

# Role Reversal Revisited

Are Public Development Institutions  
*Still* Crowding Out Private Investment in Microfinance?



*Role Reversal Revisited: Are Public Development Institutions Still Crowding out Private Investment in Microfinance?* was made possible by the generous sponsorship of Calmeadow Foundation and the Council of Microfinance Equity Funds (CMEF).



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MicroRate is the first microfinance rating agency dedicated to evaluating performance and risk in microfinance institutions (MFIs) and microfinance funds, also known as microfinance investment vehicles (MIVs). As the oldest and most well-respected organization of its kind, MicroRate has conducted over 600 ratings of 200+ MFIs throughout Latin America, Africa, Europe, and Central Asia. MicroRate is a leading social rater and has also become the largest MIV evaluator in the industry.

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## Introduction and Summary

In little more than 20 years, Microcredit has grown into a \$100 billion plus activity. This makes it one of the rare development success stories. Such a stunning rate of growth was made possible, because the poor who receive these credits use them to create wealth. That newly created wealth in turn allows borrowers to repay their loans with interest. Unlike typical development projects, which depend on subsidized funding, microcredit pays for itself. It can thus access capital markets to fund its growth.

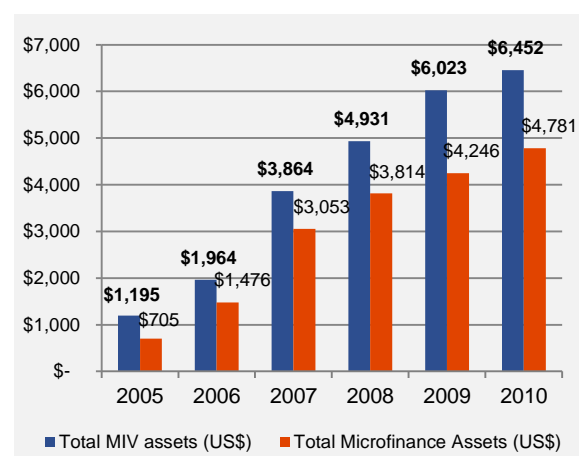
This report looks at the respective role of official development finance institutions (DFIs) and private lenders in funding microfinance institutions (MFIs). It starts from the premise that as the microfinance industry matures, its growth can and should be financed by private resources. The role of development finance institutions is to pave the way for those resources: DFIs should only go where private lenders don't yet dare to tread and act as catalysts for private funding but they should not compete with it.

The DFIs themselves and the governments who control them agree with this premise. They recognize that the funding capacity of DFIs is limited and that it has to be spread over many other sectors, besides microfinance. They also know that today microcredit, despite all of its advances, meets only about 10% of potential demand. If a billion persons are to gain access to microcredit, rather than 100 million or so as at present, then there is no alternative to commercial funding. The primary role of DFIs therefore is to help create the conditions, which will attract private funding to MFIs.

Private foreign funding began to flow in earnest to MFIs during the last decade. It mostly took the form of investments in

microfinance funds ("Funds"),<sup>1</sup> which specialized in lending to microfinance institutions in developing countries. By the end of 2004 there were 43 Funds with combined assets of \$0.9 billion.<sup>2</sup> Three years later that figure had grown to \$3.9 billion<sup>3</sup> (see Fig. 1) and microfinance funds had surpassed DFIs as the most important source of foreign lending for microfinance institutions (see Fig. 2).

**Figure 1: Microfinance Fund Assets, 2005-2010 (US\$ millions)<sup>4</sup>**



However, as lending by Funds grew, MicroRate – the first rating agency specializing in microfinance – noticed a surprising pattern. If DFIs mobilize private funding flows, one would have expected private money to initially go to the largest, least risky MFIs, while official development funding concentrates increasingly on less creditworthy institutions which private money is not yet prepared to touch. But this is not what MicroRate observed during dozens of MFI ratings in 2005 and 2006. To the

<sup>1</sup> These intermediaries are usually referred to as "Microfinance Investment Vehicles" or "MIVs", because not all of them are funds in the strict sense of that term. For simplicity's sake, this report refers to all of them as "Funds" even though some MIVs are organized as cooperatives, finance companies etc.

<sup>2</sup> Goodman, Patrick. "Microfinance Funds: Key Features" ADA and KfW, 2005. <<http://www.microcapital.org/downloads/resourcepapers/ADA-MFInvestmentFunds.pdf>>

<sup>3</sup> MicroRate, "The State of Microfinance Investment 2011: MicroRate's 6<sup>th</sup> Annual Survey and Analysis on MIVs."

<<http://microrate.com/>>

<sup>4</sup> Ibid.

contrary, DFI lending was heavily concentrated in the most creditworthy MFIs. It became evident that DFIs were picking the “low-hanging fruit” whereas microfinance funds had to make do with MFIs that were too small or too risky or both, to appeal to the official development institutions. The roles of commercial funding and development funding had reversed; commercial lenders were being crowded out by DFIs.

In early 2007, MicroRate published these findings in its report *Role Reversal*,<sup>5</sup> which documented the pronounced tendency of DFIs to avoid risk when lending to MFIs. The policy to step back whenever private funding becomes available was being honored in the breach. *Role Reversal* caused considerable controversy (see Appendix IV).<sup>6</sup> In its wake, many DFIs pledged themselves anew to a policy of supporting and complementing private funders. Four turbulent years later, *Role Reversal Revisited* reviews how well those pledges have been kept.

## DFI funding today

The microfinance market in 2011 looks much different from 2007. Despite the worldwide financial crisis, the sector has doubled in size and transformed from a mostly NGO-driven market to one dominated by regulated financial institutions. Microfinance is now a maturing industry.

Not surprisingly, the role of the DFIs has shifted as well. Equity investments are receiving more attention; MFIs are being encouraged to broaden their services beyond microcredit; and DFIs have helped to create hedging facilities for emerging market currencies (see Box 1).

While DFIs have considerable achievements to show, the practices which exposed them to criticism four years ago have not disappeared. To the contrary, they have grown and multiplied.

This report shows that official lenders, far from stepping back to make room for private loans, have significantly increased their share of foreign loan financing for microfinance funds. DFIs have also become *more* risk averse – just 10 large microfinance institutions absorbed nearly half of all DFI lending to

### Box 1: MFX and TCX: Covering Foreign Exchange Risk

In early 2008, a group of private organizations concerned about the growing foreign exchange exposure of MFIs came together to form MFX. This currency hedge fund allows MFIs to purchase cover for developing country currency exposures that are otherwise difficult to manage.

Though formed with private capital, MFX would not have been possible without DFI support. MFX was built on a foundation provided by TCX, a fund established in 2007, with two DFIs (FMO and KfW) taking the lead funding roles. But TCX did not have an explicit mandate to serve microfinance, and its high collateral requirements were prohibitive for individual MFIs and most Funds. This is where the support of the Overseas Private Investment Corporation (OPIC), a development investment arm of the US government, proved critical. OPIC put up a guarantee that enables MFX to transact with counterparties (MFIs and Funds) without the need for collateral. This is a key element that has enabled MFX to serve the broader microfinance market.

Since its launch, MFX has played an important role in increasing local currency lending to MFIs. Since executing its first hedge in October 2009, MFX has carried out over \$100 million in hedging transactions. It is no coincidence that during that period, MIV lending in local currency grew by 56%, nearly all of it hedged. None of this would have been possible without extensive DFI support.

