

## *Social Investment*

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By the end of the 20<sup>th</sup> century, two competing ideas had taken root in mainstream economic thought. The first is that market failure is ubiquitous, characterized by a conspiracy of information problems, coordination problems, and externalities. The second is that government failure, if not ubiquitous, is all too common. The two ideas came to define high-level economic debates about possibilities for redistribution and aid, both domestically and across countries. The ideas yield hope for constructive intervention but warn of the prospect for making matters worse. Together, they form the perimeters within which debate has been squeezed.

We describe a third idea, the possibility that “social investment” can, under the right conditions, address market failure by side-stepping or at least aiming to ameliorate government failure through a careful choice of intermediary structures. We tackle the logic and tensions inherent in social investment—the support, with philanthropic objectives, of nonprofits, “social businesses” like Grameen Bank of Bangladesh, and profit-maximizing businesses serving the poor. Social investors aim to generate a financial return alongside a “social return,” but, unlike for typical investors, projects are chosen in which the strength of social returns compensates for weaknesses in financial returns.

Social investment is an idea that has taken off in practice, both in the world of philanthropy and in the portfolios of government agencies. Interest from academic economists has been scattered, though, and we describe the basic problems and possibilities. We focus on the building blocks of what can be a theory of “social finance” that builds upon and extends the modern theory of corporate finance (Tirole 2005).

The first idea, that market failures need to be taken seriously, gave weight to calls for government activism to improve allocations. In a signal contribution, Greenwald and Stiglitz (1986) showed that information asymmetries can undermine markets to such a degree that outcomes can’t be assumed to be Pareto efficient. As a result, in principle governments can use taxes and subsidies to improve on outcomes from decentralized exchanges, *even when they lack better information than market participants*. Another consequence is that asset redistribution can be defended in terms that go beyond fairness or justice; instead, a case can be made that asset redistribution will be productivity-enhancing by re-shaping incentives to invest and exert effort (Bowles and Gintis, 1996), or, as Hoff (1996) puts it well, transferring assets can be “catalytic” by creating collateral and facilitating access to financial markets. But as a political matter, serious asset redistribution is nearly always dead on arrival.<sup>1</sup>

The second idea drove in the opposite direction. This is the recognition that government failure needs to be taken seriously as well. As Ronald Reagan declared in his first inaugural address: “Government is not the solution to our problem; government is the problem.”<sup>2</sup> Efforts at income redistribution came under renewed attack, as did the foreign aid apparatus. The skepticism of pundits echoes well-known concerns about the dangers

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<sup>1</sup> Interesting to note however that the a primary rationale for the large scale “bailouts” of large financial institutions by Central Banks and governments during the financial crisis of 2008 (which in some cases amount to large scale actual or potential asset redistribution from taxpayers to distressed borrowers and financial institutions) is predicated on the idea that asset redistributions can raise the level of economic activity in times of financial distress. This view, associated most famously with current Fed chairman Ben Bernanke and his long-time co-author Mark Gertler, argues that asset redistributions work by partly reversing falls in the average net worth of borrowers and financial intermediaries’ that may have raised agency costs to the point of paralyzing or severely impairing the normal operation of markets. These authors are explicit that asset redistribution is what is key: “the Fed’s measures must be viewed as having a transfer component; if they were not concessionary in some way, they could have been performed by private lenders.(Bernanke and Gertler, 1990, p.108).”

<sup>2</sup> Ronald Reagan, First Inaugural Address.

<http://www.americanrhetoric.com/speeches/ronaldreagandfirstinaugural.html>

of political capture and the distortionary effects of rent-seeking, a fear that animates much thinking on tariffs and quotas in international trade (Bhagwati, 1971; Krueger, 1974).

In retrospect, the two alternatives offer a false choice between government activism and laissez-faire fundamentalism. The strategy of social investment presents the possibility that targeted subsidies and investments channeled through independent intermediaries can maintain incentives and enhance efficiency. Rather than equalizing assets or income, the aim of social investment is to open markets and access to basic institutions of economic life, including schools, utilities, hospitals, and banks. Rather than push for direct public provision of services, social investors aim to seed and expand nongovernment institutions, whether these are constituted as non-profit organizations or commercial firms.

