“Development investment is defined as capital mobilised to carry out for-profit investment in developing countries and development-related sectors of society.”
MARKET OUTLOOK

GLOBAL GROWTH FORECAST FOR THE MSME FINANCE SECTOR

10 – 15 %
The confidence barometer is, like many sentiment indicators in financial markets, a visualization of interviewees’ responses to the question “How do you expect the MSME market in your region/country to be next year, compared to this year?” Those responding “better” are graded at 100, “similar” at 50 and “worse” at 0.

As shown above, while confidence levels are lower than in previous Outlook publications (2012–15), this year’s outlook shows a rebound from that of last year (which was still narrowly in positive territory). This coincides with the findings from our experts, several of whom have experienced economic slowdowns in their markets and consequently expect a rebound next year.

— Key Results at a Glance

As last year, our experts forecast an average growth rate of 10–15% for the market in 2017.

The majority of interviewees believe that interest rates for the end client in their markets will decline in 2017.

65% of those interviewed anticipate moderate or substantial consolidation in their markets in the next twelve months.

Although mobile payments are still seen as the most likely channel, almost two thirds of those interviewed believe that deposits and lending will be one of the areas that experiences a significant impact from fintech in their markets.

Of our experts expect the share of SME financing in their markets to increase over the next 5 years, with 1 in 3 expecting an increase of more than 20%.

Over 80% of our experts see their markets as moderately or not at all saturated, with substantial or vast remaining potential.

Source: responsAbility survey
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— CORRELATION BETWEEN DOMESTIC CREDIT AND GDP PER CAPITA FOR SELECTED COUNTRIES, 1984 AND 2015

A properly functioning formal financial sector is essential for economic development. In 1984, selected countries showed roughly similar levels of development. 21 years later, most countries with greater levels of domestic credit also report higher levels of GDP per capita.

— MOTIVES FOR BORROWING (PERCENTAGE OF THE ADULT POPULATION WITH AN OUTSTANDING LOAN)

Along with housing finance, the three reasons mentioned below are the main motives in developing countries for taking out a new loan from any financial institution.

<table>
<thead>
<tr>
<th>Health or Medical Purposes</th>
<th>Education or School Fees</th>
<th>Start, Operate or Expand a Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>14%</td>
<td>8%</td>
<td>8%</td>
</tr>
</tbody>
</table>

Aggregate values for the developing world.
Adults originating a new loan for any of these three reasons in (%), 2014.

banks – offer a broad range of financial services that extend well beyond forms of credit. The growth of these financial services providers has enabled many of their customers to develop their businesses from what were often informal microenterprises into small and, at times, even medium-sized businesses. In turn, these businesses have bigger and more complex financing requirements.

While this progress is taking place at very different speeds across our investment countries (almost 100 in total), the direction of global development is consistent. This demonstrates a development success: 10 to 15 years ago, the micro-lending business was at best rudimentary in most of these countries – today, banks offering financial services to micro and SME customers can be found in many markets.

This trend has been apparent in the development of our model portfolio over the past five years (see page 31) and we are proud that, together with our investors, we have been able to contribute to this development and will continue to do so.
MICRO AND SME FINANCE AS AN INVESTMENT TOPIC

Development investments are ideal for investors seeking long-term value creation. As the investments flow into real economies, they provide access to capital in underserved markets and benefit micro, small and medium-sized enterprises (MSMEs), as well as low- and middle-income households.

For development investments, finance is an important sector that has matured and attracted significant volumes of capital. The financial sector is a critical component of any modern economy, providing savings, loans and other financial services that are vital to all areas of society. The expansion of the financial sector therefore plays a key role in economic development, driving private-sector growth while promoting a culture of saving and investment.

Over the last three decades, investment inflows into the financial sector in developing countries have been directed towards a broad landscape of specialised intermediaries that serve the vast number of unbanked market segments. Households and businesses in many countries still have restricted access to financial services, despite very positive outreach developments in recent decades. Studies show that more than 2.3 billion people are unbanked, meaning they have no access to accounts, savings and payment mechanisms. In response to this unmet demand, an ever-increasing number of financial institutions are serving the needs of broad sections of the population in developing countries, often through the provision of microfinance. As the microfinance market matures, many of these institutions are not only growing in size but are also widening their product offering as they develop from small microfinance institutions into MSME banks. To operate successfully, these organisations require debt capital to refinance their loans and, increasingly, equity capital to support transformation into more mature institutions and continued expansion.

THE DEVELOPMENT OF THE MSME INVESTMENT SECTOR

SMES account for more than 90% of the total number of formal firms worldwide, according to the World Bank, thus representing the backbone of an economy. Two out of three full-time jobs in developing economies are provided by SMEs. The informal sector, which consists mostly of MSMEs, provides jobs to more than half of the labour force in developing economies. However, while SMEs account for, on average, 51.5% of GDP in high-income countries, they contribute only 35.6% in low-income countries, according to the World Bank. This underlines how the SME sector in low-income economies is lagging far behind higher-income economies.

Access to finance plays a role in this gap. The International Finance Corporation (IFC) estimates a financing gap of USD 2–2.6 trillion for MSMEs in developing economies, which is equivalent to a third of the current outstanding MSME credit gap. More than 200 million formal and informal
MSMEs in developing economies are thought to be either unserved (i.e. do not have a loan or overdraft and need one) or underserved (i.e. have a loan or overdraft, but still find access to finance limited). More than 90% of these unserved and underserved enterprises are formal microenterprises or informal MSMEs. The origin of this persistent credit gap can be explained by the structure of the financial sector. Many developing countries have seen their microfinance sector grow substantially over the last few years. Meanwhile, at the other end of the spectrum, commercial banks have focused on products for large corporations with a high degree of professionalisation and big loan volumes. SMEs have been

"Development investment in the financial sector has evolved from a niche, philanthropy-driven segment to a mainstream investment topic."

Philip Rauh, Head Global Sales and Business Development, responsAbility Investments AG

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**MSME FINANCE – KEY FIGURES**

- 2.3 BILLION PEOPLE ARE UNBANKED
- SMEs ACCOUNT FOR 90% OF THE TOTAL NUMBER OF FORMAL FIRMS WORLDWIDE
- SMEs CONTRIBUTE ONLY 15.6% OF GDP IN LOW-INCOME COUNTRIES
- FINANCE GAP OF USD 2.1 – 2.6 TRILLION FOR MSMEs

200 MILLION

Number of formal and informal MSMEs in developing countries thought to be either unserved or underserved.
abandoned in the middle: their financial needs are generally too big and too complex for microfinance institutions, while commercial banks perceive them as too small and too risky. As a result, SMEs represent the “missing middle” in the enterprise spectrum, where every second business remains significantly credit-constrained.

Private investors, through a variety of financial products, can provide solutions to better serve the SME sector. Since the underlying portfolios of SME banks are highly diversified, linked to the real economy and therefore less correlated to global financial markets, the financing of SME banks offers investors both an attractive risk-return profile and the opportunity to be the catalyst for financial sector development.

