

Overindebtedness of microfinance clients: Challenges and opportunities in creating a healthy credit market



As a double-bottom line investor, BlueOrchard is very much concerned with the social impact of its investments and is committed to create a healthy credit market in order to achieve financial inclusion of low-income communities. The maturity level of certain microfinance markets has had some implications on the offer of microfinance services to the end client. Indeed, competition in more developed microfinance markets has provided the impetus for many MFIs to become more efficient and client-oriented, but unfortunately, has also led some institutions to pursue aggressive lending practices in order to continue growing. Some negative consequences as a result of clients borrowing from multiple lenders are now being seen: While

microentrepreneurs have historically lacked access to financial services, in certain regions, they are now confronted with overindebtedness.

Overindebtedness impacts all stakeholders in microfinance. Borrowers who cannot repay their debts because they have taken on too many loans risk losing their livelihoods, their reputation and their chance to improve the lives of their families. MFIs that lend to them will have to write off their loans, and MIVs that lend to these MFIs will have to write down their investments; thus, the performance of the MIV will be impacted. Worst of all, the excellent work of so many microfinance practitioners can be jeopardized by careless and excessive lending that damages the industry's reputation.

As responsible investors, we share our best practices and collaborate with other lenders to confront the risks of overindebtedness in different markets. A recent initiative at BlueOrchard was the launching of a first meeting of microfinance investors discussing overindebtedness in Peru. Next initiatives include jointly sponsoring client studies and using collective leverage to work with

credit bureaus and local associations to achieve superior accessibility to information and favorable policies, codes of conduct and legislation. It is the responsibility of all participants in the industry to ensure that microfinance fulfills its central mission to improve the lives of MFI clients, and that overindebtedness does not harm the very significant contribution of building a fair and inclusive financial system for all.

In this edition of the BlueNews, we were interested in addressing overindebtedness from different angles: we have looked at two different local realities, Peru and Bosnia and Herzegovina. We have also invited a Peruvian organization and a researcher to share with us the key questions of their work.

We wish you an interesting reading!

Jean-Philippe de Schrevel, CEO
BlueOrchard Investments Sàrl

Jean-Pierre Klumpp, CEO
BlueOrchard Finance S.A.

Asking the key questions on overindebtedness

By Jessica Schicks,
Centre for European Research in Microfinance

As much as overindebtedness is an urgent challenge for the microfinance sector, we know surprisingly little about it. The public recognized only recently that the impressive growth of an industry that was aiming to reach out to the underbanked might have downsides if borrowers start taking too much debt.

1. There is no consensus about how to define and measure the phenomenon. Do customers count as overindebted when they permanently default? Or at a certain debt-to-income ratio? Or simply when they are struggling hard to meet their repayment deadlines, suffering from their loans rather than benefiting from them? Without answers to these questions, we cannot tell whether an MFI's credit risk management is sufficient to counter overindebtedness or whether specific measures from a customer protection angle may be required.
2. There is little clarity about the drivers that lead microfinance customers into problems with debt. Is it the lack of credit bureaus that leads

to an uncontrollable debt load, allowing micro-borrowers to take loans from several MFIs at the same time when microfinance markets get competitive? Which external risk factors are provoking overindebtedness? Does the root cause lie in some of the established microfinance practices, e.g. inflexible repayment schedules that might not meet the requirements of people living on very volatile and low incomes? Have some MFIs pushed too much for growth? What are the cognitive biases that make borrowers take on more loans than they can handle?

3. We know that a few markets such as Bosnia, Nicaragua, Morocco and Pakistan have overheated in pre-crisis times. Is overindebtedness an exception, limited to these particular situations? Or is it of more general relevance to the industry? In the average microfinance market, is it just the unavoidable few unlucky borrowers whose investments did not pay off who struggle with their loans? Or are there more customers affected than we should accept?