<sup>1</sup> CGAP 2010 MIV Survey

<sup>5</sup> Abrams, Julie and Damian von Stauffenberg, “Role Reversal: Are International Financial Institutions (IFIs) Crowding Out Private Investment in Microfinance?” MicroRate, 2007. <<http://microrate.com/>>

<sup>6</sup> *The Economist*, “Small Loans and Big Ambitions,” March 15, 2007. <<http://www.economist.com/node/8861522>>



MFI between 2008 and 2010. Subsidized pricing, sometimes disguised as technical assistance grants, is still used to compete with private funders (see p. 13) and so-called “trophy lending” (loans which are motivated more by a DFIs desire to show a microfinance portfolio on its balance sheet than by the borrowers need for funding) is still rampant. In a new development, DFIs have created Funds to provide liquidity for MFIs experiencing funding difficulties (MEF, MiGroF),<sup>7</sup> or for small MFIs in difficult Sub-Saharan settings (REGMIFA).<sup>7</sup> These DFI-controlled Funds have turned out to be as prone to lend to large, creditworthy MFIs at subsidized rates, as the development agencies that own them (see Boxes 2 and 3).

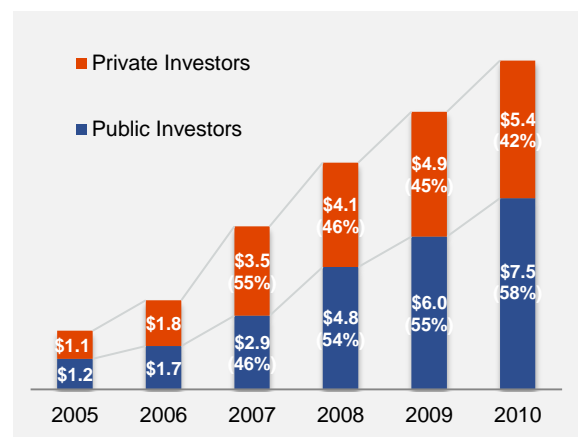
### Crowding Out – is it still an issue?

The first *Role Reversal* report concluded that DFIs were vigorously competing with private funders. This competition was fiercest in the largest, most creditworthy MFIs, where DFIs were defending a dominant position against private newcomers. Have the DFIs delivered on promises made at the time to henceforth support private capital flows to microfinance?

### Volume

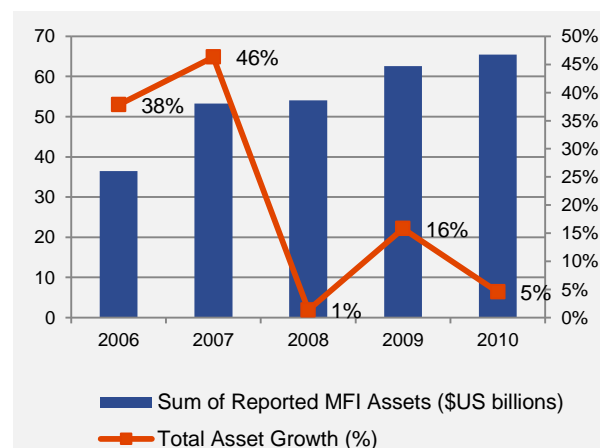
Since 2007, the data on microfinance funding are vastly improved, thanks in large part to funding surveys carried out by CGAP.<sup>8</sup> This research reveals that from 2008 to 2010, DFI funding for microfinance grew by 159%. At the same time the pace of foreign private lending slowed dramatically. As a result, private funders, who accounted for 55% of all foreign funding in January 2008, provided only 42% of funding by the end of 2010 (see Fig. 2).

Figure 2: Foreign funding of microfinance (US\$ billion)<sup>9</sup>



Funding flows to MFIs of course respond to the pace at which the MFIs themselves grow. Up to 2008, that pace was very rapid, but it slowed to a near stand-still in 2008 and it has remained relatively modest since (see Fig. 3).

Figure 3: MFI Global Growth (\$US billions)<sup>10</sup>



Before 2008, rapid MFI growth was able to accommodate all the funding DFIs and private Funds had to offer. Demand for funding was large enough to allow both to increase their lending dramatically (see Fig. 5). Competition between DFIs and Funds was therefore not over who would be able to lend,

<sup>7</sup> Microfinance Enhancement Facility (MEF), Microfinance Growth Facility (MiGroF), Regional MSME Investment Fund for Sub-Saharan Africa (REGMIFA).

<sup>8</sup> Consultative Group to Assist the Poor.

<sup>9</sup>Adapted from CGAP Focus Note, “Foreign Capital Investment in Microfinance: Reassessing Financial and Social Returns,” May 2011. <<http://www.cgap.org/gm/document-1.9.50967/FN71.pdf>>

<sup>10</sup> MIX Market.

## Box 2: Microfinance Liquidity/Enhancement Facility

During the depths of the global financial crisis in late 2008, IFC and KfW began urgent discussions to support MFIs that might be imperiled by the impending liquidity squeeze. A new fund, initially named the Microfinance Liquidity Facility (MLF), was announced in December 2008, with commitments of \$280 million from IFC and KfW and a total expected fund size of \$500 million. According to IFC's initial project documentation, "The MLF's objective is not to support the impressive growth rates experienced by MFIs over the last decade, but to serve as a defensive facility to support strong institutions in the current credit freeze."

The expected liquidity crunch did not materialize. While some MFIs did experience a challenging period, this lasted only a few months. By the time the Facility was officially launched in February 2009, it was already clear that funding for MFIs was not drying up. MFIs that needed funding were for the most part able to find it. Without having disbursed a single dollar, the Facility had already achieved its primary objective: it sent a powerful stabilizing signal to commercial lenders and MFIs that funding would be available if needed.

Despite this success, the DFIs now faced a dilemma of what to do with the new facility. Since disbursements had not yet started, it would have been easy to declare victory and abandon the effort. That was not the path they chose to take.

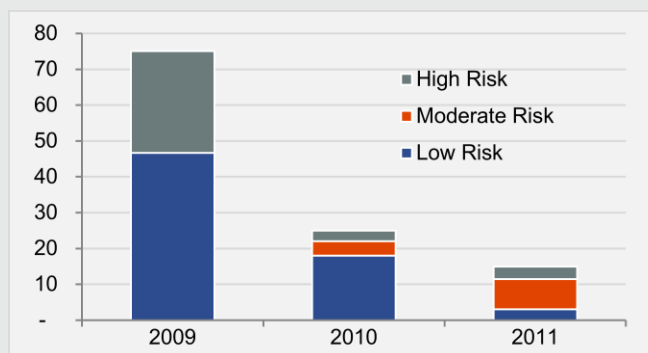
Instead, IFC and KfW redefined the Facility in terms with which they were more comfortable. By the time disbursements began in May 2009, the Microfinance Liquidity Facility had morphed into the Microfinance Enhancement Facility (MEF). The pledge not to support excessive growth of MFIs was dropped.

In all fairness, the Facility did extensively support MFIs in difficulty. Half of the loans disbursed by March 2011 went to MFIs in Bosnia and Nicaragua or to MFIs in other countries that were struggling with weak loan portfolios (see Fig. 4). But given its ambitious targets, the MEF didn't stop there. The other half of the loans went to well-established names like Access Bank (Azerbaijan), Mibanco (Peru), and Financiera Crear Arequipa (Peru) – MFIs that were only mildly affected by the global microfinance downturn and had easy access to commercial funding.