— INCREASED INFLOWS FOR DEVELOPMENT INVESTMENTS

Development investment is defined as capital mobilised to carry out for-profit investment in developing countries and development-related sectors of society. Private capital plays an important role in scaling up investees and expanding their reach. As illustrated by the success of the microfinance business model, development investments are a valuable solution for both retail and institutional investors who are eager to generate financial returns while making a positive social and/or environmental impact. The financial crisis of 2008 may have made investors more cautious overall, but microfinance has continued to expand as an investment topic, underlining its success and resilience. While microfinance investors – development-finance institutions, foundations and philanthropists – played a key role in the early growth of this investment topic, the big change of the past decade was the arrival of commercial investors seeking market-risk-adjusted returns.

In terms of private investment, the current market for commercial microfinance is estimated at about USD 11.6 billion. Studies conducted since 2006 show a compound annual growth rate of nearly 30%, on average, for investor inflows in the sector (see page 11). Among the broader composition of assets reported by leading investors, microfinance remains the leader, accounting for 78% of total assets in 2015 (see page 11). From an asset-class perspective, fixed-income funds (mostly private debt) represent about 75% of volume while equity funds have reached 10%. However, equity funds experienced the strongest growth in terms of total assets (+28%) in 2015. This was mostly via direct microfinance equity investments (72%) that took “small minority” stakes (less than 25% ownership). Yet in order to fully comprehend the sheer size of development investment in the financial sector, it is also important to consider the contribution of public investors, including development finance institutions (DFIs).

While government programs differ in size, commitments to the financial sector from major DFIs amount to around USD 50 billion. It should be assumed that a substantial proportion of those commitments also target SME financing, not just microfinance.

The growth of the MSME market, reflected by the increase in assets under management, signals rising interest from investors aiming to access the real economy while contributing to growth and prosperity in the developing world. This marks not only a major shift in the range of products offered to investors, but also a significant change in the conventional wisdom relating to investor appetites. As a result, investors can play a key and unprecedented role in financial-sector development in emerging markets.
A common definition of SMEs includes businesses with fewer than 250 employees, although this can vary, according to the country, from fewer than 100 employees to fewer than 500 employees. 

The OECD reports that SMEs account for more than 90% of manufacturing enterprises and an even higher share of many service industries in OECD countries; in most OECD countries, SMEs generate two-thirds of private-sector employment and are the principal creator of new jobs.

We use assets under management in microfinance investment vehicles as a proxy. The yearly survey is performed by Symbiotics and includes 93% of the market participants. The market size is extrapolated to show the full market scale.

Sources:
- Symbiotics, CGAP, responsAbility Investments AG
- 2016 Symbiotics MIV Survey, September 2016, Symbiotics
**IMPROVING BUSINESS ENVIRONMENT**

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**PUBLIC CREDIT REGISTRY COVERAGE AROUND THE GLOBE**

The extent of credit registry coverage has improved dramatically in the last decade. This allows financial institutions to make more informed decisions, lowering the rates charged to good clients. Nevertheless, considerable room for improvement remains in many developing countries.

Values below region names show increase in public credit registry coverage in percentage points from 2005 – 2015

Source: World Development Indicators, World Bank (2016)

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**WORLD BANK DOING BUSINESS INDEX, 2007 – 15**

The last few years have seen a substantial reduction in the time required to start a business in many developing countries. This will foster entrepreneurs and further augment the pace of growth in MSMEs in the developing world.

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**Days required to start a business**

<table>
<thead>
<tr>
<th>Year</th>
<th>OECD</th>
<th>Georgia</th>
<th>Peru</th>
<th>Vietnam</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>19</td>
<td>11</td>
<td>73</td>
<td>37</td>
</tr>
<tr>
<td>2015</td>
<td>6</td>
<td>3</td>
<td>25</td>
<td>20</td>
</tr>
</tbody>
</table>
The responsAbility Micro and SME Finance Market Outlook 2017 aims to provide an in-depth and concise overview of expected developments in the industry over the next year. As stated in previous reports, it is estimated that about 10,000 microfinance institutions (MFIs) exist worldwide. However, only around 500 MFIs would potentially satisfy responsAbility’s eligibility standards in terms of sustainability, business model, thoroughness of analytics and overall impact on sector development. The number of SME lenders in the developing world is much harder to define, not least with many MFIs and banks also operating in this space, nevertheless, we estimate the number of investible institutions at around 300–400.

With more interviews than ever before and a broader scope, this year’s survey is intended to look at the prospects for these investible institutions across micro and SME finance. Although the number of institutions under discussion is therefore larger, responsAbility has been investing in institutions that are partially or wholly present in the SME segment for many years. This expertise allows us to pinpoint interviewees that can provide an overview of the micro and SME finance space for key markets, while adding new questions that specifically target the SME segment.

Among the questions asked, one of the most important indicators relates to portfolio growth, often a good proxy for the overall progress and expansion of financial inclusion worldwide. However, growth by itself cannot tell the whole story. Therefore, a range of other topics have also been included relating to other key performance indicators (portfolio quality, interest rate dynamics), market structure (regulation, business environment, sector consolidation), longer-term developments (future trends in funding, use of fintech), and the challenges faced by SMEs and SME lenders.

The study is divided into three parts which complement one another and together produce a comprehensive qualitative and quantitative picture of the micro and SME finance market in 2017.

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**SURVEY RESULTS**

**INTRODUCTION AND METHODOLOGY**

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Growth forecasts for every country are published biannually by the International Monetary Fund (IMF). These forecasts serve as a basis for the assessment. While the degree of correlation between the micro and SME finance market and the macroeconomic context varies by country, broad growth patterns can be seen as a proxy for changing demand for loans and other market dynamics.

**MACROECONOMIC FORECASTS** *(PAGES 14–15)*

responsAbility can draw on regularly reported data from more than 250 micro and SME finance institutions to examine market trends. From this group, we have constructed a constant subset of 200 that we regard as a “model portfolio”, representative of micro and SME finance across a broad range of key markets. The increase in scope to include SME is also reflected in the composition and activities of our model portfolio. Although still dominated by microfinance, on average 20% of the total gross loan portfolio is dedicated to SME lending. This therefore acts as a strong basis for extrapolating results from our adjusted survey questions and respondents to the model portfolio. Based on this market tracker, as well as the data compiled in the interviews, we then estimate the development of key performance indicators, such as growth and portfolio quality, for 2017.

**SURVEY RESULTS** *(PAGES 16–21)*

Based on our extensive network of micro and SME finance experts, we were able to hold 43 interviews with practitioners worldwide, including decision-makers at MFIs, rating agencies, as well as investors and advisors. The interview guideline included 21 questions on eight different topics.

**QUANTITATIVE EXTRAPOLATION** *(PAGES 31–33)*

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1. MicroRate, The State of Microfinance Investment 2013; responsAbility Research

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**BREAKDOWN OF EXPERTS BY REGION**

<table>
<thead>
<tr>
<th>Region</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global</td>
<td>9%</td>
</tr>
<tr>
<td>APAC</td>
<td>23%</td>
</tr>
<tr>
<td>MENA</td>
<td>30%</td>
</tr>
<tr>
<td>LATAM</td>
<td>21%</td>
</tr>
<tr>
<td>Eeca</td>
<td>23%</td>
</tr>
</tbody>
</table>

Source: responsAbility survey
2017 is expected to show an acceleration in global output, principally driven by growth in the developing world. According to the IMF World Economic Outlook, global GDP is expected to increase by 0.3 percentage points to 3.4%, reaching 1.8% in the developed world and 4.6% in the developing world. For growth in 2017, as in 2016, divergence will remain the key motif: growth rates will vary between the developed and developing worlds, between regions and within many regions, with fundamentals sometimes differing sharply between neighbouring countries.