The question remains whether these narrow interventions, even when aggregated across sectors, can be large enough and deep enough to address broad social and economic inequalities—and whether, by side-stepping the government, social investment also side-steps possibilities for larger, more meaningful public sector reform. Before answering those larger questions, social investment needs to be understood in its own right.

The aim for most social investors is to use funds to build institutions that can achieve scale and attract additional revenue sources and financing. As in the broader investment world, achieving leverage is critical. We show that there are two important kinds of “leverage”, and that one, having to do with mobilizing locally-held capital, is often overlooked. More generally, we assess the justification for subsidy and ways of maximizing its impact. We describe how subsidized social investments can boost output in ways that traditional commercial capital on its own cannot or will not. The analysis also leads us to reject common claims. In analyzing the lack of access to markets in low-income communities, we see that some market segments can be served profitably, but others cannot. There can be no presumption of a “fortune at the bottom of the pyramid,” particularly when serving the poorest communities. Moreover, financial strategies like

securitization have sharper limits in the social investment context, and contrary to popular belief higher profitability alone cannot deliver higher leverage.

#### THE NEW WORLD OF PHILANTHROPY

Social investment reflects a blurring of the working modes of philanthropy and business. The blurring has occurred in two ways. First, philanthropists of all stripes, from government aid agencies to family foundations, are increasingly using methods borrowed from for-profit businesses and investors. The strategies of venture capitalists are being adapted by “venture philanthropists” seeking to fund socially-minded institutions with promising ideas at early stages of development. They hope that the ideas will form the basis of sustainable institutions capable of serving populations at wide scale. As a recent survey of philanthropy put it:

The modern philanthropist dislikes the term *charity*, preferring to speak about his *social investments*. His language is entrepreneurial, sprinkled with references to metrics, scalability, leverage, and venture philanthropy.<sup>3</sup>

The changes are expanding to foundations with the increasing favor of program-related investments over grants (PRIs include loans, equity shares, recoverable grants, linked deposits, and guarantees).<sup>4</sup> Foreign aid too is often delivered as soft loans, guarantees and equity and quasi-equity investments, rather than as grants, reflecting the rhetoric of social investment in language supporting World Bank IFC project portfolios.

Much social investment runs through purpose-built funds. Oikocredit, for example, a Dutch social investment organization, has since 1978 been making long-term loans to “enterprises and institutions for the empowerment of poor people in developing

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<sup>3</sup>Weisberg, Jacob, “The Philanthropist's Handbook: How billionaires give their money away.” *Slate* magazine (on-line). Posted Wednesday, Nov. 15, 2006, at 3:30 PM ET: <http://www.slate.com/id/2153857/>.

<sup>4</sup> Marble, Melinda (1989), *Social Investment and Private Foundations*, Council on Foundations, Washington, DC.

countries.”<sup>5</sup> Their first social investment in microfinance, for example, was a \$150,000 loan for 5 years at 9% interest to Alternativa, a non-governmental organization providing microcredit to street vendors and small-scale entrepreneurs in Lima, Peru. Between 1994 and the end of 2004, Oikocredit made a cumulative total of 285 loans or investment agreements to 161 institutions in 41 countries, totaling \$88 million. Their net profit, returned to shareholders as a dividend, was 2%. The dividend allowed investors a modest return on capital, but they earned substantially less than alternative investments. Oikocredit’s investors trade off the foregone financial return for the possibility to influence and transform new institutions.<sup>6</sup> By the end of 2008, foreign “microfinance investment vehicles” like Oikocredit had outstanding investments exceeding \$10 billion in the sector (CGAP, 2009).