Welcome and necessary as the Facility was when it was announced in late 2008, many of its disbursements proved ill-timed. The peak of MEF disbursements in late 2009 / early 2010 coincided with the time when excess liquidity of Funds was at its highest level. It was inevitable that under these circumstances MEF lending to MFIs with ready access to commercial funding had – and continues to have – a crowding-out effect.

The designers of the MLF were well aware of this danger. The Facility announcement and other policy documents stressed that the MLF/MEF would complement private funding, not replace it. But in the end, the DFIs penchant for aggressive outreach and disbursement targets made large loans to low-risk MFIs all but inevitable, undermining a key element of the Fund's original mission.

**Figure 4: MEF funds for both high and low-risk MFIs, \$US millions<sup>4</sup>**



High risk = MFIs in Bosnia or Nicaragua or with combined PAR 30 + write-offs > 10%; Moderate risk = PAR 30 + write-offs 5-10%; Low risk = PAR 30 + write-offs < 5%. In Peru, where elevated PAR is a market feature categories have been lowered (e.g. 5-10% PAR + write-offs is qualified as low risk).

### Sources:

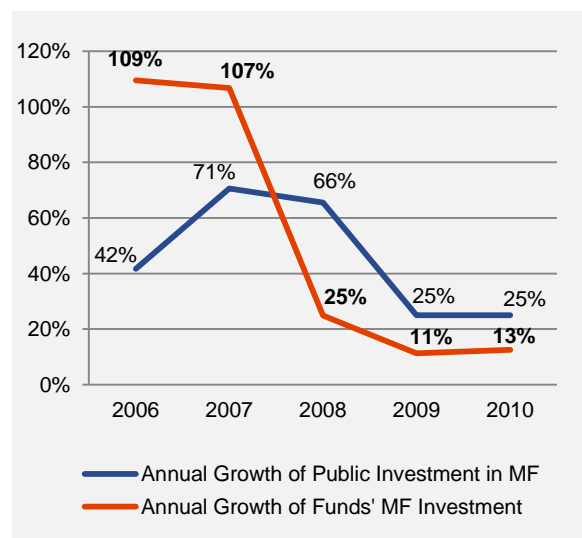
1. IFC, Issue Brief: Microfinance Enhancement Facility. IFC: Washington DC, February 2009.
2. IFC, <<http://www.ifc.org/ifcext/spiwebsite1.nsf/f451ebbc34a9a8ca85256a550073ff10/62d5df63e8c74993852576ba000c2cf5?OpenDocument>>
3. Microcapital Monitor. "Know a Fund: Interview with Mark Berryman. February 2009." <[www.microcapital.org](http://www.microcapital.org)>
4. Chart: www.mef-fund.com, MIX Market.

but over who would lend to the most desirable borrowers. The DFIs had no difficulty in winning that contest by offering larger loan amounts at lower interest rates (see Fig. 9 on p. 13) and on longer terms.

Although DFIs had cornered much of the market of large (Tier I) MFIs, private Funds nonetheless managed to grow very rapidly by lending to smaller (Tier II) microfinance institutions. DFIs were picking the “low-hanging fruit,” but the harvest was big enough to accommodate all. In fact, it was this inversion of roles, with DFIs concentrating on the safest MFIs and private microfinance funds taking the greater risks, which led to the title *Role Reversal*.

This situation changed fundamentally, when MFI growth came to a standstill in 2008. The microfinance industry could no longer absorb as much foreign lending as was being offered by Funds and DFIs. In this situation, the competitive advantage of DFIs began to tell. From 2008 on, DFI lending to MFIs grew much more rapidly than lending by private Funds (see Fig. 5).

Fig. 5: Fund growth versus DFI growth<sup>11</sup>

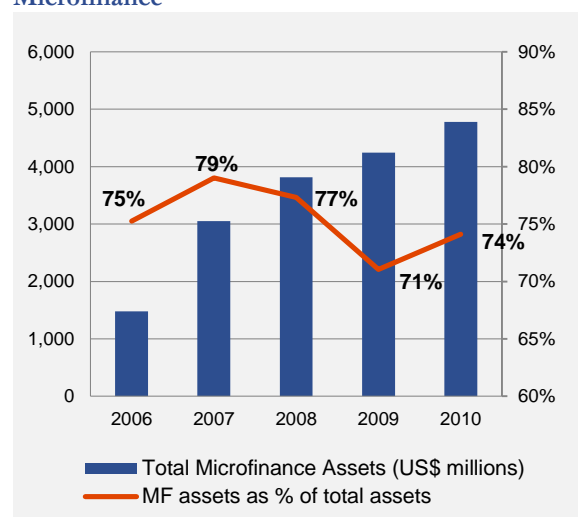


<sup>11</sup> Adapted from CGAP, “Foreign Capital Investment in Microfinance: Reassessing Financial and Social Returns,” Focus Note, May 2011.

One explanation for the growing dominance of DFI lending after 2007 could be that in the wake of the worldwide financial crisis, private funding for microfinance dried up. In that case official development money would have stepped in where private money was no longer prepared to go.

However, Funds emphatically deny that this was the case and numbers bear them out. Non-MFI assets held by Funds – mostly liquid funds – grew from 21% of total Fund assets at the end of 2007 to 29% at the end of 2009. At the end of 2010, non-MFI-assets were still at a high 26% (see Fig. 6).

Figure 6: Percentage of Fund Assets Invested in Microfinance<sup>12</sup>



In other words, as DFI lending surged ahead Funds were struggling with unprecedented levels of liquidity. One of the largest Funds, responsAbility, even took the drastic step of suspending acceptance of new investments because liquidity had reached untenable levels.<sup>13</sup>

### Mind the gap

From the perspective of evaluating crowding out, the question is this: did DFIs cede ground to private funders in cases where

<sup>12</sup> MicroRate, “The State of Microfinance Investment 2011.”

<sup>13</sup> responsAbility. <[http://www.responsability.com/domains%5Cresponsability\\_ch/data/secure\\_pdf/100505\\_ra\\_medienmitteilung\\_aussetzung\\_ausgabe\\_fondsanteile\\_en.pdf](http://www.responsability.com/domains%5Cresponsability_ch/data/secure_pdf/100505_ra_medienmitteilung_aussetzung_ausgabe_fondsanteile_en.pdf)>

investment-ready MFIs continued to demand funding for growth? The growing dominance of DFIs in foreign funding for microfinance suggests that they did not. Funds' high liquidity levels strengthen that impression. But is this corroborated by what is happening at the MFI level? Are DFIs still funding microfinance institutions that have easy access to commercial loans?

In their own defense, DFIs point out that some of their lending in 2009/10 went to market-stabilizing efforts. However, there is much evidence suggesting that what initially was intended to stabilize, ended up displacing available private funding. This happened with the two largest stabilization efforts – the MEF (\$500 million) and MiGroF (\$250 million) – which themselves became, and continue to be in 2011, sources of displacement, as the DFIs shifted focus from market support to funding MFI expansion (see Box 2 and 3).