— 2016 – EXPECT THE UNEXPECTED

2016 was a difficult year for much of the developed world. Output levels remained stagnant across most of the European Union, with the fallout from Brexit and other populist movements adding to levels of uncertainty. The US, while performing better, failed to live up to expectations of faster growth in the second half of the year. This in turn has reduced expectations of interest rate rises by the Fed, leading to a stabilisation in the US dollar and assuaging fears of capital outflows from emerging markets. However, in the developing world, growth accelerated for the first time in five years. A key element of this was China, which exceeded expectations slightly, as a surge in credit boosted output and assuaged fears of a hard landing. Combined with the ongoing strength of the Indian economy, this boosted average performance for the Asia Pacific region and many markets beyond.

GDP GROWTH, HISTORIC AND FORECAST

Both the stabilisation in the dollar and higher Chinese consumption contributed to a relative recovery in commodities, albeit well below the levels of 2014. Finally, beyond simple economics, an exceptionally strong El Niño had a varying impact across different geographies, provoking drought or floods in different parts of the world.

— WHAT DOES THIS MEAN FOR DEVELOPING ECONOMIES IN 2017?

The last twelve months have underlined the ubiquity of political and economic shocks, with radical measures that defy orthodox thinking no longer limited to developing markets. Post-Brexit, 2017 will see mainstream parties in several EU states (France, Italy, Germany) and the US grapple with populist movements. With growth weak and monetary policy likely to remain very loose in much of the developed world, yields will remain low for at least the next twelve months, while strains are still evident in many banking sectors nearly a decade after the start of the financial crisis. Meanwhile, large, relatively mainstream emerging markets such as Brazil, Russia and South Africa are undergoing their own periods of economic volatility partly due to political uncertainty. Overall, the gap between growth in the developed and developing worlds will continue to grow, a trend that is expected to continue until 2020.

Of course, the effects of volatility in more mainstream markets may still be felt in several of our investment markets. If anything, though, these factors will add to the heterogeneity of economic outlooks among developing economies in general. The scale of further rate rises in the US appears to have reduced substantially from what was expected twelve months ago, yet any future increases may still have a moderate effect on developing world currencies and the cost of funding. For most developing countries, however, the spectre of widespread capital outflows seems to have largely dissipated, although the degree of openness to, and correlation with, external flows will vary greatly across markets. The slowdown in China and decline in commodity prices will also reduce growth in economies dependent on either factor.

— VARIED OUTCOMES ACROSS VARIOUS COUNTRIES

The vast majority of solid growth prospects for 2017 will be located in our target markets. Yet the developing world will continue to show a divergence of outlooks between and within regions. As mentioned, Asia Pacific continues to perform strongly. Of the six markets represented among our survey interviewees, four (Bangladesh, Cambodia, China

Source: IMF World Economic Outlook, October 2016

IMF World Economic Outlook, October 2016
of our experts stated that the correlation between the MSME finance sector and the economic context within their market was very strong, with 43% claiming that it was moderate. This marks a slight increase on last year, and the continuation of an upward trend for the last few editions of the Outlook. This is hardly surprising – as institutions become larger and more sophisticated, their connection and that of their clients with the national and global economy will grow stronger. As such, this trend might be seen as an inevitable part of financial sector development. At the same time, the impact on micro and SME finance institutions will vary according to the type of crisis. Short-term volatility in equity markets is unlikely to have an effect, but prolonged weakness in terms of local currency or remittances can place pressure on institutions and their clients. In terms of global economic events, our experts expect little impact from the headline economic event of the last few years, Brexit. Instead, commodities and local currency depreciation were expected to be the most important drivers (if any) out of those listed, while the impact of interest rate rises in the US was perceived as more of an indirect factor.

“This past year has been a challenge ... Nigeria has to take advantage of its large population, its strong entrepreneurship.”

Edward Greenwood, Board Member, Finca Nigeria

IMF GDP FORECASTS, TOP 15 MSME FINANCE MARKETS

<table>
<thead>
<tr>
<th>Country</th>
<th>2016</th>
<th>2017</th>
<th>CHANGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>7.6%</td>
<td>7.6%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Cambodia</td>
<td>7.0%</td>
<td>6.9%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>Armenia</td>
<td>3.2%</td>
<td>3.4%</td>
<td>+0.2%</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>4.3%</td>
<td>4.3%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Peru</td>
<td>3.7%</td>
<td>4.1%</td>
<td>+0.4%</td>
</tr>
<tr>
<td>Georgia</td>
<td>3.4%</td>
<td>5.2%</td>
<td>+1.8%</td>
</tr>
<tr>
<td>Ecuador</td>
<td>-2.3%</td>
<td>-2.7%</td>
<td>-0.4%</td>
</tr>
<tr>
<td>Kenya</td>
<td>6.0%</td>
<td>6.1%</td>
<td>+0.1%</td>
</tr>
<tr>
<td>Paraguay</td>
<td>3.5%</td>
<td>3.6%</td>
<td>+0.1%</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>-2.4%</td>
<td>1.4%</td>
<td>+3.8%</td>
</tr>
<tr>
<td>Bolivia</td>
<td>3.7%</td>
<td>3.9%</td>
<td>+0.2%</td>
</tr>
<tr>
<td>Turkey</td>
<td>3.3%</td>
<td>3.0%</td>
<td>-0.3%</td>
</tr>
<tr>
<td>Egypt</td>
<td>3.8%</td>
<td>4.0%</td>
<td>+0.2%</td>
</tr>
<tr>
<td>Bosnia Herzegovina</td>
<td>3.0%</td>
<td>3.2%</td>
<td>+0.2%</td>
</tr>
<tr>
<td>Mongolia</td>
<td>0.1%</td>
<td>1.0%</td>
<td>+0.9%</td>
</tr>
</tbody>
</table>
Growth expectations in Latin America remain similar to those of last year. With many micro and SME finance markets more mature than those of other regions, it is perhaps unsurprising that the pace of growth is slower. Nevertheless, the continuing strength of the US will have a positive influence via increased trade and higher remittances, prompting 10–20% forecasts from Central American interviewees. The average forecast in South America remained constant even for those markets whose economies were relatively dependent on commodity exports (Ecuador, Bolivia, Peru).

**Sub-Saharan Africa 5–10%**

The expected rate of growth in sub-Saharan Africa has fallen in comparison to last year’s forecasts, even if it remains higher than the sharply reduced GDP growth outlook for 2017 from the IMF. Yet the diversity of responses underlines the range of market maturity and economic dynamics within Africa, not to mention the limited intra-continental trade that limits regional correlation. While the outlook for Kenya was slightly more muted due to the introduction of an interest rate cap, it was still more positive than Nigeria, where currency volatility and a sharp economic slowdown have made the operating environment considerably more complicated. Conversely high demand due to a combination of lower import prices and the persistent gap in financial inclusion will drive more rapid portfolio growth in other markets.