The second turn is that many socially-minded institutions receiving funding also increasingly look like businesses. Museums have raised entry prices and run ambitious shops with mail-order catalogues. Schools are hiking tuitions. Environmental groups buy and sell land. Community development programs work with banks to facilitate mortgages in low-income neighborhoods.<sup>7</sup> Indeed, some of the institutions hope to become commercially viable and eventually compete in the marketplace for capital on the strength of their balance sheets alone.

The microfinance sector is home to some of the best-known examples of the new hybrids, and is in many ways the leading edge. Muhammad Yunus, the 2006 Nobel Peace Prize winner and founder of the Grameen Bank, a financial institution for the poor of Bangladesh, describes his philosophy by drawing a sharp line when describing his conception of a social business:

First of all, I’m not in favor of nonprofit things. These are charities. I’m not involved in that. I don’t particularly get excited about it. I’m talking

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<sup>5</sup> Heinen, Erik, “The MFI as a Borrower: Institutional Characteristics and MFI Performance,” *Microbanking Bulletin*, August 2005, p.33.

<sup>6</sup> Heinen, Erik, “The MFI as a Borrower: Institutional Characteristics and MFI Performance,” *Microbanking Bulletin*, August 2005, p.33.

<sup>7</sup> Marble (1989) gives examples of a wide range of social investments.

about the business part of it where you do things so that you get your money back.

And there you have a distinction between two kinds: one, to make personal gain out of it. The other one, the way we run the business, for the results we want to produce in people. So one is a profit-maximizing business. The other is a social business. I'm on the social business side of it. If somebody wants to run it as a profit-maximizing business, welcome. This is competition. My mission is to get the person out of poverty rather than how much money I'm making out of it.<sup>8</sup>

While funds from social investors are often lumped in with “private sector” funding in categorizing funding flows, they are distinct from commercial investments in the same way that Muhammad Yunus distinguishes between two kinds of microfinance institution. Social investment funds that generate “below market” returns—like the 2% return in the Oikocredit example—are implicitly delivering subsidies to recipients. Investors may get their money back, but they lose money once opportunity costs are factored in. Maximizing financial returns, of course, is not their chief objective, and we ask how the subsidies can be used to best advantage.

#### THE SAMARITAN'S DILEMMA

Our start above has been with a view of markets in which incentives matter, information is imperfect, legal enforcement may be weak, and pledgeable assets are insufficient to secure loans to low net worth borrowers. Moral hazard leads to agency costs that limit financial access. It is a caricature of the real world, but one which we believe captures important elements of reality. The depiction also captures mainstream views within the economics profession that have been dominant for the past quarter century, and assumptions about the operation of financial markets that form the basis of the theory of modern corporate finance (Tirole, 2006; Bernanke and Gertler, 1990).

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<sup>8</sup>Bajaj, Vikas, “Out to Maximize Social Gains, Not Profit [Interview with Muhammad Yunus].” *New York Times*, December 9, 2006.

Imagine instead a world in which markets work perfectly, collateral is not an issue, information flows freely and without cost, and contracts can be written and enforced without constraint. This is, more or less, the world of mainstream micro-economics between 1920 and 1970. It is also the world of introductory micro-economics courses today, in which pedagogy dictates that complexities be saved for later. It is not a particularly realistic depiction of the actual world, but it helps provide intuition.

In this idealized, frictionless world, the initial distribution of resources does not affect the productive potential of the economy. Capital goes to those who can use it best, and no entrepreneurs with worthy projects are denied loans. In this world, social investors offering capital at market rates add nothing. There are no gaps to fill.

Social investors offering capital at below-market rates, as most do, will *reduce the total sum of output*. They may help to improve the income distribution, but their actions distort the efficient allocation of capital away from its most productive uses. This is because funds are channeled to institutions whose expected marginal return to capital is less than the marginal cost of funds as captured by the market rate of interest. Moreover, the subsidized institutions can undermine for-profit institutions with which they compete. In this world, philanthropists are most effective by providing charity as traditionally construed: as lump sum gifts. Healthcare, education, and safety nets of various kinds may be in order to improve the well-being of poor populations. In this way, a strong optimism about the efficacy of markets turns out to be twinned with an embrace of old-fashioned charity rather than social investment.