If we want to rise to this new challenge in the microfinance sector, meet our obligation to protect clients from slipping into overindebtedness and ensure a sustainable financial services

offer to the poor, we will need answers to the above questions. In cooperation with the Smart Campaign, the microfinance industry's global effort for client protection, and with the Financial Cooperation Evaluation Department of KfW Entwicklungsbank (development bank) in Germany, we will take a first step and investigate overindebtedness among microfinance customers in Accra, the capital of Ghana. Based on our knowledge about overindebtedness in developed markets and about the specifics of microfinance, the project will provide detailed answers on the experiences of microborrowers who are struggling with their debt, on the extent of overindebtedness in this specific country, and on some of the major factors that increase the risks of overindebtedness.

For a more detailed discussion of overindebtedness in microfinance see <http://ideas.repec.org/p/sol/wpaper/2013-64675.html>

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Focus on Bosnia and Herzegovina



The microfinance sector in Bosnia and Herzegovina (BiH), launched in 1996 with support from the World Bank and other international agencies, has grown tremendously in the last 15 years. There are now an estimated 50 MFIs operating in a well banked country of just over 4 million people – resulting in a very crowded and competitive sector.

Until 2008, most MFIs reported very strong annual growth – up to 80% – in their attempts to achieve larger market shares. Unfortunately, the global economic crisis hit the BiH economy hard in late 2008. Sales and exports dropped, remittances shrunk, and government spending was cut – all resulting in some clients facing significant challenges repaying their loans. The economic crisis also exacerbated the failings in microfinance institutions' risk management. The aggressive growth of the industry had resulted in riskier lending, a boom in consumer lending and under-trained staff in a widespread "fight for clients". Reporting to the national credit bureau was not mandatory until mid-2009 for MFIs, and thus MFIs had no solid tool to ensure their clients

did not have loans from multiple institutions affecting their repayment capacity. The poor and deteriorating economic conditions combined with fiercer competition amongst banks and MFIs and laxer credit processes led directly to a higher level of overindebtedness in Bosnia. Portfolio quality began to deteriorate significantly and according to the Bosnian Association of microfinance institutions, the average portfolio at risk over 30 days for the 12 largest MFIs increased from 2.5% in December 2008, to 6.9% in June 2009 and 10.5% in June 2010.

Without empirical data on client indebtedness on a national scale, several different studies have been commissioned to fill the information gap. Most estimates from these studies and anecdotal evidence mention ranges of 30% to 50% of clients with both multiple loans and a likelihood of repayment problems and more than one third of MFIs clients borrowing also from a commercial bank. Particularly concerning attributes of borrowers who find themselves in trouble are those with multiple loans, monthly debt obligations that

exceed their net income, multiple guarantees outstanding for *other* borrowers, and those guaranteed borrowers also being overdue on payments. Multiple loans and cross-borrowing from different institutions are obviously concerning as an aggravating factor of overindebtedness.

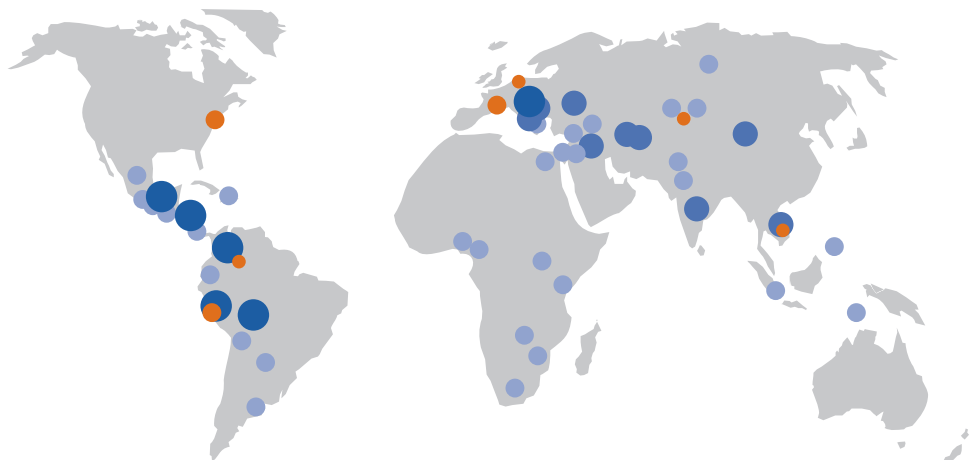
In response to these troubling circumstances, MFIs have adopted a more conservative approach to disbursing loans, conducting more in-depth analyses of payment capacity, and limiting growth objectives. They are also using credit bureau information now that reporting is mandatory and being more conscientious about avoiding cross-selling and overindebtedness. Several market leaders are collaborating to support common clients in arrears, and have jointly sponsored a Center for Financial and Credit Counseling currently offering seminars on household budget and savings, and detailed explanation of responsibilities and obligations stated in credit contracts.