**Middle East and North Africa 10–15%**

Forecasts continue to be relatively optimistic in the Middle East and North Africa, with many interviewees pointing towards high levels of demand in their markets. High youth unemployment in markets such as Tunisia and Jordan, as well as banking sectors that are often indifferent to low-income households, combine to create huge demand for credit to MSMEs, many of which operate informally. The biggest obstacles to achieving strong growth may thus be regulatory, rather than in terms of demand. Conversely, experts from this region described relatively little impact on micro and SME finance due to geopolitical factors such as migration or conflict.
Sentiment remains cautious in Eastern Europe, Caucasus and Central Asia (EECA). However, Russia’s gradual recovery will improve remittance flows and export revenues, raising hopes that 2017 will be the year in which a rebound will take effect. A return to growth for the region should also lead to the stabilization of local currencies, the volatility of which has had a dampening effect on many of the region’s financial sectors.

Once again, the highest growth expectations come from the Asia Pacific region, albeit with responses reflecting a variety of economic contexts, regulatory dynamics and market maturities. Growth remains more resilient than expected in China, although the slight slowdown will affect exports from neighbouring markets such as Mongolia. Stronger growth will come from South and South-East Asia, where demand remains robust, despite the relative maturity of many micro and SME finance markets. The confirmation of small finance bank (SFB) licenses for four institutions marks further acknowledgement of the impact, potential and realized, of micro and SME finance in India.

“The inclusive finance space has had a really good year in India … overall prospects are now brighter in 2017, thanks to progress made in 2016. This will open the door to new classes of investor.”

— Eric Savage, CEO Unitus India

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**EASTERN EUROPE, CAUCASUS AND CENTRAL ASIA AROUND 10%**

**ASIA PACIFIC 25–30%**
As well as growth, our experts asked about their expectations for a variety of other performance indicators for their markets. 60% thought that portfolio quality would stabilize or strengthen in 2017, albeit with only 14% expecting an actual improvement. However, the breakdown for portfolio quality forecasts varied considerably by region, and even within region. Our experts in Africa showed the greatest divergence of opinion, with few expecting a year of status quo: 33% expected an improvement, against 50% expecting a deterioration. In Asia, 70% of interviewees expect portfolio quality to deteriorate in 2017, compared to only 20% in Eastern Europe, Caucasus and Central Asia (EECA). However, this difference in outlook may be due to the baseline effects of 2016. Many Asian markets currently have high growth and low non-performing loan (NPL) ratios, making further improvement improbable. On the other hand, the slowdown in much of the EECA region may have bottomed out, with portfolio quality improving as financial sectors recover in 2017. For those that did expect a deterioration, the drivers varied considerably. The general state of the economy, currency volatility and saturation in certain areas were all cited, with several interviewees also pointing to climate-related factors.

On the other hand, predictions for the direction of end-consumer prices, or the interest rates paid by the clients of MSME financial institutions, were much more homogenous. 86% of our experts believe that interest rates paid by clients will remain the same or decline in 2017, with 51% expecting a decline. This decline in rates marks the continuation of a trend highlighted by responsAbility for the last five years. As MFIs and SME lenders become more efficient (in some cases through the application of technology), operational costs have declined, leading to a similar drop in interest rates and a more competitive financial sector. As described in the focus topic, this process is often accelerated by transformation. The mobilisation of savings as a new source of funding, plus adherence to more stringent regulatory standards, will on average lead to a decline in both operational costs and interest rates charged to customers. This is to the benefit of low-income households in the developing world, as well as marking the continuous progress of financial sector development.
The broader trend in terms of business environment and regulation in 2016 was positive, with only a handful of markets experiencing legislation that further restricted or complicated operations. This trend is expected to continue into 2017, with 93% of our experts expecting an improvement or stabilization in regulation and supervision. This reflects both the increasing sophistication of regulators in many developing countries and the self-evident benefits of financial sector development. Put simply, governments are now more and more aware of the benefits of a properly supervised increase in financial inclusion.

One of the most striking results from the survey surrounded the theme of consolidation. 65% of our experts expect moderate or strong sector consolidation next year, as smaller institutions merge, are bought or close. However, this trend can vary according to the region. In Asia, Mongolia’s market is dominated by less than ten institutions, making further consolidation unlikely. In neighboring China, a combination of the large number of small Microcredit Corporations (MCCs), slower economic growth and strong government pressure to reform or merge is expected to see a considerable drop in the number of institutions. Yet in Latin America and EECA, those interviewed consistently expected consolidation in their markets. This shift was mostly attributed to greater competition and more stringent regulation. The latter may include increased capital adequacy requirements, an approach adopted by some authorities to increase the robustness of the sector in light of difficult economic conditions. If introduced correctly, consolidation might be seen as an inevitable part of financial sector development that will be beneficial in the long term; the vast majority of those merging or closing are small institutions that would otherwise struggle to remain financially viable.

WHAT TRENDS DO YOU EXPECT IN TERMS OF CONSOLIDATION IN 2017?

- No consolidation, the number of institutions will increase
- No consolidation, the number of institutions will remain the same
- Some consolidation, the number of institutions will decrease slightly
- Strong consolidation, the number of institutions will decrease drastically (i.e. more than 20%)

HOW DO YOU SEE THE DEGREE OF SATURATION IN YOUR MARKET?

- Close to saturated, remaining potential is small
- Gradually saturating, remaining potential is substantial
- Not saturated, remaining potential is vast
THE URGENT NEED FOR SME FINANCING

Given the substantial credit gap for MSMEs mentioned earlier in this report, it is unsurprising that access to financing was cited as the biggest obstacle to growth for SMEs. This response mirrors World Bank surveys that found similar results across most developing countries. Our own survey also showed that in some markets even those SMEs that are able to access finance struggle to meet high refinancing costs. Our experts highlighted how SMEs are also hampered by collateral requirements and issues surrounding bureaucracy. Such issues underline how many small businesses struggle to “formalise”. However, several of those interviewed described how informal MSMEs struggle even more due to lack of formal registration, legal rights and credit history.

Fortunately, 91% of interviewees said that the proportion of financing in their markets dedicated to SMEs would increase in the next five years. Yet this figure marks the continuation of a trend rather than the beginning. While the trend of more “commercial” institutions downscaling into microfinance has been well documented, it is important to note that many MFIs long ago identified SMEs as an underserved segment and have accordingly moved into this area. The persistent gap in financing for SMEs is in part due to the fact that many SME lenders have similar problems to those of their clients. When asked about the obstacles facing SME lenders themselves, the most common responses were regulatory hurdles (complementary to bureaucracy in reflecting a business environment that is complex or even obstructive) and lack of finance. The latter may reflect not only insufficient funding in general for SME lenders, but also a lack of long-term funding to match the longer-term requirements of SMEs compared to micro-enterprises (e.g. for asset financing).

“SMES WILL BE THE ENGINE OF GROWTH IN JORDAN – IT IS THE ONLY SOLUTION.”

SANDY SALKHAM
CFO VITAS JORDAN

WHAT ARE THE FACTORS LIMITING THE GROWTH OF SMEs IN YOUR MARKET?

- Financing obstacle
- Collateral requirements
- Bureaucracy
- High refinancing costs

Source: responsAbility survey

THE PROPORTION OF SME FINANCING IN YOUR MARKET OVER THE NEXT 5 YEARS WILL ...