The view is too far from reality to be taken seriously as an exact guide for action, but it holds important cautionary lessons. By not paying adequate attention, social investors can end up channeling resources to institutions and projects that yield low returns, where costs exceed benefits. Excessive subsidies can create unfair competition with for-profit firms. Moreover, subsidization can create dependence and weaken incentives for diligence and innovation.

## MORAL HAZARD AND AGENCY COSTS

Greenwald and Stiglitz (1986) describe a very different world, arguing against the existence of perfect competition, or even the far weaker expectation that free market outcomes will be even “constrained efficient.” The notion of constrained efficiency means that--given the initial distribution of assets, structure of the economy, and the assumption of voluntary exchange--there is noway to improve outcomes for some without making outcomes worse for others. In thinking about credit markets, for example, if potential borrowers had additional assets to pledge or if new previously infeasible contracts could be developed, improvements could be made. But given the existing informational and technological constraints, there are no remaining potential surpluses that can be grabbed to make credit markets “more inclusive” without taking resources from someone (without due compensation).

In a world ruled by an omnipotent and benevolent planner empowered to redistribute resources within society, the planner could reallocate resources such that capital gets into the hands of constrained individuals with worthy investment projects. Output should then increase and credit markets become “more inclusive”. But, of course, the planner is a fiction. The reallocation can’t occur via market transactions where buyers must fully compensate sellers, and borrowers must fully compensate lenders. To generate gains via the free market, the winners would have to be able to *commit* to compensating those who gave them the money, but incentive constraints often render these commitments non-credible. The specific problem is that the borrower’s lack of assets to use as collateral means they cannot commit to make high enough repayments in states of the world where their projects fail or deliver low returns, and they cannot agree to compensate by offering much higher repayments when their projects do well without undermining their own incentive to make those projects succeed. The problem for the borrower in a nutshell is: why work hard to raise expected project returns if most of the increase in returns is pledged away to others. The problem is that maintaining good incentives requires that borrowers hold on to some “limited liability rents.” The net result is that remaining potential gains to financial trade may be impossible to realize because borrowers can’t commit to repaying in full.

The nature of incentives, the imperfection of information, and the lack of consequences for defaulting on obligations thus conspire to leech any such stated commitments of their credibility. That is the bite of moral hazard, and this is why the decentralized, free-market outcome is not fully efficient in contexts like this, particularly where would-be entrepreneurs have low net worth. Outcomes may be as good as they will get without intervention (i.e. they may be “constrained efficient”), but they are not the best imaginable.

The tragedy in this world is that it leaves open the possibility of potentially large gains that could come at relatively small costs—possibilities that are never seized by self-interested actors despite their appeal. Getting \$100 loan to an asset-deprived entrepreneur could launch a new profitable business, to take the classic microfinance example. A simple utilitarian calculus would surely endorse enacting such gains—perhaps via a tax and subsidy system. But the unfettered market constrained by moral hazard would leave such potential gains on the table.

Social investors can change this equation. Specifically, philanthropic-giving can raise output, increasing an economy’s overall productivity—and lead to GDP increases in addition to poverty reduction. The possibility arises because social investors, by definition, are willing to absorb costs and redistribute resources in order to bring gains. Here, specifically, they can absorb the costs of “limited liability rents” in ways that reduce agency costs and expand market transactions.

#### OUTPUT-ENHANCING SOCIAL INVESTMENT

The question then is: How can social investors most powerfully enact such “productivity-enhancing” investments.<sup>9</sup> Social investors seek to fill gaps left by markets. The particular gap filled by supporting microfinance is created by the unwillingness of most

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<sup>9</sup> This language is from Pranab Bardhan, Samuel Bowles, and Herbert Gintis, “Wealth Inequality, Wealth Constraints, and Economic Performance,” an essay in the *Handbook of Economic Growth* (North-Holland).

commercial banks to serve the poor. Traditional banks have had good reason to hesitate: microfinance is difficult.