With this re-focus on basic lending methodologies, portfolio quality and client needs and the systematic use of the Credit Bureau, it is our hope that the sound application of client protection principles and sector consolidation eventually should help support a healthier market in BiH. In this difficult environment, BlueOrchard continues to monitor the situation of its five clients on a continuous basis and is committed to keep supporting the Bosnian microfinance sector in the long term.

*Sarah Leshner and Pauline Fruchaud,
Senior Investment Analysts*

Geographical reach and diversification as a factor of stability

BlueOrchard has currently investments in **about 40 countries**, working with **over 100 microfinance institutions**. The wide diversification of our portfolio is an important factor of stability and risk management. The reliability of our portfolio enables us to constantly expand our reach and our network of partnerships. We finance cooperatives, non-governmental organisations, rural banks, non-bank financial institutions, the microfinance sections of banks, apex institutions and second tier lending institutions, in emerging economies.



Situation as of December 2009, figures include both debt and equity placements

- BlueOrchard office
- <2% Countries where our exposure is less than 2% of aggregate managed portfolios
- 2% to 7% Countries where our exposure is between 2% and 7% of aggregate managed portfolio
- 7%+ Countries where our exposure is over 7% of aggregate managed portfolio

Overindebtedness: The Latin American perspective



The potential overindebtedness of the customers of microfinance institutions is a complex, multi-faceted issue. Each market is different and the market participants such as customers, MFIs, regulators, or the ultimate investors in these funds have their own perspective. Moreover, overindebtedness affects an MFI's portfolio

quality so each MFI's credit risk manager must be aware of potential financial impact of overindebtedness on the MFI as well as the social impact on borrowers. While each has a distinct perspective, all concerned recognize that overindebtedness is a potential threat to the market and customers.

Twenty years ago microfinance professionals could hardly imagine that overindebtedness would be a problem. Then the most pressing issue was encouraging the establishment of MFIs in unserved areas and providing the necessary lending capital. Such severe shortages of microfinance continue in certain regions, but microfinance institutions have largely succeeded in achieving significant market penetration (at least in urban areas). Markets have matured, and the average level of debt increased. The risk of overindebtedness became especially clear with the financial crisis and associated macroeconomic downturns. Several countries, including Nicaragua and Bosnia showed that rapid growth was based on competition among MFIs that led to lower loan criteria. Some borrowers, formerly excluded from financial services, were able to take on more debt than was prudent.

Some important lessons have been learned about how to mitigate the potential risk of overindebtedness:

- In all competitive microfinance markets, there should be a credit bureau (public or private)

that consolidates credit information on customers. There are several credit bureaus in mature Latin American microfinance markets such as Peru, Bolivia, Colombia and Ecuador. But the level of detail of available information varies. The vast majority of MFIs in Latin America use these bureaus. However, relatively few exploit this information as a part of portfolio risk analysis. In those markets where regulation requires periodic monitoring of the potential overindebtedness (for example Peru) there is broader analysis of aggregate information. Another complicating factor is the presence of unregulated entities (cooperatives and non-regulated institutions) that may not report to the credit bureaus. From a risk management standpoint, a competitive market without a centralized credit bureau is a more challenging operating environment.

- It is difficult to define what overindebtedness is. This is a subjective question since clients have a different risk appetite and a low lending limit encourages borrowers to go to other lenders.

Despite these challenges, some principles can help move the industry forward:

- Accept the complexity of the question: The most common methodology of microcredit lending focuses on the borrower's capacity to repay its debt, based on the analysis of economic and family unit. But due to the informal nature of these businesses, this analysis is subjective. In addition, each MFI uses its own credit policies and procedures, and ratios to measure the ability of the borrower to repay. This makes it difficult to find a uniform criterion for an analysis of the market as a whole.
- Track the number of loans a client has but be sure to understand it in the context of the individual market. The number of lenders or loans a borrower has is traditionally a key indicator of overindebtedness. This is important information but to say that an MFI that shares 60% of its clients with other institutions does

not mean that 60% clients are overindebted. MFIs in mature markets may offer different types of services (housing, credit cards and business loans). The client debt burden should therefore be understood in the context of the market.