- Decrease 5 %
- Stay stable 4 %
- Increase strongly (+20 %) 35 %
- Increase (+10 %) 35 %
- Decrease strongly (>20 %) 0 %

Source: responsAbility survey

1 Source: World Bank Enterprise Surveys
Expectations for the medium term appear to have evolved in line with the changing context of many markets. Some interviewees had pointed to a strengthened local bond market as a potential source of innovation in their business environments, notably in more developed markets such as Peru, India or Kenya. However, the overall trend was for interviewees to view less of a role for local debt and equity than in last year’s survey.

Instead, those surveyed pointed to a significant, ongoing role for international debt and equity. For some of our experts the rise in demand for the latter reflects increased capital requirements (in some cases due to transformation), erosion of capital adequacy due to the operating environment or the need to match products with longer maturities (e.g. mortgages). In line with the expectation that several markets will see a moderate degree of transformation in 2017, expectations of a greater role played by savings increased even further this year.

Although many markets are yet to replicate success stories like M-Pesa in Kenya, our experts remain positive in terms of their expectations for the impact of financial technology, or “fintech” When asked to select one or several channels by which fintech would play a greater role in the next three years, the area picked by the greatest proportion of interviewees was, unsurprisingly, payments. Here the advantages are clear: payments are relatively easy to automate, can allow transfers to friends and family who may not have bank accounts, and offer a safer and more convenient means to carry out transactions for both customers and merchants.

Yet a high proportion of our experts also pointed to deposits and lending as a channel that would benefit, for example, from the use of risk-scoring algorithms. This approach has already been rolled out via M-Pesa’s sister service, M-Shwari, as well as across many lenders in the developed world. Of course, many borrowers may still prefer the human touch, while some loans will require more detailed analysis. In addition, financial institutions may not have access to the depth of credit information or client activity available in other markets. However, greater adoption of these automated services could reduce operational costs for many financial institutions in the developing world, in turn leading to lower interest rates for low-income households.

Looking further ahead...

“Savings will become dramatically more important in 3–5 years.”

Eric Savage, CEO, Unitus, India

In which of the following business areas will fintech play a significantly more important role in 3 years’ time?

Source: responsAbility survey

What types of funding will play a significantly more important role in the future?

Source: responsAbility survey

In which of the following business areas will fintech play a significantly more important role in 3 years’ time?
Institutional transformation is a key ingredient in financial sector development. This can also be observed in responsAbility's investment portfolio, which has seen a major increase in regulated financial institutions.

**THE ECONOMIC CONTRIBUTION OF SMEs**

SMEs constitute a significant proportion of jobs worldwide and provide a critical component of a country's economic context. In developing countries, SMEs have the potential to be a key driver of development.

MICRO AND SME FINANCE: OPPORTUNITIES AND CHALLENGES FOR EQUITY INVESTORS

Philipp Cottier has been head of the Equity Investments division of responsAbility Investments AG since March 2016, while Michael Fiebig is in charge of equity investments in the financial sector. How do they assess the investment potential of micro and SME finance? And what regions will be especially interesting to investors in 2017?

— WHAT GLOBAL DEVELOPMENTS ARE YOU OBSERVING IN THE FIELD OF MICRO AND SME FINANCE?

Philipp Cottier: We are observing an increase in microfinance institutions transforming into banks, a greater need for capital at these financial services providers, more initial public offerings, consolidation in mature markets, and increasingly successful exits. In general, the market is becoming more dynamic, which is good news for investors.

15 – 20
USD 15 – 20 MILLION – TYPICAL EQUITY INVESTMENT SIZE, UP FROM USD 2.5 MILLION.

— WHERE ARE YOU SEEING THE TRANSFORMATIONS INTO BANKS?

Michael Fiebig: Institutions are maturing and growing worldwide. In many markets, an extension of their activities into, say, savings products is only possible by transforming into a bank. In India, a whole series of microfinance institutions made first strides in the regulatory process of transforming into a “small finance bank” in 2016. That signals a major development step for the Indian financial sector.

— WHAT OPPORTUNITIES DO TRANSFORMATIONS OFFER INVESTORS?

Michael Fiebig: Tighter regulatory requirements, as well as continued growth, are causing financial institutions to need more capital. As a result, the average amount of each investment is rising. While this figure was about USD 2 – 5 million a few years ago, we are now talking in the order of USD 15 – 20 million for a typical transaction, a five-fold increase. In order to make such sums available, investors must be stronger financially. Banks are also aiming to reduce the complexity of their ownership structure and would prefer to work together with three or four large investors instead of cooperating with lots of small ones.

— WHAT TYPE OF OWNERS ARE THESE LARGER BANKS LOOKING FOR?

Philipp Cottier: Apart from financial strength, they are interested in stability, meaning a long-term commitment. They are also looking for owners who know a lot about their specific market. Here it is advantageous to be active, like responsAbility, in all investable micro and SME finance markets of the world and to provide experience in relation to all possible challenges.

— WHAT TRENDS ARE YOU SEEING IN TERMS OF EXITS?

Michael Fiebig: Strategic investors, such as banking groups, are increasingly interested in the field of micro and SME finance and/or want to expand into new geographical markets. In order to achieve this, they buy into something that allows existing investors to exit successfully. As a result, the micro and SME finance market in a growing number of countries is now much closer to the general market than it was only 10 years ago.

— ARE YOU ALSO SEEING A RISE IN INITIAL PUBLIC OFFERINGS?

Michael Fiebig: Yes, these are increasing as well, even though they are still very limited to particular markets. Several of the Indian institutions mentioned earlier, for example, have decided to go public and are running their business very successfully as a result.

— WHICH REGIONS ARE ESPECIALLY INTERESTING FOR EQUITY INVESTMENTS IN 2017 AND BEYOND?

Philipp Cottier: For 2017, we are expecting the biggest investment opportunities in Asia, which is experiencing the strongest growth worldwide. The African financial industry is still interesting. In the mature markets of Latin America, there are also opportunities on offer, thanks to consolidation. In the medium term, however, attractive possibilities should arise for equity investments in all global micro and SME markets.

"THE MARKETS ARE BECOMING MORE DYNAMIC. WE ARE INCREASINGLY OBSERVING SUCCESSFUL EXITS."

PHILIPP COTTIER

23
In an eventful year for micro and SME finance, one of 2016’s most striking moments was the Reserve Bank of India’s confirmation of three small finance bank licences (and seven more expected), with institutions set to start operations in the next few months. This marks a revolutionary step for the industry, with the regulator of one of the biggest economies in the world creating banking licences specifically for micro and SME finance. All three institutions will thus transform from lending-only microfinance institutions (MFIs) into small banks.

Yet the theme of transformation within the micro and SME finance industry is far from new. The last twenty years have seen a large number of microfinance institutions undergo a transformation in their structure and business model, shifting from NGOs to regulated lenders to banks. This change is a key element in financial sector development, enabling more sophisticated, transformed institutions to attract more funding and offer a wider range of products, notably savings accounts. The result is an increase in both scale and depth of financial inclusion, with the provision of savings alone having a proven impact on development overall. Within responsAbility’s portfolio a wave of institutions have undergone transformation over the last few years: in Q2 2016, 60% of the institutions in our model portfolio were accepting savings amounting to USD 31 billion, compared to 53% accepting a total of USD 22.2 billion 4 years ago. On a broader level, many of the most mature markets for microfinance and SME lending have seen sector-wide waves of transformation, as the most developed institutions take the next step in their evolution (see Chart I). But why do institutions transform? What are the implications for them and their clients?

