treat clients responsibly and dimension 5 – treat employees responsibly may

qualify more under the “do no harm” approach to social performance, dimensions 1, 2 and 3 are more driven by positive intend and the social DNA of a microfinance institution (the previous chapter on Working towards common goals already illustrated this point). The single largest difference between the CERISE benchmark and LMDF is in 1A – Social strategy where MFIs financed by LMDF on average have a score of 83 compared to a peer group average of 68 (Table 4.3).

LMDF's portfolio also compares very favorably in the sub-elements Board accountability (2A), Client needs and preferences (3A), Employee satisfaction (5C) and Privacy of client data (4D).

The smallest difference between the peer group and LMDF's portfolio are in issues related to the formalisation of processes. For example, the elements Mechanism for complaint resolution (4E), HR Policy (5A) or Reporting of client-level data (1B) show the lowest difference. This may be partially due to the fact that MFIs financed by LMDF are on average small and emerging MFIs which may lack formalisation of certain procedures and

GRAPH 4.2:
SOCIAL PERFORMANCE OF LMDF'S PORTFOLIO COMPARED TO A SECTOR PEER GROUP



policies. It is also telling that the lower positive difference between HR Policy (5A) contrast with a very large positive outperformance of the peer group in terms of Employee satisfaction (5C).

its mission to “specialise in facilitating the growth of promising emerging microfinance institutions which address the financial needs of marginalised communities and individuals in developing countries”.

These outcomes are proof for LMDF’s commitment towards its social vision and mission, in particular

TABLE 4.3:
LMDF’S PORTFOLIO COMPARED TO PEER GROUP

	Average score Cerise-SPI4 database (N=197)	Average score LMDF (N=19)	Gap
1- DEFINE AND MONITOR SOCIAL GOALS	60	69	9,0
1A - Social strategy	68	83	15,0
1B - Reporting of client-level data	51	55	4,0
2- COMMITMENT TO SOCIAL GOALS	49	60	11,0
2A- Board accountability	42	54	12,0
2B- Senior management accountability	46	56	10,0
2C- Staff accountability	60	69	9,0
3- DESIGN PRODUCTS THAT MEET CLIENT’S NEEDS	60	68	8,0
3A- Client needs and preferences	49	61	12,0
3B- Benefits to clients	71	75	4,0
4- TREAT CLIENTS RESPONSIBLY	69	76	7,0
4A- Prevention of over-indebtedness	75	83	8,0
4B- Transparency	73	79	6,0
4C- Fair and respectful treatment of clients	71	78	7,0
4D- Privacy of client data	66	76	10,0
4E- Mechanisms for complaint resolution	59	61	2,0
5- TREAT EMPLOYEES RESPONSIBLY	68	75	7,0
5A- HR policy	68	71	3,0
5B- Communication of terms of employment	76	81	5,0
5C- Employee satisfaction	61	72	11,0
6- BALANCE FINANCIAL AND SOCIAL PERFORMANCE	74	79	5,0
6A- Growth rates	76	84	8,0
6B- Alignment of objectives	72	80	8,0
6C- Responsible pricing	79	84	5,0
6D- Compensation	56	6	6,0
Total	63	71,2	7,8

Source: Cerise SPI4



TABLE 4.4:
LMDF'S PORTFOLIO COMPARED TO PARTICULAR PEER GROUPS

Sub-group	Average score LMDF	Average score Cerise benchmark	n LMDF	n Cerise
Legal form: Cooperatives	77	54	5	46
Size: small MFI	77	57	3	71
Geography: Sub-Saharan Africa	76	53	3	64

Source: Cerise SPI4

TABLE 4.5:
FIVE DATA POINTS WITH THE LARGEST NEGATIVE GAP BETWEEN LMDF'S PORTFOLIO AND CERISE PEER GROUP

Indicators	Details	Gap
4 E 3 1	Management regularly reviews KPIs (e.g., percent resolved, average time to resolve) and takes corrective action to resolve mis-handled cases and improve systematic shortcomings.	-18%
4 C 2 2	Terms and conditions for individuals may differ based on 1) risk-based analysis, 2) target markets defined in the provider's mission, 3) accommodations based on special needs. Such differentiation should be consistently applied, stated in advance and made with the goal of benefitting clients.	-17%
1 B 3 2	The provider has a formal environmental policy which specifies its environmental goals, targets, and indicators.	-16%
4 E 3 4	The analysis of complaints data, satisfaction surveys or reason for drop-outs contributes to improving operations and services	-16%
6 D 1 1	The CEO/Managing Director's compensation takes into account the results of his/her performance evaluation (see Essential Practice 2A.4).	-15%