- Some indicators serve as early-warning signs that a market may be "overheating". These include rates of MFI portfolio growth that are inconsistent with economic growth in highly penetrated markets. BlueOrchard also analyzes significant increases in an MFI's gross portfolio (and average debt balance) without substantial addition of new clients. Of course, each of these possible warnings must be viewed in context of the market and its competitive environment.
- Analyzing the impact of indebtedness on the quality of life of the microfinance customers is even more complex. It would entail a study on a sample of customers overtime for analyzing how the credit (and potential oversupply) influenced their standard of living. Conducting a study of this nature is essential to understanding what might be a tipping point in which microcredit can become detrimental to micro-entrepreneurs

In conclusion, the microfinance industry is in the process of learning how to best address overindebtedness. BlueOrchard believes that each market participant must assume responsibility for their role. The borrowers should only take-on debt which they can reasonably honor. MFIs should have sound lending practices including properly balanced incentives for growth and robust credit risk monitoring. MIVs must make certain their borrowers are in-turn lending responsibly. Ultimately, each of the various actors will benefit from greater public information and transparency regarding overindebtedness.

*Yolanda Chenet
in collaboration with Camilo Mendez
and Alfredo Ebentreich Aguilar,
BlueOrchard Finance America Latina*

A question to COPEME, the Peruvian association of private organizations for the promotion of micro and small enterprises

What initiatives do you pursue at COPEME to deal with the challenges of overindebtedness?

In COPEME, aware of the importance of having information that provide early warning signs in relation to overindebtedness, and as part of a strategy to generate value for the microfinance industry, we have prepared a quarterly report called "Microfinance in Peru", which is distinguished by its analytical content and executive

presentation of figures. It addresses key issues, and even shows information that had not been previously published in Peru, such as statistics on levels of borrowing by microfinance clients. This has been a result of an agreement with Equifax (credit bureau generating the information), which allow us to know, within the portfolio of MFIs, the number of clients that are unique and those who have loans with two, three, four, five or more institutions, whether

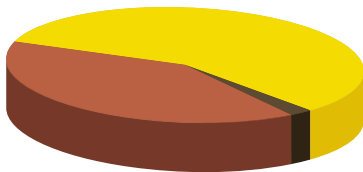
they are regulated or not. This information constitutes an element to be considered in the decision making process of the MFI. Also included in the quarterly report are various analysis, such as supply of microcredit, delinquency levels, number of new clients in the financial system, financial competition by region, business environment and financial and economic situation, which makes this publication unique in the Peruvian market.

The socio-economic profile of micro-creditors

- The average loan size made by BlueOrchard Finance S.A.'s partner MFIs to micro-entrepreneurs is USD 1,217 as of 30 June 2010.
- More than half of the clients of our partner MFIs are women (58%).
- Nearly half of the MFIs' clients are rural micro-entrepreneurs (45%).
- About one in four works in agriculture (22%).
- Over two thirds of the loans in our partner MFIs' portfolios are dedicated to micro-entrepreneurs.
- The vast majority of the loans are granted to individuals (compared to group loans).

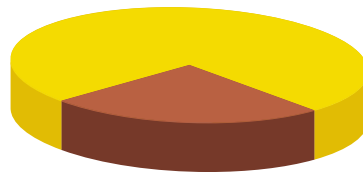
The following charts show the characteristics of BlueOrchard's fund portfolios taken together in terms of social indicators: the gender participation in our partner MFIs' loan portfolios, the types of activities financed by these MFIs, the location of the micro-entrepreneurs, what part the different services and products of the MFIs take and what methodology is followed by the MFIs. The figures are based on a breakdown of active borrowers of the MFIs in BlueOrchard's global portfolio as of 30 June 2010.