A third DFI-dominated Fund, the Regional MSME Fund for Africa (REGMIFA, target size: \$200 million, main sponsors: IFC and KfW), was created to lend to smaller, less developed MFIs in Sub-Saharan Africa, which could not attract private funding. Because of this difficult target group, REGMIFA was endowed with a generous \$2.4 million subsidy to support operating expenses and with a large Technical Assistance fund. In theory, this package of operating subsidy and technical assistance made sense. In practice, REGMIFA, like the other DFI-financed Funds, often lends to MFIs with easy access to private funding. In a particularly cynical use of donor funding, technical assistance grants have been used to “sweeten” funding offers to MFIs who also are considering competing offers from private Funds (see Appendix 3).

### Displacement through inertia

Compartamos Banco, by far the largest Mexican MFI was the single largest recipient of DFI funds during 2008-10.<sup>14</sup> Compartamos

is not only large (over 2 million borrowers), it is also highly profitable. The bank enjoys unequalled access to capital markets. As recently as late 2010, Compartamos became the recipient of a combined \$64 million loan from the International Finance Corporation (IFC), the private-sector affiliate of the World Bank, and from the Inter-American Investment Corporation (IIC), which is part of the Inter-American Development Bank Group. This is a recent, but by no means the only example of continued trophy lending after *Role Reversal* drew attention to the practice in early 2007.

In announcing this loan, IIC cited that it would help Compartamos “diversify its sources of funding.”<sup>15</sup> The statement is odd, considering that Compartamos had already obtained funding from a large number of sources. No less important, Compartamos has held a banking license since 2006, though as of year-end 2010, it had not raised any funds from retail deposits. It is thus worth asking – could large DFI loans to mature MFIs like Compartamos provide them with a disincentive from raising deposits? Could they thus be hindering the deepening of the financial offerings to the poor that the DFIs claim to be supporting? As it happens, a few months after borrowing \$64 million from IFC and IIC, Compartamos bought Peru's large and highly profitable Financiera Crear for \$63 million.<sup>16</sup> That the amounts are so similar could be a coincidence, but the acquisition highlights that Compartamos is far beyond the point where it requires funding from development finance institutions.

Mibanco, Peru's largest MFI, with assets over \$1.5 billion and net profits of \$34.6 million in 2010, is equally considered a prime borrower with ready access to private funding. At the

<sup>14</sup> DFI Dataset (see Appendix I).

<sup>15</sup> Inter-American Investment Corporation, “Banco Compartamos S.A. receives IIC loan of up to US\$32 million,” November 2010. <<http://www.iic.int/newsrelease/view.asp?id=787>>

<sup>16</sup> Microfinance Focus, “Mexico's Compartamos to acquire 82.7% stake in Peruvian Microfinance firm,” March 2011. <<http://www.microfinancefocus.com/mexico%E2%80%99s-compartamos-acquire-827-stake-peruvian-microfinance-firm>>



end of 2010, Mibanco held loans of \$161 million from foreign lenders. Most (70% - up from 61% in 2009) of that amount was owed to DFIs. Mibanco's largest foreign creditors were the IADB/IIC (\$ 43.9 million) and the IFC (\$30.1 million).<sup>17</sup> IFC, which had been Mibanco's leading foreign creditors for years, was poised to regain its leadership position with a syndicated \$40 million loan announced in late 2011.

More evidence for DFI displacement comes from the Eastern Europe and Central Asia region (ECA). ECA has been long-dominated by the DFIs. At the start of the market downturn in 2009, DFIs accounted for a full 64% of foreign investment<sup>18</sup> – a number all the more notable given the region's already high dependence on foreign funding. In this region the driving forces behind massive DFI lending appear to be Europe's geo-political objectives in former eastern bloc countries, rather than specific development goals.

Institutions such as the European Bank for Reconstruction and Development (EBRD) and the European Investment Bank (EIB), along with Germany's KfW and the Netherland's FMO help to fulfill those objectives, with microfinance just happening to be a small part of a broader agenda.<sup>19</sup> Not surprisingly, these geo-political considerations are taking precedence over developing private funding flows to MFIs.

At the institutional level, the issue can be illustrated by the case of AccessBank in Azerbaijan, a DFI-created institution and one of the country's largest microfinance providers. The financial highlights of AccessBank during the years 2009-10 would be the envy of many MFIs – its excellent portfolio quality was barely affected by the crisis, while assets grew by 89%, much of it

funded through healthy growth of customer deposits, which expanded nearly six-fold.<sup>20</sup>

Here then could be an ideal story of DFIs fostering the growth of an institution and then stepping back. Were it only so. In 2010 alone the DFI share of AccessBank's borrowings increased from 39% to 45%. It is difficult to imagine that over-liquid Funds would not have eagerly lent to such a strong institution as AccessBank if given an opportunity. Yet their position in AccessBank declined by \$21 million during the same period.

Ironically, the largest contributor to AccessBank's funding in 2010 was a \$7.5 million loan from the Microfinance Enhancement Facility (see Box 2). It is difficult to see why the likes of AccessBank received loans from a facility that was created to stabilize troubled MFIs. Since AccessBank is majority-owned by three DFIs (EBRD, KfW and IFC) one would have hoped that that they would encourage the Bank to fund itself commercially. However, the owners appear to have pushed in the opposite direction.

### Fuel for the pyre

Crowding out private funding is a serious charge against publicly-funded institutions. It is all the more serious when large, established MFIs already have access to an oversupply of funding.<sup>21</sup> For institutions that should presumably be focused on providing seed funding, participating in such over-supply is difficult to justify. There are few better examples of this than Bosnia and Morocco.

<sup>17</sup> Mibanco Annual Reports.

<sup>18</sup> CGAP, "Cross-Border Funding of Microfinance," Focus Note, April 2011. <<http://www.cgap.org/gm/document-1.2.50740/FN70.pdf>>

<sup>19</sup> The political objectives need not even be explicitly stated in these institutions' missions. Their geographic emphasis on their eastern neighbors is sufficient to assure that those objectives are met.

<sup>20</sup> Data pertaining to AccessBank Azerbaijan is from MIX Market and the institution's annual reports.

<sup>21</sup> ADA, "Can 'Bad' Microfinance Practices Be the Consequence of Too Much Funding Chasing Too Few Microfinance Institutions?" 2010.

### **Box 3: DFI funding channeled through microfinance funds.**

Microfinance funds are mainly funded by private investors, but they are also significant channels for DFI funding. CGAP finds that microfinance funds obtain on average about 30% of their funding from the DFIs. Such DFI funding of Funds has a clear catalytic impact when it provides seed capital or when it finances higher risk tranches. Even if they invest in senior tranches, DFIs may sometimes help Funds to mobilize private funding. But not all DFI funding helps the Funds through which it flows. When available funding exceeds demand – as has generally been the case after 2008 – DFI funding crowding into Funds will crowd out private investors. In extreme cases such funding harms the Funds it claims to support.

The outright harmful effect is most easily seen in a new breed of wholly (or largely) DFI-financed Funds that have gained popularity since 2009. In these new vehicles, the DFIs don't invest in private Funds. Instead, DFIs create their own Funds and then select an administrator from among existing fund managers specializing in microfinance. The Microfinance Enhancement Facility (MEF, administered by Blue Orchard, responsAbility and Cyrano, see Box 2), the Regional MSME Fund for Africa (REGMIFA, administered by Symbiotics, see page 8) and the Latin American Microfinance Growth Fund (MiGroF, administered by Blue Orchard) are examples. In these DFI-funded vehicles the private manager acts as an administrator. For a fee, he proposes, disburses, and supervises investments, but lending decisions are made by the DFIs themselves; they also bear the risk.