Source: Cerise SPI4

Focus on working responsibly

Facilitating responsible microfinance is LMDF's mission. This section particularly focuses on whether MFIs provide their products in a responsible manner with regards to clients and their own employees. The CERISE database covers five key dimensions with regards to the responsible treatment of clients (prevention of over-indebtedness, transparency, fair and respectful treatment of clients, privacy of client data and mechanisms for complaint resolution) and three dimensions with regards to the responsibility to employees (HR policy, communication of terms of employment and employment satisfaction).

LMDF's portfolio compares very favorably to the main dimensions of the Client Protection Principles. In particular MFIs in LMDF's portfolio treat client data with the necessary level of privacy, an issue of increasing importance worldwide.

The last Social Performance Report of the Fund had identified two areas of weakness among LMDF's partners: (1) A lack of adaptation of the Client Protection Principles which ensure fair and equitable treatment

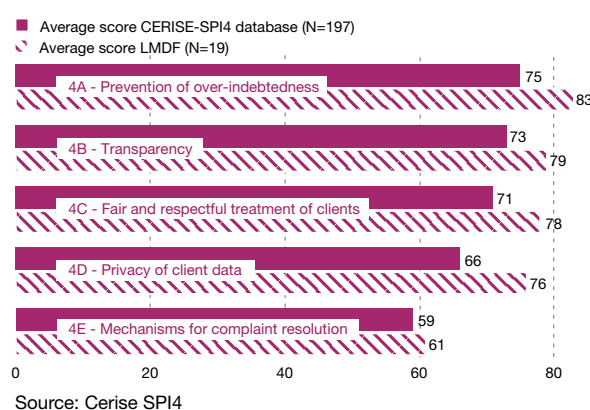
of clients and (2) a higher than average staff turnover indicating difficult working conditions and low staff satisfaction.

SPI4 data allows a more detailed analysis of the portfolio compared to the CERISE peer group. Graphs 4.6 and 4.7 show that much progress has been made on providing responsible microfinance services to clients and treating employees well. LMDF's portfolio compares very favorably to the main dimensions of the Client Protection Principles. In particular MFIs in LMDF's portfolio treat client data with the necessary level of privacy, an issue of increasing importance worldwide.

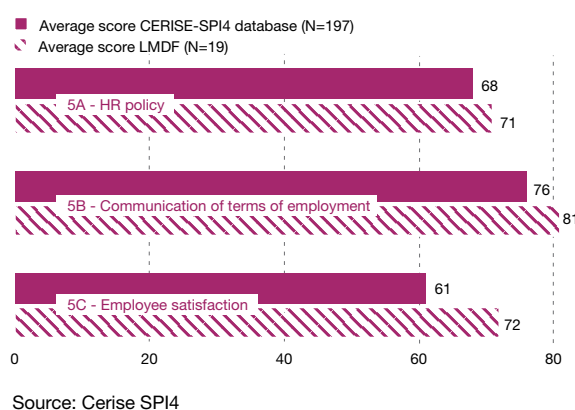
The more detailed data on treating employees well shows the largest positive gap between LMDF's portfolio and the benchmark on employee satisfaction (5C). But the MFIs financed by LMDF also compare favorably in terms of HR policies and communications with staff.

These results are very encouraging, particularly in view of the weaknesses identified during the last report. Yet, the scores of LMDF's portfolio and the peer group leave significant room for improvement.

GRAPH 4.6:
FOCUS ON DIMENSION 4: TREAT CLIENTS RESPONSIBLY



GRAPH 4.7:
FOCUS ON DIMENSION 5: TREAT EMPLOYEES RESPONSIBLY



LMDF's portfolio and over-indebtedness

The risk of over-indebtedness has been an important topic of the microfinance sector for a number of years. Providing clients from low-income households and informal micro-entrepreneurs with credit requires careful judgement about the repayment capacity of the client. In a competitive market, clients may have access to several sources of loans from MFIs but also to consumption loans and through credit cards.