Gender



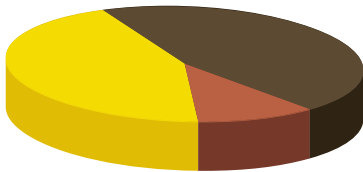
- Female 58%
- Male 40%
- Legal Entities 2%

Methodology



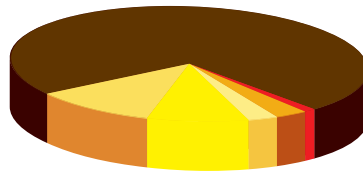
- Individual loans 75%
- Group loans 25%

Location



- Rural 45%
- Urban 43%
- Semi-urban 11%

Products



- Microcredit loans 74%
- Consumption 11%
- SME loans 9%
- Housing 3%
- Other products 3%
- Education / Health / Emergency 1%

Activities



- Trade 42%
- Agriculture 22%
- Services 16%
- Other 12%
- Manufacture 7%

Short news

Following the Social Investor Meeting held in Switzerland in June 2010, BlueOrchard has convened two meetings of like-minded investors during regional conferences held in Latin America. Representatives of 12 microfinance investment managers participated in these meetings, with the shared objective of exchanging thoughts and initiatives aimed at assessing and combating the issue of overindebtedness in Peru. There was a range of outlooks on the situation, but general consensus that regulation is very strong in the country, and borrower-level information is highly accessible and of good quality and detail.

Participating investors have agreed to jointly commission a study that would cover both the credit risk implied by higher debt levels of borrowers, as well as the impact on clients. Next steps include using collective leverage to work with credit bureaus and local associations to achieve superior accessibility to information and favorable policies, codes of conduct and legislation. Anyone interested in participating should contact Sarah Leshner at Sarah.Leshner@BlueOrchard.com.

Events

Arlington, VA (USA). 1-5 November 2010 – SEEP Network Annual Conference. Ann Miles, Maria Teresa Zappia, Jane Bieneman and Sarah Leshner will represent BlueOrchard.

Geneva, (Switzerland). 9 November 2010 – Festival Les Créatives. Maria Teresa Zappia will participate to the roundtable "Fostering women's economic independence via micro-financing".

San Francisco, (USA). 15-17 November 2010 – 3rd Microfinance Summit. Sarah Leshner will speak at the conference.

Kuala Lumpur (Malaysia). 22-23 November 2010 – Global Business Leaders Forum 2010. Jean-Pierre Klumpp will speak on "New Innovations for Accessing Finance".

Luxembourg. 30 November-1 December 2010 – European Microfinance Week. Vincent Oswald will represent BlueOrchard.

Hong Kong (China). 2-3 December 2010, Microfinance Investment Summit. Geert Roosen, Julie Cheng and Matteo Marinelli will represent BlueOrchard.

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BlueOrchard's Microfinance investment vehicles – facts and figures

Dexia Micro-Credit Fund

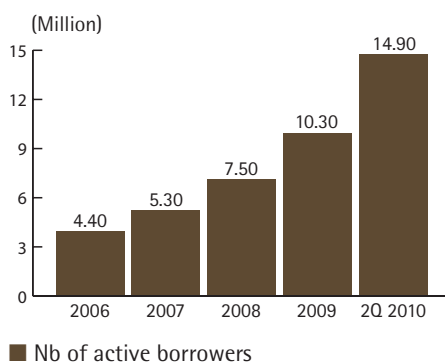
BlueOrchard's flagship commercial investment fund designed to refinance microfinance institutions (MFIs) specialised in financial services to micro-entrepreneurs in emerging markets. It represents 48% of the portfolio managed by BlueOrchard. Inception date: September 1998.