There are various problems with this arrangement. One is that it forces managers to compete with themselves. All administrators of DFI-sponsored Funds also manage large private Funds. When DFIs charge lower interest rates than their privately funded counterparts – which is often the case (see “The issue of rates”, p. 13) – then the rates that private Funds can charge come under pressure as well. This is of course how competition is supposed to work, except that rates at which Funds see themselves forced to lend are now often so low, that they no longer cover risks. As DFIs push their lending to MFIs, they are driving rates to unrealistically low levels. This threatens to asphyxiate one of the most remarkable features of microfinance: large private funding flows from investors in rich countries to the poor in the developing world.

DFI-sponsored Funds also demote Fund managers to mere administrators. True, they earn attractive fees, but they no longer exercise the core skill of a fund manager, because investment decisions are now taken by the DFIs themselves. Arguably, this in itself is a form of Role Reversal: Administrative bodies (Government-owned development institutions) make MFI-level investment decisions, while private fund managers are relegated to administrative functions. Since development institutions measure their success in terms of volume rather than profits, their default setting is to avoid risk. Instead, they push to meet pre-established lending targets. Little wonder, that most DFI funding goes to the few, well-established MFIs that can absorb large amounts of money.

The DFI-sponsored Funds which have emerged in the last three years are notable failures as far as their developmental role is concerned. The MEF had abandoned its original role of providing liquidity to cash-strapped MFIs, before it began disbursing funds. It now routinely lends to highly creditworthy MFIs with easy access to alternative funding sources. MiGroF was similarly created to make sure that sufficient funding would be available at a time of turbulence in financial markets. However when OPIC and the IADB set up this regional Fund, they already knew that there was an over-supply of funding for MFIs. REGMIFA is a sad tale of a worthy, but poorly executed concept. Funds (including technical assistance grants) that are sorely needed by small, financially weak African MFIs instead end up in institutions that have easy access to commercial funding.

### *Trouble in Morocco*

The microfinance market in Morocco has been dominated by DFIs since the beginning. With government restrictions limiting interest rates on foreign loans, private foreign lending has been slow. The DFIs have been more than happy to fill the gap. In so doing, they also encouraged lending by local banks, including through direct guarantees. Between 2005-7, funding of Moroccan MFIs grew by 620%,<sup>22</sup> with Spain's Agencia Española de Cooperación Internacional para el Desarrollo (AECID) leading the charge.<sup>23</sup> During the same period, one MFI saw its funding increase by 900%, fueling portfolio growth that it was demonstrably not ready to shoulder.<sup>24</sup> Relying on the same systems and oversight processes that were already noticeably strained when it was a \$30-million institution, this MFI grew to \$200-million in a period of just two years.

But problems were not limited to this one institution. Multiple lending was becoming rampant. By 2007, 40% of clients in Morocco were holding multiple microfinance loans, and this was taking place at the very same time that loan sizes themselves were being increased.<sup>25</sup>

The result was predictable: massive delinquencies and a market-wide crisis that required government intervention. This is a credit bubble for which DFIs bear direct responsibility.

Would private Funds have been more cautious than their government-owned counterparts? Since private lenders played a minor role in Morocco, one can only speculate. The example of Bosnia raises doubts that they would have. But it is a fact that markets punish private lenders much

more harshly for mistakes: a disappointing return affects a Fund's ability to attract more money, whereas the governments that own DFIs would hardly notice loan losses. Least sensitive to market signals are institutions like Spain's AECID,<sup>26</sup> which are funded through annual government budget allocations. Their main worry is to place the allocated funds, not whether these funds are reasonably priced or indeed whether they are likely to be repaid.

One private Fund that did lend to a Moroccan MFI read the situation correctly and withdrew from the country in 2007.

### *Overfunding in Bosnia*

From the beginning, the Bosnian microfinance sector was a creation of the international development agencies.<sup>27</sup> And although private foreign investment eventually overtook DFI funding, making this country of 3.8 million people the topmost recipient of private foreign microfinance funding,<sup>28</sup> Bosnia still constituted the largest recipient of DFI lending during the crucial 2007-08 pre-crisis years.<sup>29</sup>

There is little evidence to suggest that this level of DFI funding was needed. By all accounts, Bosnian MFIs were awash in excess funds, leading to a credit bubble. And while private funders must bear their share of the blame, the DFIs are no less responsible. The Bosnia of 2007-08 simply did not meet the criteria of a market that required DFI funding. As the largest recipient of private funding, Bosnia had no need for any catalytic funds. Nor did DFI loans help stabilize the market during these critical two years. On the contrary, public funds only fed the gathering credit bubble.

<sup>26</sup> AECID, a development agency that is part of Spain's Ministry of Foreign Affairs.

<sup>27</sup> Welle-Strand, Anne; Kjøllesdal, Kristian; Sitter, Nick, "Assessing Microfinance: The Bosnia and Herzegovina Case," *Managing Global Transitions* (8). <<http://www.bi.no/OsloFiles/MICRO/2010/Assessing%20Microfinance.pdf>>

<sup>28</sup> CGAP, "Foreign Capital Investment in Microfinance: Reassessing Financial and Social Returns."

<sup>29</sup> DFI Dataset (see Appendix I).

<sup>22</sup> MIX Market.

<sup>23</sup> Center for Global Development, "Who Inflated the Microcredit Bubbles," March 27, 2010. <[http://blogs.cgdev.org/open\\_book/2010/03/who-inflated-the-bubbles.php](http://blogs.cgdev.org/open_book/2010/03/who-inflated-the-bubbles.php)>

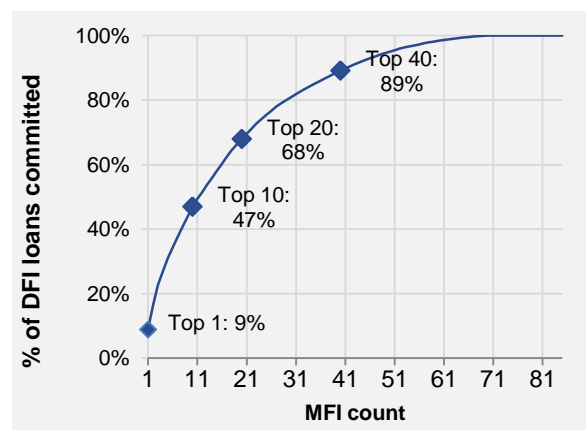
<sup>24</sup> Center for Financial Inclusion, "Weathering the Storm: Hazards, Beacons, and Life Rafts." 2011.

<sup>25</sup> Ibid.

## Blazing new paths

One of the often stated objectives of DFIs is to support MFIs that private funders consider too risky. But notwithstanding public statements to the contrary, DFI funding continues to be heavily focused on large MFIs. During 2008-10, 47% of direct DFI lending went to just 10 MFIs (see Fig. 7).