One difficulty stems simply from the economics of building a business based on making lots of small-scale transactions: the fixed costs of setting up and running institutions can be high and there are limits (political, economic, and social) to how high fees and interest charges can go.

The second difficulty stems from operating in contexts where banks seldom can directly observe the diligence of customers and collateral is limited. Even where customers hold adequate assets, they may be costly for a bank to appropriate via the judicial system. Banks thus stay away.

This second difficulty, though, has been mitigated by microfinance institutions through the development of new technologies, contracts, and management practices that ameliorate these risks. All of this takes effort and comes at a cost, but the high repayment rates achieved by leading practitioners are testimonies to impressive successes. The innovations have greatly reduced the problem of moral hazard—i.e., the problem caused when customers fail to exercise the diligence required to repay debts, a problem that emerges when the consequences of default are limited. Requiring that collateral be pledged (and threatening to seize it) is the most obvious way to heighten the consequences of default. Even without collateral, though, microfinance institutions have found ways to increase the consequences of default through techniques like “progressive lending,” “group lending,” and active monitoring of various sorts.

The essential insight in mitigating moral hazard is that incentives are improved by exposing people to the consequences of their actions. In the context of health insurance, for example, moral hazard occurs when people fail to take necessary precautions to ensure good health. Or when they over-use available medical services. These problems are typically addressed by deductibles (coverage starts only after an initial amount of services have been exhausted) and co-insurance (patients pay a fraction of their medical

bills) in contracts. Neither mechanism puts *all* costs onto patients—the aim is to leave patients exposed to just enough to generate good incentives. In the microfinance context, the denial of new loans in the case of default (via “progressive lending”) and the peer pressure associated with group lending can similarly reduce moral hazard by adding reasonable consequences for bad outcomes; microlenders have also found positive incentives like eligibility for larger loans and social recognition as ways to point incentives in the right direction.<sup>10</sup> The point is to get the incentives right—to be neither so draconian that social objectives are undermined, nor so soft that incentives are undermined. Microlenders may also work to expand the financial contract space by actively monitoring borrowers in ways that serve to directly limit the borrowers’ gains from and scope for moral hazard, and hence reduce the need for collateral. They may, for instance, send loan officers to make unannounced home visits, or insist that borrowers be placed on a schedule of small but frequent repayments and that loan officers or peer group members intervene quickly and personally in the event of a single missed payment.

#### THE SECOND LAYER OF MORAL HAZARD

Given the success in controlling moral hazard, investors ought to be interested in funding microfinance institutions and expanding their scale. Investments should be pouring in, and they are starting.

But most investments continue to chase the leading hundred or so microfinance institutions. Moreover, most investments to date have been made by social investors, not by investors pursuing pure profit or optimal portfolio diversification. A survey of 50 microfinance investment funds, for example, found that only 8 are “seeking moderate to high financial returns,” while three quarters were “not seeking a financial return or only *eventually* seeking a financial return.”<sup>11</sup> US-based Foundations making program-related investments are bound by tax law to invest in ways such that income generation is not a primary objective.

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<sup>10</sup> Armendáriz de Aghion, Beatriz and Jonathan Morduch (2005). *The Economics of Microfinance*. Cambridge, MA: MIT Press.

<sup>11</sup> Barrés, Isabelle, “Bulletin Highlights-Supply of Funding,” *Microbanking Bulletin*, August 2005, p.49. Italics in original.

The natural question is why are commercial investors not playing a larger role, and is there a special role for social investors? We argue that commercial investors play important roles, but by virtue of their philanthropic objectives, social investors can help increase leverage, expand scale, and increase the total output of the sector in ways that commercial investors cannot.

One of the chief difficulties for investors—whether driven by commercial or social ends—is a second layer of moral hazard. The basic moral hazard problem described above involves the microfinance institution and the customer. This second problem involves the investor and the microfinance institution. Once it is the investor’s resources that are ultimately at risk (rather than just the microfinance institution’s resources or the customers’), the incentives are reduced for the institution to be diligent in managing finances, monitoring loans, and innovating.<sup>12</sup> The incentives to properly screen potential customers weaken, as do the incentives to monitor existing borrowers and chase down delinquent borrowers.