I. CLUSTERS OF TRANSFORMATION IN SELECTED MARKETS

Bubble size corresponds to number of transformations in that year.
Source: responsAbility research
The most obvious benefit of transformation at the client level comes via the provision of savings to low-income households. This capacity is typically only reserved for the most advanced institutions, generally banks or deposit-taking MFIs. Yet at its most basic level, offering savings accounts at robust financial institutions allows many low-income households and SMEs to have somewhere safe to put savings for the first time, instead of storing cash at home or buying illiquid and perishable assets such as livestock. The World Bank has stated that increasing savings “can both help reduce extreme poverty and boost shared prosperity.”

Furthermore, a series of randomized control tests (RCTs) have pointed to multiple benefits from providing greater access to savings. These include higher levels of productive investment, consumption, productivity, income and financial inclusion overall, not to mention non-financial areas such as health and education. However, as we have already seen, despite recent progress, only 53% of adults in the developing world have access to an account at a financial institution. Indeed, higher-income parts of the population in emerging markets lag behind even the poorest parts of the developed world when it comes to account ownership (Chart ii). Admittedly, fewer institutions are able to offer savings due to more stringent regulation before and after transformation (see Section 3). Yet stricter standards in this regard are unsurprising: while institutions take the risk when lending, it is low-income households who risk what little money they have by placing savings with a bank. However, by overcoming the hurdles required to be able to offer savings, MFIs are enabling a critical component of financial sector development. In light of the increase in funding from mobilising savings, it is also unsurprising that studies have shown transformed institutions continuing to rapidly expand the number of borrowers, typically outgrowing non-transformed rivals and thus boosting financial inclusion.

Transformation is also often used as an opportunity for many MFIs to move into larger loans for SMEs, which are both crucial to economic development and frequently deprived of financing. In a series of global surveys of firms between 2010 and 2016, access to finance was identified as the biggest constraint in only 11% of high income countries, however, among developing countries, access to finance was listed as firms’ biggest obstacle more than any other.

In addition to greater access to more financial products, clients in general are able to benefit from lower prices on loans. One study from the Université Libre de Bruxelles (ULB) shows a 3.9 percentage point decline in average portfolio yield specifically due to transformation and the efficiencies it creates. In other words, the interest rates charged to clients dropped substantially in real terms after an organisation transformed. At the same time, transformation often allows institutions to provide loans with longer maturities (see below), filling a substantial gap for clients: long-term debt-to-asset ratios for microenterprises and SMEs in the developing world are 14% and 50% that of their respective counterparts in the developed world. Yet long-term financing is critical for economic development, reducing vulnerability to external shocks and allowing companies and households to invest more. In addition, certain types of long-term loan can have a transformative effect on human development: mortgages allow households to afford large, long-term assets, while student loans can be crucial in countries where public education funding is limited or inadequate.

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2 responsAbility Market Risk Ratings, August 2016
3 Idem
4 Financial Inclusion Index, 2014, World Bank
5 Enterprise Surveys, 2010 – 16, World Bank
6 “From NGOs to banks: Does institutional transformation alter the business model of microfinance institutions?”, Espallier et al., 2016, ULB
7 World Bank Global Financial Development Report 2015/16
— 3. INCREASED FINANCIAL SUSTAINABILITY, DIVERSIFICATION AND STABILITY FOR INSTITUTIONS.

From a financial perspective, transformation is attractive because it allows institutions to access greater, more diversified and more stable funding. Indeed, transformation can be compulsory before some types of investment can be accessed at all – many NGOs transform into MFIs because this is the only way they are able to access investment from financial institutions and thus scale up. As mentioned above, transformation can allow access to types of funding formally restricted to banks (or in some markets, regulated deposit taking institutions). Both current accounts and term deposits can bring a range of benefits to financial institutions: a more granular source of funding at varying levels of maturity that is generally quite stable. This in turn can provide a more nuanced method of asset and liability management (ALM), potentially enabling a wider variety of loan products. In addition, the fact that savings is often (but not always) in local currency creates a natural currency hedge that can otherwise be expensive from institutional lenders, overall, most MFIs will also find economies of scope in offering savings alongside credit.

Of course, attracting larger amounts of funding is not the only benefit. Improvements to governance, operations and oversight, imposed by more stringent regulation and a more sophisticated business model, typically reduce risk and increase efficiency over the long run. The ULB study mentioned previously demonstrates a 1.1% decline in operating expense ratio purely attributed to transformation. Nevertheless, greater funding should also allow an institution to become more financially robust while reaching out to more clients via new products and greater scale (see below). In addition, such institutions are able to attract and then offer longer-term funding, “often considered to be at the core of sustainable financial development.” The provision of long-term debt is much lower in the developing world – an average of 23 months per loan in low-income countries compared to 59 in high-income countries. The capacity to offer long-term financing is also enhanced by greater access to detailed credit information – variable across all markets, but more likely on average among transformed institutions. Overall, the World Bank has found that financial sector development, as measured by bank credit to GDP, has a positive impact on longer debt maturity: greater availability of credit (easier for transformed institutions to achieve) will lead to greater long-term lending, which in turn will foster overall economic development.

— 4. THE BENEFITS TO CLIENTS – GREATER OUTREACH AND WIDER PRODUCT OFFERINGS.

An analysis of responsAbility’s own scores for market risk across 143 market subtypes shows how the quality of regulation and supervision is typically much higher when institu-

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53 %

53 % – the proportion of adults in the developing world with an account at a formal financial institution.

“PROMOTING WELL-MANAGED FINANCIAL DEEPENING IN LOW-INCOME COUNTRIES CAN ENHANCE RESILIENCE AND CAPACITY TO COPE WITH SHOCKS, IMPROVE MACROECONOMIC POLICY EFFECTIVENESS, AND SUPPORT SOLID AND DURABLE INCLUSIVE GROWTH.”

IMF 2015

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6 “Are Deposits a Stable Source of Funding for Microfinance Institutions?” Abakaeva and Glisovic-Mezieres, CGAP, June 2009
7 “Should all microfinance institutions mobilize microsavings? Evidence from economies of scope”, Delgado et al., 2014.
8 “From NGOs to banks: Does institutional transformation alter the business model of microfinance institutions?”, Espallier et al., 2016, ULB.
10 Idem.
13 On average, institutions that transform are subject to regulation that is more comprehensive and more conducive to financial sector development. In addition, the quality of regulatory oversight will be higher and the stability of regulation will be greater (see Chart iii).

14 Institutions that transform will on average report more to and make greater use of credit bureaus, reducing operational costs and allowing them to disburse loans with longer maturities.

15 Of course, the mere fact of institutions transforming does not automatically trigger better regulation. Much depends on the willingness and capacity of regulators to respond to the growing sophistication of their financial sectors. Nevertheless, with the quality of oversight in many markets rapidly developing, the application of better supervision and regulation to organisations targeting low-income households can only be beneficial.