**Figure 7: Concentration of DFI Lending (2008-10, direct loans)<sup>30</sup>**



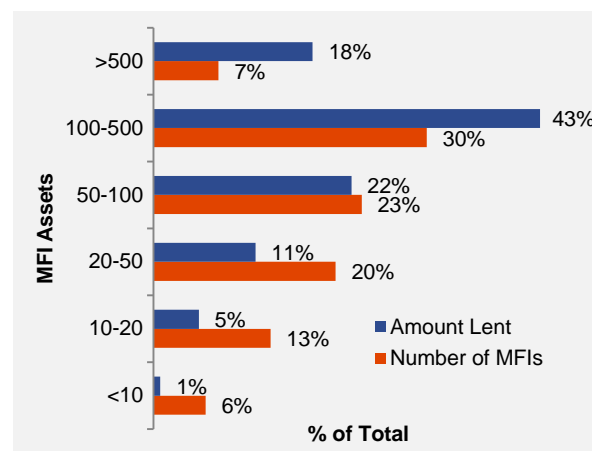
Such concentration leaves little room for investing in the small startups that DFIs claim to be supporting. And while one may expect large MFIs to receive larger loans and thus skew the overall lending distribution, large MFIs dominate even when ignoring loan size. Thus, 60% of all MFIs that received DFI loans during this period had assets over \$50 million (see Fig. 8).

To some degree, this should not be surprising. Few DFIs have the staff, resources, or ability to seek out small MFIs. Their claim to fund immature MFIs is more a reflection of DFI aspirations than capabilities.

Indeed, some private Funds succeed in reaching such small institutions where government-owned development organizations fail. One in particular – Oikocredit – has a MFI portfolio of nearly 600 microfinance institutions, with an average

investment size of around \$600,000.<sup>31</sup> Oikocredit’s lean business model, which has most of its 210 staff dispersed across 36 countries,<sup>32</sup> enables a kind of outreach that no microfinance investors – public or private – can match.

**Figure 8: Large MFIs are primary recipients of DFI loans (direct loans 2008-10, \$US millions)<sup>33</sup>**



Oikocredit’s achievement only serves to underscore how difficult it is to reach such start-up MFIs. With the greater fund absorption capacity of large MFIs, concentration at the top of the MFI pyramid is difficult to avoid. Even with its exceptional outreach, large MFIs (>\$30 million assets) account for nearly half of Oikocredit’s total portfolio.<sup>34</sup>

However, the DFIs’ focus on the top MFIs exceeds even a reasonable allowance for limited outreach capabilities, and is difficult to reconcile with the often stated goal of seeding the market.

This raises the broader question: what makes DFIs engage in such behavior? The conclusion of this report attempts to give an answer that goes beyond the obvious one:

<sup>31</sup> Oikocredit is a Netherlands Savings and Loan Cooperative, not a Fund. Yet it is one of the leading private MIVs. <http://www.oikocredit.org/en/who-we-are/facts-figures/figures>.  
<sup>32</sup> Oikocredit, “Annual Report 2010: Committed to Fair Finance,” <http://www.oikocredit.org/documents/pdf/ar2010uk.pdf>.  
<sup>33</sup> DFI Dataset and MIX Market (see Appendix I).  
<sup>34</sup> Sinha, Sanjay, *Pilot Comprehensive Ratings of Three MIVs*, July 2010. [http://www.sdc-employment-income.ch/media/Forum%20social%20performance%202020july/Presentation%2011%20Sinha%20\(2.07.2010\).pdf](http://www.sdc-employment-income.ch/media/Forum%20social%20performance%202020july/Presentation%2011%20Sinha%20(2.07.2010).pdf)

<sup>30</sup> DFI Dataset (see Appendix I).

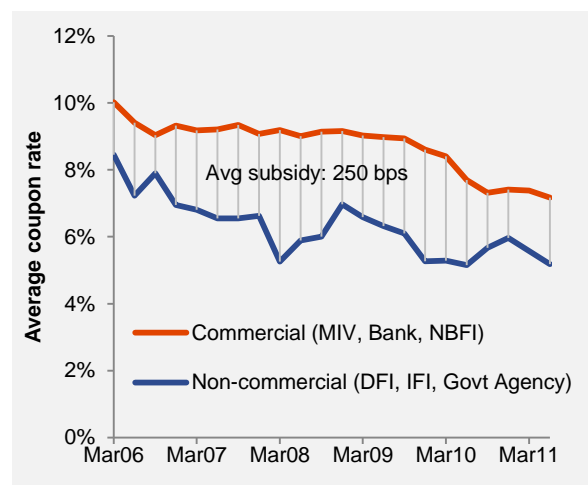


lending to the likes of Compartamos, Mibanco, Access Bank and others like them is infinitely easier, more profitable and less risky than toiling with smaller institutions.

### The issue of rates

When Funds claim to have been crowded out, they nearly always add that the DFIs they compete with offered conditions that private lenders cannot match. The most frequent complaint is about below-market pricing of DFI loans. The original *Role Reversal* presented anecdotal evidence of such pricing differences. This update has the benefit of a more extensive dataset.

**Figure 9: Subsidized rates persist despite overall rate decline<sup>35</sup>**



The evidence is incontrovertible – among MFIs rated by MicroRate, DFI loan rates were on average 360 basis points (3.6%) below commercial ones.<sup>36</sup> This finding is supported with data compiled by Symbiotics, a Geneva-based investment manager. In the Symbiotics data set, which covers a much larger number of MFIs, the rate difference between commercial and non-commercial lending is approximately 250 basis points – a level that has held surprisingly constant since 2006, despite an overall decline in rates (see

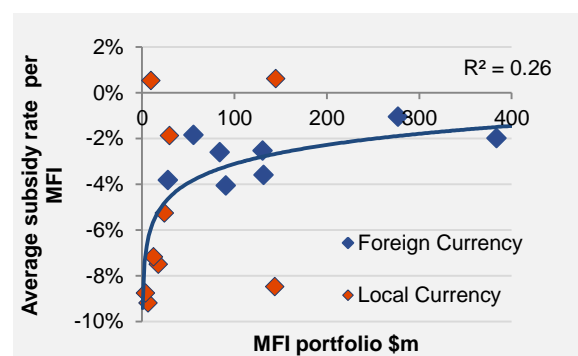
<sup>35</sup> Symbiotics data. <<http://www.syminvest.com>>

<sup>36</sup> MicroRate MFI Ratings (mostly Latin America); rate differences calculated by comparing each MFI's average DFI and non-DFI loan rates, separately for local and foreign currency loans.

Fig. 9). Together, these two datasets strongly suggest that DFIs charge interest rates that are well below commercial ones.

No less importantly, the subsidy exists for small and large MFIs alike, though at a scale that is inversely proportional to MFI size. Thus, for MFIs with portfolios in the \$200-400 million range, the subsidy is around 150-200 basis points. Meanwhile, for MFIs that are at \$20 million portfolio or below, the DFI interest rate subsidy can be 800 basis points or more (see Fig. 10).

**Figure 10: Subsidy increases for smaller MFIs<sup>37</sup>**



The subsidy element is increased further by the fact that DFI loans tend to have on average longer terms. Subsidies therefore are greater than is apparent by looking at interest rates alone. DFIs gain an additional competitive advantage because many of them are not subject to interest withholding taxes, which often increase the cost of borrowing from private lenders. Finally, technical assistance grants are occasionally offered as an inducement to borrowing from DFIs. The impact of such grants on the all-in cost of a loan can be considerable.