Figures in USD as of 30 June 2010

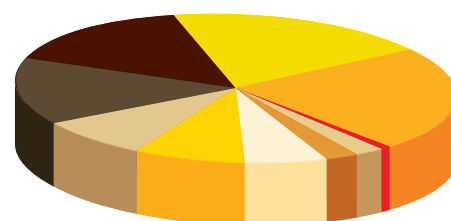
Net Asset Value USD	491 million
Portfolio:	369 million
Average outstanding loan size to MFI USD	2.5 million
Portfolio maturity	16.5 months
Number of loans outstanding:	151
Number of MFIs with outstanding loans:	89
Number of countries in which there are outstanding loans:	35
Local currencies delivered in the fund:	7 (Thai baht, Peruvian Nuevo sol, Mexican peso, Colombian peso, Kazakhstan tenge, Georgian lari, Armenian dram).
15% of the loans made from this fund are made in local currency swapped in USD	

Share value	ROI Year-to-date 2010	
USD	16,970.0	0.29%
CHF	12,196.8	0.20%
EUR	13,041.7	0.15%

Growth of active borrowers (micro-entrepreneurs) in MFIs served with the DMCF



Regional distribution in % of the NAV as of 30 June 2010



Liquidities and equivalent	23.3%
South America	19.1%
Eastern Europe	15.6%
Russia, Central Asia and Caucasus	14.3%
South Asia	8.1%
East Asia and the Pacific	8.0%
Western Europe and US	6.2%
Africa	2.5%
Central America and the Caribbean	2.1%
North Africa & Middle East	0.8%

Saint-Honoré Microfinance Fund

The fund is co-managed by BlueOrchard Finance and Edmond de Rothschild Investment Managers. It invests in a variety of microfinance institutions including apex institutions. Inception date: November 2005.

Figures in EUR as of 30 June 2010

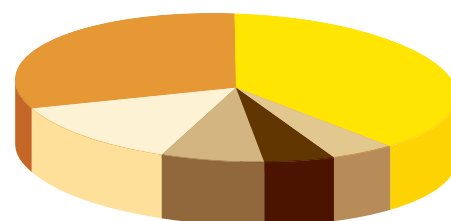
Net Asset Value:	5.87 million
Portfolio:	3.83 million
Portfolio maturity:	14 months
Number of loans outstanding:	5
Number of MFIs with outstanding loans:	5

Number of countries in which there are outstanding loans: 4

Share value	ROI 2010
EUR 5,588.4	0.24%

Liquidities and equivalent	37.9%
Western Europe	31.3%
East Asia and the Pacific	13.3%
Central America and the Caribbean	7.4%
Russia, Central Asia and Caucasus	5.3%
Eastern Europe	4.9%

Regional distribution in % of the NAV as of 30 June 2010



BBVA Codespa Microfinance Fund

A fund used for loans to MFIs in Latin America. BlueOrchard advises BBVA on these investments. Inception date: October 2006.

Figures in EUR as of 30 June 2010

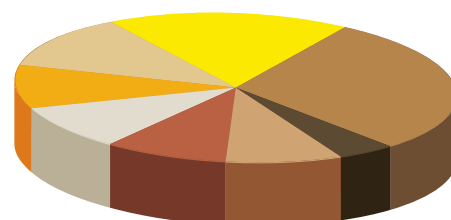
Net Asset Value:	28.4 million
Portfolio:	9.20 million
Portfolio maturity:	11 months
Number of loans outstanding:	13
Number of MFIs with outstanding loans:	12
Number of countries in which there are outstanding loans:	8

73% of the loans made from this fund are made in local currency

Share value	ROI 2010
EUR 10.87	2.57%

Ecuador	29.5%
Nicaragua	17.9%
Mexico	12.2%
Honduras	9.4%
Dominican Republic	9.1%
Paraguay	8.9%
Peru	8.6%
Guatemala	4.4%

Regional distribution in % of the NAV as of 30 June 2010



Microfinance Enhancement Facility (MEF)

The fund was established in 2009 in response to the global credit crisis to refinance loans to well-established MFIs. MEF was founded by the International Finance Corporation and KfW. BlueOrchard Finance is one of the co-managers

of the fund, together with Cyrano Management and responsAbility Social Investments.

Figures in EUR as of 30 June 2010

BlueOrchard NAV:	30.95 million
BlueOrchard Portfolio:	28.02 million

Portfolio maturity:	20 months
Number of loans outstanding:	11
Number of MFIs with outstanding loans:	9
Number of countries in which there are outstanding loans:	6

Microfinance Growth Fund (MiGroF)

The Microfinance Growth Fund was established earlier this year at USD 150 million to make debt investments in MFIs in Latin America and the Caribbean region to support the growth of

microfinance and the provision of financial services to low-income populations with limited access to mainstream financial services. The Fund made its first disbursements into Ecuador, Peru and Bolivia (totaling USD 10 million) in September.