The risks are not trivial. Oikocredit, for example, faced a portfolio at risk (90-day) of 7 percent on its \$67 million social investment portfolio (August 2004).<sup>13</sup> In a review of 104 loan contracts disbursed before the end of 2002, the average repayment rate was about 91 percent. Seventy four percent of contracts were found to be repaid “almost always on time,” but “15 percent require continuous monitoring to follow overdue payments closely, and another 11 percent can be classified as bad-debt cases that are persistent in their default. The latter cases come with high monitoring and legal costs and are likely to lead to (partial) loan loss in the end.” The challenges among the African institutions are greater: “Only 57 percent of MFIs in the African sample manage to pay “on time,” while more than one out of four are structurally delayed in payment of invoiced amounts.”<sup>14</sup>

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<sup>12</sup> The customers/savers are in a similar position to outside investors in some ways: they deposit their savings with the microfinance institution but may worry about how loans are handed out.

<sup>13</sup> Heinen, Erik, “The MFI as a Borrower: Institutional Characteristics and MFI Performance,” *Microbanking Bulletin*, August 2005, p.33.

<sup>14</sup> Heinen, Erik, “The MFI as a Borrower: Institutional Characteristics and MFI Performance,” *Microbanking Bulletin*, August 2005, p.34-35.

The worst performers tended to be newly-started, medium-sized urban banks or NGOs in Africa or Asia.<sup>15</sup>

Without collateral fully backing many of the institution's financial portfolios, this kind of moral hazard becomes a major concern for prudent investors. All efforts to attract capital to the MFI can be interpreted as an effort to sell to outside investors a portion of the MFI's loan portfolio. Selling the mostly non-secured loans in many MFI loan portfolios poses a major challenge. The problem at its core is that the value of mostly unsecured loans depends on the continued monitoring diligence of the MFI which initiated the loans in the first place. Outside investors will always be rightly concerned that the value of a pool of unsecured loans could quickly deteriorate if MFI monitoring diligence slackens, and that the incentive to monitor might be quickly diluted if too much of the share of the risk of the portfolio is borne by outside investors. These problems are compounded for investors seeking to balance social and financial returns. As *The Economist* puts it: "whereas it is easy to tell if you are succeeding in business—you make money—in philanthropy measuring performance can be fiendishly tricky and take a lot longer."<sup>16</sup>

Recognizing moral hazard matters since under moral hazard asset-poor potential customers typically face credit rationing—even though they may have worthwhile investment projects. The projects are worthwhile in the sense that they would generate enough income to allow entrepreneurs to cover the opportunity cost of funds. If the entrepreneur had a savings deposit that paid the market rate of interest, they would profitably invest these funds in their own projects. The potential trouble is that entrepreneurs without savings can only find funding for their projects at a very high premium, or not at all. The same holds for worthy *institutions* that may be rationed out of the capital market due to information problems.

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<sup>15</sup> Heinen, Erik, "The MFI as a Borrower: Institutional Characteristics and MFI Performance," *Microbanking Bulletin*, August 2005, p.39.

<sup>16</sup> *The Economist*, "Philanthropy: The new powers in giving," June 29th, 2006, [http://www.economist.com/business/displaystory.cfm?story\\_id=7112702](http://www.economist.com/business/displaystory.cfm?story_id=7112702)

## INVESTMENTS CHANGE INCENTIVES

The insight comes with recognition that the act of making an investment in a microfinance institution typically changes the incentives for the institution's owners and managers. The investors now take on risk that had once been borne by microfinance institutions. The institutions and their managers now face fewer (or different) consequences of their actions. This shift in who bears the risk for successes and failures can seriously diminish incentives for diligence on the part of institutions and their staff—such that a past history of successes may be a poor predictor of future performance.