MFIs operating in such niches are unlikely to contribute (and suffer) from a significant saturation and risks in mainstream microfinance markets.

The sector has for some time tried to address the risks of over-indebtedness by promoting credit bureaus, ensure an efficient exchange of information and implement appropriate credit policies on MFI level. The Microfinance Index of Market Outreach and Saturation (MIMOSA) has been developed to assess the overall level of financial market penetration in a given country. MIMOSA uses economic and social data to categorise countries from 1 to 6, 1 indicating an underserved and 6 a highly saturated market (Table 4.8 illustrates the details of the scoring).

Graph 4.9 shows a breakdown of LMDF's portfolio by Mimoso score. LMDF does not currently invest in any

markets which are ranked 1 by Mimoso. This is partly because these markets are fairly underdeveloped and few opportunities to invest arise. This also results from the extremely complex operating environment found in many of the markets which are ranked 1. On the other hand, LMDF is able to invest 45% of its portfolio in markets which are ranked 2 and 3, and where there is still considerable scope to support financial inclusion efforts.

19% of the portfolio is invested in saturated markets ranked 6 (namely Nicaragua and Peru). In these crowded markets, many opportunities arise and many MFIs seek financing. However, it is important to understand LMDF's strategy to work with entities which operate in a niche, be it geographically, or in terms of their outreach (working with disadvantaged women, or ethnic minorities). MFIs operating in such niches are unlikely to contribute (and suffer) from a significant saturation and risks in mainstream microfinance markets.

Over-indebtedness remains a risk in certain microfinance markets. But the sector also managed to develop concrete responses to mitigating the risk and ensure that the collective actions keep the client's interests at heart.

TABLE 4.8:
MIMOSA SCORING SYSTEM

MIMOSA Score	Penetration over / under capacity Percentage points	Standard deviation	Number / percent of countries (2014)	Market Status
6	>11.1%	3+	4 / 4%	Saturated
5	7.4% - 11.1%	2 to 3	5 / 5%	
4	3.7% - 7.4%	1 to 2	11 / 12%	
3	0% - 3.7%	0 to 1	22 / 24%	Normal
2	-3.7% - 0%	-1 to 0	33 / 35%	
1	<-3.7%	<-1	18 / 19%	Underserved

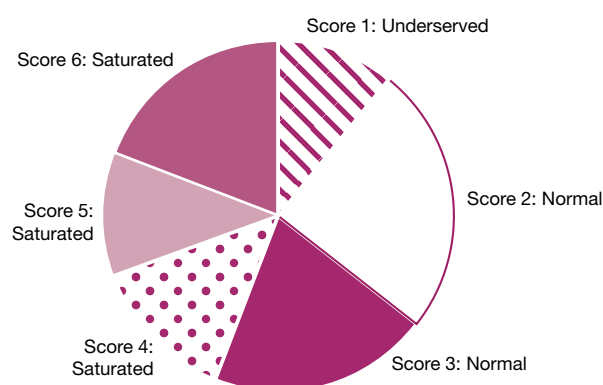
Source: MIMOSA

Another country at risk of over-indebtedness is Cambodia which has seen a very rapid growth of the microfinance sector over the last years. The latest available MIMOSA index (from 2016) for Cambodia is 6 indicating a highly saturated market, an increase from an index of 4 in 2011 and 5 in 2014.

The due diligence executed by LMDF's investment adviser, ADA, in Cambodia now includes a very detailed a systematic review of specific risks of the

microcredit portfolio, including how many loans have been re-financed with larger amounts, the number of loans a client holds, the ratio between loan and income levels and the average increase of loan amounts between one credit and the next. Over-indebtedness remains a risk in certain microfinance markets. But the sector also managed to develop concrete responses to mitigating the risk and ensure that the collective actions keep the client's interests at heart.

GRAPH 4.9:
LMDF PORTFOLIO BY MIMOSA RANKING



Source: LMDF Analysis, portfolio as of 31/03/2017

CASE STUDY: PANA PANA – A NICHE IN A SATURATED MARKET

Nicaragua is one of the markets defined as saturated by Mimosa and has a ranking of 6 on its saturation scale. However, LMDF continues to support projects in Nicaragua provided that they have undergone a careful selection process. It looks to finance MFIs acting in particular niches and geographies where financial inclusion remains relatively low.