As this report was being written in late 2011, DFIs and DFI-controlled Funds were lending to MFIs at less than 6%. To put this into perspective, during the second half of 2011, microfinance institutions in poor countries were able to borrow from DFIs at rates which often were lower than those paid by investment-grade companies in industrialized

<sup>37</sup> MicroRate MFI Ratings (mostly Latin America), 2007-10.

countries. Ostensibly, low lending rates should benefit the poor because they reduce the borrowing costs of MFIs. If this is true at all- and in MicroRate's experience it rarely is - the benefit will be of short duration. By forcing lending rates below market levels, DFIs are defeating the goal of opening access to capital markets. Markets tend to have a keen sense for the relation between risk and reward. When rewards consistently fail to compensate for risks, investors will sooner or later place their money elsewhere.

### Five Areas for DFI Action

*Role Reversal* identified five areas in which DFIs could support microfinance. Each of them promised a large impact at low cost. How have the DFIs fared in these areas?

- 1. Make DFI funding transparent.** Perhaps the most effective measure to discourage crowding out requires virtually no cost or effort. Greater transparency would discourage DFIs from engaging in the most brazen cases of trophy lending and crowding out. Transparency was notably poor four years ago and it has not improved since. It is practically impossible to find out to whom DFIs have lent, how much, and on what terms. MicroRate obtains this information from the MFIs it rates, but most DFIs still will not release data about specific loans.<sup>38</sup> KfW<sup>39</sup> for example – highlighted in the original *Role Reversal* for its lack of transparency – remains as opaque as ever. Shouldn't government-owned development finance institutions be accountable to the public for the use of the funds entrusted to them?
- 2. Maximize commercial participation in innovative capital markets transactions.** Both, before the original *Role Reversal* and through 2008, DFIs took catalytic positions in a number of transactions, including CDOs and more traditional guarantees. This is still the case, though markets for the more complex transactions, such as CDOs, have dried up following the crisis of 2008. DFIs continue to take subordinate positions in mixed public-private Fund structures, thus catalyzing private capital. At the same time, the growing preference of DFIs for outsourcing public-only funds to the same companies that manage private Funds has created a source of conflict, especially when the outsourced funds come with aggressive outreach targets attached. As a result, DFI performance has become increasingly poor in this category.
- 3. Seed the next generation of microfinance institutions.** DFIs have been early subscribers of Greenfield MFIs backed by foreign networks. However, in terms of developing existing institutions, especially those with local roots, the DFIs score remarkably poorly, with several market players (such as Oikocredit) outscoring the DFIs by a large margin.
- 4. Help develop mechanisms to cover foreign exchange risk.** With the creation of TCX and MFX (see Box 1), the DFIs – especially FMO and OPIC - have answered the call for foreign currency hedging structures and played a key role in expanding local currency lending. For this they deserve much credit.
- 5. Promote microfinance infrastructure.** DFIs have met this call to a significant extent, with their support of local credit bureaus. Other attempts, like various initiatives to subsidize MFI ratings have been less effective (full disclosure: MicroRate has benefited from these initiatives). They may have been justified initially, but donors (including DFIs) have found it difficult to step back and let market mechanisms take over.

<sup>38</sup> One notable exception is the MEF, a DFI-financed Fund discussed in Box 2. The MEF publishes a full list of investee portfolio on its website, including loan amounts, and dates of disbursement and maturity.

<sup>39</sup> Kreditanstalt für Wiederaufbau, a DFI owned by the German government and one of the most active lenders to MFIs.

It is gratifying to see DFIs succeeding on many of these points. The recent market downturn has also demonstrated the DFIs' unique ability to act as lenders of last resort and thus help stabilize unsettled microfinance funding markets. In a sector that is lacking in the type of liquidity support central banks can provide, the DFIs are well-positioned to fill that role when required.

However, with respect to the main point of *Role Reversal* – that publicly-funded DFIs are displacing private capital – the record is discouraging.

One hesitates to justify using taxpayer money (that ultimately backs these institutions) to undermine the socially-responsible investments those very same taxpayers are seeking to make. It is understandable that DFIs find it difficult to step back and leave the field to private funders after they have invested much effort and money to help develop a viable microfinance industry. But step back they must, if microfinance is to reach its full potential. As the sector continues to develop, it will inevitably outgrow the ability of even the largest DFIs to satisfy its funding needs. It is not too soon to accept this reality and to do everything that can be done to prepare private institutions for the role they must play.

### **Why DFIs continue to crowd out private investments?**

The fundamental feature that drives DFI displacement of private capital stems from two factors: the mistaken belief that the relevance of a Development Finance Institution is expressed through lending volume and an institutional culture modeled on the private sector.

Like many government entities, DFIs measure their success by the volume of funding they make available, as well as via direct impact targets, such as the number of countries, institutions, or end-clients reached by DFI

funds. This perspective results in seeing shrinking levels of funding as a sign of diminishing relevance. Unfortunately, such thinking undermines the very notion of catalytic impact that the DFIs so strongly espouse in their policy statements.

The other factor driving displacement of private capital is the adoption by many MFIs of an institutional culture modeled on the private sector, which emphasizes winning and competition. Adopting private sector practices might improve the DFIs' efficiency and flexibility, but such a culture is based on a faulty premise. DFIs' return requirements are, after all, illusory – as long as DFIs don't jeopardize their credit ratings, the governments that own them expect those institutions to fulfill a developmental mission, not to generate high returns.

### **Hope for DFI involvement in microfinance**

DFIs are uniquely positioned to do things private money cannot. They can (and do) catalyze markets by investing in market infrastructure, such as credit bureaus and foreign exchange hedging facilities. They can (and occasionally do) provide stability by acting as lenders of last resort and by providing long-term funding when it is unavailable from other sources. They can (and do) support private market transactions by taking first-risk positions, thus encouraging private capital to flow to projects with important social benefits that might not be funded otherwise.

However, for all the good they can accomplish, DFIs can also overreach. Despite their pledges to not compete with private funding – pledges which have grown more insistent after the first *Role Reversal* report – DFIs have greatly increased the scale on which they crowd out private capital. At a basic level, stepping back and handing business to others goes against the grain of an

institutional culture that seeks to emulate the competitiveness of the private sector, especially when it is driven by explicit lending targets.

Avoiding crowding-out behavior requires changing how DFIs measure their performance. Aligning targets with their core mission would help the long-term objective of developing an institutional culture that combines the best of private sector efficiency with an emphasis on support rather than on competition.

### Concluding Recommendations

Recommendations directed at DFIs themselves have already been made in a previous section. Among those, greater transparency is easily the one that promises the greatest impact for the least expenditure of effort and money. But efforts made by DFI managements alone – welcome and necessary as they are – will not be enough to achieve the changes that are needed. These efforts should be complemented on two fronts:

**1. Create an effective dialog between Funds and DFIs.** Individual Funds are reluctant to complain about DFI behavior, because many of them have received, or hope to receive funding from those institutions. Some Fund managers also administer DFI-controlled Funds and depend on income from that source. Nonetheless, a channel is needed, through which microfinance funds can present their interests to DFIs. At present, two organizations represent microfinance funds.<sup>40</sup> One solution could be to broaden their mandate so that they can play this role effectively.

**2. Encourage the policy-making bodies of DFIs – normally the Board of Directors – to evaluate how effectively their institutions support private funding for microfinance.** Such reviews should be undertaken by experts working directly for the Board. To protect their objectivity, these experts should be barred for a number of years from other consulting assignments for the same DFI. The results would allow the Directors to ensure that their policies are implemented, instead of being largely ignored by DFI management teams, as is the case today.

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<sup>40</sup> The Council of Microfinance Equity Funds (CMEF) and the International Association of Microfinance Investors (IAMFI).