Drawing on the discussion of moral hazard above, we can begin to create a landscape of outcomes. In a free market system, with profit-seeking financial intermediaries and without social investors, we expect that the landscape of finance for the poor would be divided into four broad market segments:

1. *The highly-leveraged.* The first involves institutions lending to better-off borrowers that have collateral—and where courts function effectively to seize assets. Here, microfinance looks similar to conventional banking and should be maximally leveraged since outside investors can invest with limited concern about the diligence of the institution's staff. Loans do not have to be monitored in the same way that un-collateralized loans do. In the worst case, if customers default on their obligations, collateral will be there as a back-up. More re-assuringly, the worst case is unlikely to materialize since the fear of losing collateral should give customers adequate incentives to repay loans. Investors will still worry about currency risk, political risk, or macro-economic/environmental risk, but investors can feel confident that the fundamental investment should be unaffected by the institution's management structure, ownership rights, or degree of leverage.
2. *The moderately-leveraged.* A second group of institutions serves borrowers with less collateral than the first group. The institution has to compensate through costly monitoring and other special efforts in order to ensure loan repayment. Given moral hazard, the more monitoring that is required, the more the institution

itself has to have incentives to monitor if it is to attract outside investors. The institution's owners have remain exposed to some significant part of the risk associated with the failure to monitor sufficiently. If they didn't, potential investors would hesitate to invest. The microfinance institution can thus achieve some leverage, but not as much as would be possible when all loans are secured.

3. *The un-leveraged.* A third group of institutions serves borrowers with even less collateral. Required monitoring is so high that no external leverage is possible at all. The institution is sustainable, and even profitable, at its existing scale. The institution lends primarily out of its own capital or by mobilizing resources from its own customers (quite often through forced savings) and proceeds on that basis—but commercial investors fail to invest.<sup>17</sup>
4. *The un-banked.* The fourth group of institutions are really not institutions at all. They would fail to exist in a free market system. Required monitoring costs are so high that institutions would lose money servicing customers on a commercial basis. The customers may have worthy projects, but they lack basic assets and are perceived to be so risky that they remain un-banked. The potential customers would only be served if subsidies emerged to launch the institutions.

#### THE TWO KINDS OF LEVERAGE

We argue that there are two kinds of leverage that matter, and that this recognition typically push social investors either to focus on the lower-end of markets that serve the poor or, for quite different reasons, to focus on the higher-end of the microfinance spectrum. The first kind of leverage involves bringing new pro-poor institutions into being through capital donations and by subsidizing costs of locally informed equity but typically does *not* draw in outside commercial funding. These are the latent institutions identified in the fourth category above. Once in existence, the institutions can sustain themselves over time and may be able to tap into the capital of their customers, and

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<sup>17</sup> In an expanded model, and in the real world, many of these institutions might strategically commit to non-profits or “social businesses” ownership and governance structures as a strategy to attract social investors since their ability to tap into conventional commercial funding lines is nil or limited.

perhaps limited pools of informed capital in their region, but they are unlikely to be able to tap broader capital markets, even if the initial informed investors are able to earn a high return on equity. By helping to bring these institutions into existence, social investors can help put the local capital to use and, in that way, multiply the power of their gift.

The second kind of leverage involves social investments that can “crowd in” commercial capital to a maximal extent, and the focus here is the second category above. The first category of institutions, those that are already highly leveraged in free markets, need little boost to reach scale.

There is a middle ground in which little or no additional leverage is likely, captured by the third category above, where institutions *already exist* in the free market but they are not well-positioned to access commercial capital. Social investments in this middle ground will have far less of a multiplier effect than investments directed either up-market or down-market because capital contributed by social investors leverages little or no additional outside financing.<sup>18</sup> These institutions serve their customers well and are profitable. But the institutions are poorly-positioned to expand rapidly because of the inherent riskiness of their portfolios, and, if rapid expansion is the goal, social investors should look elsewhere.