MiGroF is sponsored by the IDB/FOMIN, IIC and OPIC.

BlueOrchard Microfinance Securities 1, LLC (BOMS 1 – 2004/2005)

The world's first international structured microfinance product created by BlueOrchard with two partners offered US private and institutional investors an opportunity to acquire notes collateralised by MFI debt obligations. The deal was closed in two tranches (2004 and 2005).

Figures in USD as of 30 June 2010

Notes outstanding:	57.8 million
Portfolio:	58 million
Number of loans outstanding:	16
Number of MFIs with outstanding loans:	13
Number of countries in which there are outstanding loans:	7

Regional distribution as % of the portfolio as of 30 June 2010



- South America 66.9%
- Central America and the Caribbean 22.1%
- East Asia and the Pacific 6.5%
- Russia, Central Asia and Caucasus 4.5%

BlueOrchard Loans for Development 1, (BOLD 1 – 2006)

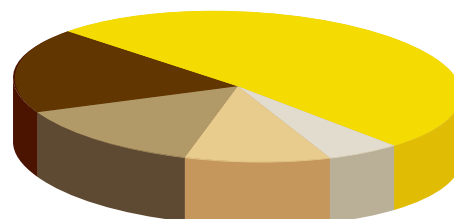
A second collateralised debt obligation closed in April 2006 with Morgan Stanley and FMO (the Netherlands Development Finance Company) as partners.

Figures in USD as of 30 June 2010

Notes outstanding:	96.7 million
Portfolio:	94.1 million
Number of loans outstanding:	21
Number of MFIs with outstanding loans:	21
Number of countries in which there are outstanding loans:	13

22% of the loans made from this fund are made in local currency

Regional distribution as % of the portfolio as of 30 June 2010



- South America 51.5%
- Russia, Central Asia and Caucasus 18.7%
- Central America and The Caribbean 13.8%
- East Asia and the Pacific 10.5%
- East Europe 5.5%

BlueOrchard Loans for Development 2 (BOLD 2 – 2007)

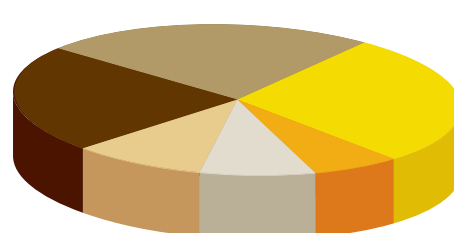
A third collateralised debt obligation closed in May 2007 with Morgan Stanley and FMO (the Netherlands Development Finance Company) as partners. Like its predecessors, BOLD 2 finances non-guaranteed loans to a diversified portfolio of MFIs. Part of the loans is in local currencies, with exchange rate risks being covered by derivative products. The senior tranches A (USD 44 million) and B (USD 16 million) were rated by Standard & Poors and received respectively AA and BBB ratings.

Figures in USD as of 30 June 2010

Notes outstanding:	110.2 million
Portfolio:	106.7 million
Number of loans outstanding:	20
Number of MFIs with outstanding loans:	20
Number of countries in which there are outstanding loans:	11

34% of the loans made from this fund are made in local currency

Regional distribution as % of the portfolio as of 30 June 2010



- Russia, Central Asia and Caucasus 28.1%
- East Europe 23.1%
- South America 24.4%
- Africa 9.4%
- Central America and the Caribbean 8.4%
- East Asia and the Pacific 6.6%

BlueOrchard Private Equity Fund

The BlueOrchard Private Equity Fund is a SICAV registered in Luxemburg in December 2007. The Fund seeks to forge long-term partnerships with microfinance organisations across the world. It acquires minority stakes in their capital

while playing an active governance role by sharing international experience, information, networks, knowledge and taking active part at board level. It is committed to achieve strong tangible social returns along with market financial returns.

Figures in USD as of 30 June 2010

Total Assets (committed capital):	163 million
Total investment disbursed:	49 million
Number of equity investments:	10