— 5. THE CHALLENGES OF TRANSFORMATION

The benefits of transformation to clients, institutions and even the financial sector overall are considerable. Yet even if the last two decades have seen a large number of transformations in absolute terms, this only represents a minority of MFIs overall. This trend is understandable – most institutions are not ready for the regulatory requirements of transformation, or may feel that they can fulfil their aims in their current form. In some markets, institutions face excessively high barriers to entry, put simply, sometimes central banks are unwilling to issue more banking licences. Elsewhere, MFIs may decide that the operating environment is not ready, or prefer to maintain a not-for-profit structure. For many it may be a simple matter of cost: transformation typically involves major changes to organisational and physical structure, involving the recruitment of new departments, upgrading IT systems, and overhaul of branches (including the cost of marketing new products). It can also entail large legal costs, not to mention more stringent prudential and reporting requirements. The process can take many years, requiring an equally long-term outlook from shareholders and funding partners. Such an approach can be especially beneficial to equity investors, with average return on equity dropping during and immediately after transformation, before accelerating beyond the level of non-transformed institutions. Investors must therefore be willing to provide a stable and durable source of funding in order to allow the institution to map out a long-term adjustment. MFIs and their investors are thus able to play a key role in increasing financial inclusion and boosting economic development.
HKL – TRANSFORMATION AT A TIME OF RENEWAL
OUTLOOK FOCUS TOPIC CASE STUDY

As one of the most mature microfinance markets in the world, Cambodia has often been on the cutting edge of the sector. Yet even within this context, Hattha Kaksekar Limited (HKL) stands out as one of the market leaders, as well as a key example of the rationale and benefits behind transformation.

— FROM SMALL NGO TO LEADING MICROFINANCE BANK.

Founded in 1994, Hattha Kaksekar, or “Farmer’s Hand” started as a NGO focusing on food security in Pursat province. At this time, Cambodia was still riven by endemic poverty as the country recovered from decades of conflict and sanctions, not to mention the deaths of around two million people (a quarter of the population) under Khmer Rouge rule in 1975–79. By the time Cambodia had reintegrated into the international community in the early 1990s, Cambodia was one of the poorest countries in the world, with virtually no private sector. 77% of the population were earning less than USD 3.10 per day and 28% of the population were undernourished.

“In the first four communes where HKL started disbursing loans, people did not have sufficient food for their daily consumption, nor funds to cover their basic needs for living and the creation of micro and small businesses,” explains Hout Ieng Tong, CEO of HKL and one of the company’s first employees.

In 2001, Hattha Kaksekar NGO was registered as a limited company and received the right to operate across Cambodia. Although only offering microcredits, HKL grew rapidly, reaching a portfolio of USD 14 million with 23,000 borrowers by 2007, and expanding to 39 branches or sub-branches in seven provinces. In 2010, management decided to transform HKL into a Micro-Finance Deposit Taking Institution (MDI). As Hout Ieng Tong explains, “We decided that we wanted to collect deposits to reduce our dependence on international funding, while creating economic value from local savings.”

Nevertheless, this change was not without its challenges. “We changed to a new online core banking system that had to be rolled out bit by bit, testing and fixing errors day and night until it was fully operational.” Yet as Bonida Vann, Vice-President and Social Performance Management Director, explains, not all of the challenges were technical. “Due to the bad times experienced during the Pol Pot regime, the mindset of the Cambodian people was one of keeping savings at home. Getting customers to deposit their money with us was a slow process to begin with, requiring extensive marketing.” The question of trust remains fundamental to HKL, as Hout Ieng Tong points out: “Savings are different from loans simply because customers’ money is kept at the institution. So HKL needs to be consistently outstanding in terms of branches, service quality, product variety and many other areas.”

1 World Bank World Development Indicators
Today HKL operates 151 branches and sub-branches in 25 different provinces of Cambodia, with a presence in more than 10,000 villages. With more than 2,200 staff, HKL had more than 112,000 borrowers and nearly 218,000 depositors by the end of 2015, with a loan portfolio of USD 364 million and total deposits held of USD 236 million. “HKL is now one of the top ten financial institutions in Cambodia, as well as a market leader in providing financial services for low-income households,” says Michael Fiebig, Head of Financial Institutions Equity at responsAbility. Yet the organisation continues to develop while remaining true to its founding ideals, after its acquisition by Krungsri, the fifth-largest financial group in Thailand in terms of assets, loans and deposits, with 70 years of history in the country. From small NGO to part of a regional leader in microfinance banks, HKL has thus embarked on a transformation that will continue to drive financial sector development in Cambodia.

An HKL loan officer visits micro-entrepreneurs in rural Cambodia and an SME selling canisters of drinking water.

**USD 236 MILLION OF DEPOSITS HELD BY HKL, NEARLY ALL FROM LOW-INCOME HOUSEHOLDS IN CAMBODIA.**
Lack of adequate financing sources remains a major factor limiting growth of MSMEs in developing countries. Credit gaps vary by region but are significantly higher on average in the developing world than in developed countries.

Values show MSME credit gap in billion USD.

Source: IFC Enterprise Finance Gap Database (2011)

As many markets see an improvement in the depth of credit information, as well as more sophisticated collateral management, some institutions are shifting from group lending to individual lending. One example is in Kyrgyzstan, where a clear shift has taken place even in the last four years.

Source: responsAbility research
THE RETURN OF GROWTH
THE RESPONSABILITY MODEL PORTFOLIO

The responsAbility Model Portfolio was introduced in 2012 to illustrate the development of key figures and provide a tangible outcome for the responses given in our experts’ interviews. The model portfolio comprises 100 leading micro and SME finance institutions, kept constant over time and reporting a broad range of monthly data from which key indicators are drawn. At inception the aim was to represent the investable microfinance universe as best as possible so as to provide an in depth insight into financial sector development over time. While this core concept has remained unchanged, the institutions within the model portfolio have also created a significant presence in the SME finance space, with 20% of "MSME finance institutions in the Model Portfolio manage a cumulative loan portfolio of USD 43.7bn” the total gross loan portfolio dedicated therein. Taking this into account, along with additional, more SME oriented interviewees and questions, results can be thus extrapolated to the model portfolio so as to provide a quantitative proxy for key micro and SME finance markets.

PORTFOLIO GROWTH TO CATCH UP AFTER SHARP DECLINE

At the end of 2015, the model portfolio saw its lowest ever rate of growth at less than 2% year-on-year. Much of the steady slowdown during 2015, as well as the sharp drop at the end of the year, can be explained by the heavy depreciation of local currencies against the USD, the currency in which the model portfolio is denominated. Nominal growth rates in local currency remained high during 2015, at an average of over 16%, reflecting constant demand for MSME financial services. Since then, growth has rebounded in USD terms, albeit not achieving our experts’ forecasts of 10–15% in last year’s publication. In the first half of 2016, the gross loan portfolio grew by 4.6% – understandable in an environment of low interest rates, macroeconomic volatility and low commodity prices. Once again, growth rates in local currency were higher at 7.5% for the first half of 2015. Going forward our interviewees expect growth rates to continue on this positive trend and slowly but surely rebound to a sustainable path of 10 – 15% on a year-on-year basis. As described before, growth will be principally driven by high rates in Asia Pacific and the recovery in Eastern Europe, while other regions will report growth figures comparable to previous quarters.