Pana Pana, for instance, is based in the North Atlantic Autonomous Region of the country, a semi-autonomous region with very different dynamics from the rest of the country. Its cultural, linguistic and political differences have left the region marginalised and its inhabitants have received limited support from the central government. For this reason, NGOs operating in the region are a life line for the population. Pana Pana focuses its attention on rural populations, women, the poor and the extremely poor, as well as those from ethnic minorities. This enables the MFI to continue to operate in a responsible manner, providing financial services to those most in need.



Estelina Lam, financed by Pana Pana, in her grocery store // Nicaragua

Conclusion and Outlook

The title of this report “Social Impact in a Changing Microfinance Sector” hints at two key trends. The first trend is that the microfinance sector is evolving rapidly. Many MFIs have reached an impressive degree of institutional maturity. They increasingly rely on deposits and local financial markets for their refinancing, so that the previously crucial role of MIVs in the development of the sector is reducing. This is good news and reason to celebrate, yet it also raises the question about the future role for microfinance funds.

The second trend is the importance of social impact in this changing sector. In many countries, the microfinance sector has completed a development cycle. Does that mean the job is done? We would argue no. No because financial inclusion of marginalised populations remains an elusive goal in many places, even in some of the most developed microfinance markets. The consideration of social impact, i.e. to which degree do the actions of MFIs better the lives of their clients, should be one vector to push the sector forward.

In many countries, the microfinance sector has completed a development cycle. Does that mean the job is done? We would argue no.

How will these two trends guide LMDF in the years to come? We think that the key links between a social vision and reality identified in LMDF's first social performance report published in 2015 remain valid: (1) Standardised data to assess social performance, (2) linking social objectives to concrete

actions and policies of LMDF and (3) ensure that social performance goals are shared among all key stakeholders of the Fund, may they be public or private. And we added a fourth dimension for this report.

Improvement in availability of data

Key sections of this report rely on standardised social performance data, mainly based on the Universal Standards for Social Performance Measurement. The fact that an increasing number of MFIs accept the standards as a legitimate way to take stock of their social performance management is a huge step forward. 19 out of 36 MFIs financed by LMDF have submitted comprehensive and standardised social performance data. To be able to assess in detail half of our investment portfolio is progress, yet much remains to be done. We would hope that almost all of the social mission driven MFIs financed by LMDF will be able to submit their social performance data in the future. We will ensure that we are strict about having such data available. We would never consider financing an MFI without having seen its balance sheet and income statement, and social performance data should be equally important.

Data should drive actions

The increasing wealth of available data needs to influence our decisions and priorities. This social performance report is a good way to take stock. Yet, we can push the frontier further by including more elements of social performance in our investment decisions. We should also do our part to encourage MFIs to include social performance considerations



and consideration of client needs in their decision-making processes. One concrete step for LMDF will be the systematic inclusion of SPI4 data (in the Alinus version adapted to investor due diligence processes) in all investment proposals.

The increased availability of data and systematic incorporation of social performance considerations into our decision process should allow us to identify MFIs who are overcoming the current barriers of the sector.

The data also inform us about the areas where MFIs we finance tend to be weaker. The absence of environmental policies in many MFIs is a source of concern. We need to assess what can be done to encourage MFIs to better balance their lending practices with the need for a healthy environment.

Interest of stakeholders in social performance

The fact that the Fund is publishing a second social performance report speaks to the interest shareholders and other stakeholders have shown in our first report. It is essential for

a social fund to provide a serious analysis of its social impact from time to time. Publishing a detailed and dedicated report every two or three years is a good way to respond to this interest.

Changing models

This second social performance report adds a fourth objective for the future. The increased availability of data and systematic incorporation of social performance considerations into our decision process should allow us to identify MFIs who are overcoming the current barriers of the sector. This may require re-thinking some elements we take for granted at the present moment. Driving forces such as digitalisation and decentralisation/agency models may help new models to emerge. By the time we publish the next social performance report we can hopefully report that progress has been made in the interests both of our investors and micro-entrepreneurs that we support.

Kaspar Wansleben
Executive Director

“It is just and fair that people
have equal access to capital.
Finance can be a powerful tool
for social change”

Suzanne Biegel, founder of Catalyst at Large



Loan collection during a community bank group meeting // Nicaragua

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