#### INFORMED CAPITAL

We have assumed, without stressing it, that social investors are not insiders in the institutions receiving funds. Investors have no special knowledge and no special clout. In the language of corporate finance, they constitute “uninformed” capital. The investors may be Silicon Valley entrepreneurs, European religious groups, Japanese aid agencies—each captured by the desire to maximize the social impact of their resources, but retaining some distance from the ultimate beneficiaries. They play a role in expanding the financial

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<sup>18</sup> Social investment allocations should also depend on the weights that investors attach to aiding the various populations under consideration. Social investors would typically want to financial institutions that target poorer communities, but the possibilities of leverage will tend to tilt their allocations toward somewhat more affluent communities where each dollar of social investment leverages more outside resources.

frontier but primarily by being willing to deliver implicitly or explicitly subsidized funds which help relax constraints, reducing agency costs, and expanding lending by leveraging either locally informed or external uninformed investors.

But imagine instead that social investors have knowledge of better ways to run an institution, good information about the diligence and management of the institution receiving the investment, and that they have clout to affect the institutions' direction. If investors are uninformed, they will have little means to instill good incentives or mitigate moral hazard. If they are informed, though, matters can be improved. The power of informed social investors comes when they are able to combine capital with knowledge, and in that way are able to attract "uninformed" investors, which in turn helps to reach scale and lower costs. Incorporating this element into the framework will not change the basic conclusions above, but it could open up new practical strategies.

#### CONCLUSION

There is a great deal of diversity in the aims and methods of those seeking to promote social and economic innovations like microfinance. Investors are a diverse lot, as are institutions. We have tried to step back to assess basic principles that underlie conversations about philanthropy and social investments. Of necessity we have simplified and paved over some differences, and we hope the gains in clarity outweigh the losses in comprehensiveness.

Little analytical has been written on social investment, or for that matter on the incentives and constraints that guide philanthropy. We are looking instead, partly out of necessity, to a very different literature that shares important challenges and questions: the economics of corporate finance.

Our consideration of strategic social investment begins with two ideas. The first is that effective giving leads to multiplier effects. It “crowds in” other resources by catalyzing the investments of others, increasing the recipient’s ability to “leverage” its resources. Leverage (i.e., to be able to obtain funds to use in addition to an institution’s own equity) is critical as it determines an institution’s ability to reach wide scale. Effective social investment generates maximal leverage, holding constant other social concerns.

The second consideration is that philanthropic giving changes the incentives for recipients to work hard (as does commercial lending).

In this framework, profitability is neither necessary nor sufficient for attracting commercial capital. Merely earning high return on inside equity will not generate the leverage to take institutions to wide scale. Moreover, productivity can be *enhanced* by supporting institutions that would not exist if profitability was the sole criterion for survival.

The framework has a specific implication for the most effective use of social investment. We describe arguments that push social investment either “high” or “low” when directed to asset poor communities. Specifically, we show that smart subsidy involves allocations that either goes to institutions serving relatively well-off (but still poor) customers, where the potential for leverage is maximized, or to institutions serving the poorest customers. There is less “bang for the buck” in supporting a middle range of institutions that are self-sufficient with their own resources but for which leverage (and thus potential scale) is limited.

Our argument that profitability does not translate automatically into the ability to expand leverage is a conclusion at odds with the popular wisdom that drives projects like the MIX Market and other pro-commercial microfinance initiatives. Profitability can help, but the incentive problems attached to un-collateralized lending must also be addressed. As a group, the most leveraged institutions in the MIX Market’s sample are the most

financially sustainable, but there is variation within the group and some not-profitable institutions have achieved substantial leverage.<sup>19</sup>

In this sense, the push by microfinance advocates (e.g., experts at CGAP and Accion) to convince microfinance institutions to become profitable in order to attract commercial capital misses an essential part of the story. Profitability on its own is neither necessary nor sufficient to attract commercial capital.

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<sup>19</sup> Stephens, Blaine, "Bulletin Highlights-Microfinance Institutions," *Microbanking Bulletin*, August 2005, p.60.

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