GROSS LOAN PORTFOLIO
OF THE RESPONSABILITY MODEL PORTFOLIO

Source: responsAbility research
PRESSURE ON PORTFOLIO QUALITY AMID A CHALLENGING ECONOMIC ENVIRONMENT

As mentioned previously in this and other editions of the Outlook, the impact of a deteriorating macroeconomic environment on MSME financial institutions can vary according to the type of crisis, the channels by which it manifests itself, the structure of the market and the strength of the institution. To a certain extent then the challenges mentioned in the macroeconomic section have had an influence on portfolio quality. The chart to the right shows the cumulative trend of overdue loan payments of more than 30 days (PAR>30) and refinanced loans. The part of PAR>30 overdue by 90 days (PAR>90) is also shown. This reflects a difference of approach between microfinance, where the more conservative measure of PAR>30 is typically used, and SME lenders or commercial banks, where PAR>90 is generally applied. Finally, the flow of write-offs is also indicated. As of Q2 2016, PAR>30 plus refinancing had increased to 8.5%, 11.0% when factoring in write-offs. This compares to equivalent figures of 5.7% and 7.4% respectively one year earlier. However, the same period saw a relatively small movement in PAR>90, up only 0.2 percentage points in the same period and 0.1 percentage points at the end of the year. Taking into account the qualitative feedback from our experts and the general macroeconomic outlook, we expect this figure to remain constant around 11% throughout next year and therefore not to return to the all-time high recorded in Q1 2016.

Finally, regulatory improvements introduced over the past few years should mitigate a more difficult operating environment. When suggested several regulatory changes (e.g. credit bureaus, deposit insurance) that might be introduced in 2017, 60% of the experts stated that most were already in place.

UNBROKEN DEMAND FOR MSME FINANCE

Despite a challenging year in some markets, demand for financial services is unbroken: between Q2 2014 and Q2 2016 MSME finance institutions in our model portfolio added 1.3 million customers on average every quarter. This represents a continuing success story in bringing about financial inclusion in the developing world. This growth will be strengthened in the next few years by technological innovation, growing populations and a greater variety of products offered by MSME financial institutions. The vast majority of our experts expect growth to be particularly strong in the SME sector, with demand still substantially outstripping supply.
**SAVING FOR A RAINY DAY?**

An additional revelation relates to the amount of savings reported in the model portfolio. While savings had previously always grown on a quarterly basis, in Q3 2015 savings declined for the first time. There are several drivers for this development. First, the depreciation of local currencies against the USD may have reduced local currency savings volumes in USD terms. Second, given the higher economic uncertainty, clients may have withdrawn deposits to cover a temporary loss of income. The short decline therefore illustrates the value of savings in absorbing the impact of economic shocks on low-income households in emerging markets.

Nevertheless, accumulated savings in the model portfolio have grown again since the end of 2015, rising to USD 31.4 billion in Q2 2016. 63% of our experts expect savings to play a more significant role as a source of funding for MSME finance institutions in the next three years. This represents a 10 percentage point increase from last year’s survey, reflecting the importance of deposit-taking institutions in meeting customers’ needs.

**LOOKING BACKWARDS WHILE GOING FORWARD**

Since 2011, our experts have been predicting growth rates for the financial sectors in their markets. No analysis would therefore be complete without a comparison between previous forecasts and actual growth. This allows us to adjust our methodology and hopefully allow for insight into any disparity, past or future.

As can be seen in the chart, the last few years have seen a gap between forecasts and actual growth in USD, especially in 2015. Some of the disparity can be ascribed to currency factors, although rising inflation during a time of depreciation may limit the value of higher growth in local currency. Yet in the past three years, we have seen the outbreak of the Russian crisis, a shift in the commodity super-cycle, the beginning of the Chinese economic restructuring and several other events that would have seemed surprising to many observers twelve months beforehand. After a year that has illustrated the potential for political and economic shocks in both the developed and developing world, our experts nevertheless remain cautiously optimistic on average, with a great deal of work remaining in order to achieve global financial inclusion.

**KEY FIGURES MODEL PORTFOLIO**

- **ASSETS:** USD 59.6 BILLION
- **ACTIVE BORROWERS:** 36.5 MILLION
- **SAVINGS VOLUME:** USD 31.4 BILLION
- **LOAN PORTFOLIO DEDICATED TO SMES:** USD 12.8 BILLION

**ACTUAL AND PREDICTED GROWTH RATES FROM THE MARKET OUTLOOK**

- Actual market growth in USD
- Actual market growth in local currency
- Average forecast

Source: responsAbility research
SMALL PHONE, BIG IMPACT

— RISING ACCESS TO MOBILE INTERNET

It is the developing world – driven by the increased affordability of devices – that will produce most of the future growth in internet connectivity, adding a further 2.9 billion smartphone connections by 2020.

<table>
<thead>
<tr>
<th>SWITZERLAND</th>
<th>KENYA</th>
</tr>
</thead>
<tbody>
<tr>
<td>SIM penetration (% pop.)</td>
<td>132 %</td>
</tr>
<tr>
<td>Prepaid SIM card</td>
<td>36 %</td>
</tr>
<tr>
<td>Access to broadband</td>
<td>84 %</td>
</tr>
<tr>
<td>Cost for 500 MB bundles per month</td>
<td>$30.6 USD = 0.4 % of average monthly income</td>
</tr>
<tr>
<td>New mobile phone costs (average)</td>
<td>$3.77 USD = 1.6 % of daily average income</td>
</tr>
<tr>
<td>Costs 10 minutes Prepaid mobile Tariff</td>
<td>$0.4 USD = 11 % of daily average income</td>
</tr>
</tbody>
</table>

Sources: GSMA, BCG, CGAP, ITU

— VAST GROWTH POTENTIAL

Less than half of the population in developing markets currently has a mobile subscription, at 45% by the end of 2014. This leaves significant room for growth, with the penetration rate expected to rise by 11 percentage points by 2020 to 56%. By 2019 total global mobile subscriptions will reach 8.5 billion.

In Kenya, by April 2015, M-Shwari had more than 10 million accounts, with 1 in 5 Kenyan adults active clients and 50,000 loans disbursed per day via mobiles.

Digital payments in India are expected to grow to USD 500 million by 2020, a tenfold increase.

Sources: GSMA, BCG, CGAP, ITU
responsAbility Investments AG is one of the world’s leading asset managers in the field of development investments and offers professionally-managed investment solutions to private, institutional and public investors. The company’s investment vehicles supply debt and equity financing predominantly to non-listed firms in emerging and developing economies. Through their inclusive business models, these firms help to meet the basic needs of broad sections of the population and to drive economic development – leading to greater prosperity in the long term.

ResponsAbility currently has USD 3.2 billion of assets under management that is invested in over 500 companies in 96 countries. Founded in 2003, the company is headquartered in Zurich and has local offices in Bangkok, Geneva, Hong Kong, Lima, Luxembourg, Mumbai, Nairobi, Oslo and Paris. Its shareholders include a number of reputable institutions in the Swiss financial market as well as its own employees. ResponsAbility is registered with the Swiss Financial Market Supervisory Authority FINMA.

Further information is available at: www.responsAbility.com

*as of 31.08.2016

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