## Appendix I: Data sources

The **DFI dataset** was developed through intensive research of publicly available data on DFIs to determine their level of funding of microfinance during 2006-2010, and also to evaluate their level of transparency with the public. Transaction amounts represent the amount a DFI approved or announced (as opposed to the amount actually disbursed). When currency was not in USD it was converted using the rate given by OANDA for Dec 31 of the approval year. The sources used include DFI websites, including project documentation, news releases, annual reports, and, when available, lists of transactions. Other sources used include the CGAP/MicroCapital Monitor dealbook and CGAP research papers. MFI websites were also consulted as necessary.

The **MicroRate MFI dataset** is drawn from data collected from MFIs during ratings performed during 2006-2010. All funding source information is collected from MFIs including public and commercial sources, as well as deposits. The cost of funding is also included. This dataset encompasses 76 unique MFIs, 67 of which are from Latin America.

The **CGAP cross-border funding dataset** and its components, the CGAP Funder and MIV surveys, provide important high-level data on overall market funding levels and trends. Due to the scope of these surveys, it is the most reliable source of information available for microfinance cross-border funding. However, detailed information on specific countries, funders, or MFIs is not available.

**MIX Market** data are used throughout this paper, often in conjunction with data from other datasets. It is the most comprehensive resource for MFI-specific data.

In some cases, such as for Compartamos, AccessBank, or Mibanco, **MFI annual reports** are used to evaluate these MFIs' funding structure and trends. These are often complemented with data drawn from the other sources.

## Appendix II: DFI List

Development Finance Institution (DFI)	Public Sector Shareholders	Percent of equity held by Public Sector	Geographic focus
Agencia Española de Cooperación Internacional (AECID)	Government of Spain	100%	Global, special focus on Latin America
Asian Development Bank	Multilateral: Member Governments	100%	Asia and Pacific
BIO	Government of Belgium/Belgian Corp. for International Investment	81.5% <sup>41</sup>	Global
Corporación Andina de Fomento (CAF)	Multilateral: Latin American governments, and Governments of Spain and Jamaica	99.9% 0.1% owned by private financial institutions	Latin America
European Bank for Reconstruction and Development (EBRD)	Multilateral: Member Governments, EIB, EU	100%	E. Europe/Central Asia
European Investment Bank (EIB)	Multilateral: Member States of EU	100%	Global
Netherlands Development Finance Company (FMO)	Government of Netherlands	51%	Global
International Finance Corporation (IFC)	Multilateral: Member Governments	100%	Global
Inter-American Development Bank/Multilateral Investment Fund (IADB-MIF)	Multilateral: Member Governments	100%	Latin America/Caribbean
Inter-American Investment Corporation (IIC)	Multilateral: Member Governments	100%	Latin America/Caribbean
Kreditanstalt für Wiederaufbau (KfW)	German Federal Government 80% German States 20%	100%	Global

<sup>41</sup> BIO is 50% controlled by Belgian Department of Development Cooperation, and 50% by Belgian Corporation for International Development, which is in turn 63% controlled by public institutions.

## Appendix III: Quotes from DFI Policy Statements

DFI	Statement from DFI
Asian Development Bank	ADB's private sector operations will make a concerted effort to enhance private sector participation in public sector projects. (Source: <a href="http://www.adb.org/Documents/Policies/Microfinance/microfinance0703.asp?p=microfnc">http://www.adb.org/Documents/Policies/Microfinance/microfinance0703.asp?p=microfnc</a> )
BIO	The aims of these interventions are based around three key objectives: (1.) Optimizing the development impact (both qualitative and quantitative); (2.) Supporting sustainable projects; (3.) <b>Additionally (intervening where the need is the greatest), in relation to the market and other DFIs.</b> (Source: <a href="http://www.bio-invest.be/en/what-we-do/sectors.html">http://www.bio-invest.be/en/what-we-do/sectors.html</a> )
European Bank for Reconstruction and Development (EBRD)	<b>The Bank invests only in projects that could not otherwise attract financing on similar terms.</b> Mission: Investing primarily in private sector clients whose needs cannot be fully met by the market, the bank fosters transition towards open and democratic market economies. (Source: <a href="http://www.ebrd.com/pages/about/what.shtml">http://www.ebrd.com/pages/about/what.shtml</a> )
Netherlands Development Finance Company (FMO)	FMO serves as a niche market. This means that, while we are a bank <b>we only provide finance where regular commercial banks are not willing to do so. Our access to government funds means that we are also able to take higher risks than purely commercial players. We work in countries – and with clients and projects-with a higher risk profile, in order to be “additional” to the market.</b> This means that we provide long-term finance where most loans are short term. We provide high-risk, innovative financial structures-such as mezzanine and equity – in addition to regular loans.” (Source: <a href="http://www.fmo.nl/smartsite.dvs?id=1675">http://www.fmo.nl/smartsite.dvs?id=1675</a> )
IFC	Purpose: to create opportunity for people to escape poverty and improve their lives by: 1. Promoting open and competitive markets in developing countries 2. <b>Supporting companies and other private sector partners where there is a gap</b> 3. Helping generate productive jobs and deliver essential services to the underserved 4. Catalyzing and mobilizing other sources of finance for private enterprise development. (Source: <a href="http://www1.ifc.org/nps/wcm/connect/corp_ext_content/ifc_external_corporate_site/about+ifc">http://www1.ifc.org/nps/wcm/connect/corp_ext_content/ifc_external_corporate_site/about+ifc</a> )
IDB-MIF	From its very beginning, IDB has supported private sector development through operations to enhance competitiveness and access to credit with the intermediation of public bodies and under sovereign guaranteed operations. (Source: <a href="http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=35291148">http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=35291148</a> )
Inter-American Investment Cooperation (IIC)	The IIC seeks to provide financing to companies that do not have access to medium- or long-term financing from the capital and financial markets. ... It particularly targets small and medium-size companies that have difficulty-obtaining financing from other sources on reasonable terms. (Source: <a href="http://www.iic.int/apply/">http://www.iic.int/apply/</a> ) Purpose: (3) Stimulate the development of investment opportunities conducive to the flow of private and public capital, domestic and foreign, into investments in the member countries (Source: <a href="http://www.iic.int/charter/">http://www.iic.int/charter/</a> )
Kreditanstalt für Wiederaufbau (KfW)	KfW Entwicklungsbank and DEG support the creation of infrastructure, environmental and climate protection, and private sector initiative and investment as drivers of sustainable development. (Source: <a href="http://www.kfwd.de/kfw/en/KfW_Group/Press/Materials_for_the_press/Presentati2.jsp">http://www.kfwd.de/kfw/en/KfW_Group/Press/Materials_for_the_press/Presentati2.jsp</a> )

## Appendix IV: Economist Article<sup>42</sup>

### Small loans and big ambitions

The commercialisation of microcredit and what stands in the way  
Mar 15th 2007 | from the print edition

COMPARTAMOS may not be the biggest bank in Mexico, but it could be the most important. Established in 1990 as a non-profit group making small, uncollateralised business loans to the poor (“microcredit”), Compartamos today reaches over 612,000 clients. It also turns a profit. It is one of the few microlenders rated by international credit-rating agencies, which has allowed it to issue bonds. Last June Compartamos received the green light from the Mexican government to convert into a bank. It is so well run that bankers whisper about a possible public listing.

Microfinance, like Compartamos, has made huge strides in the past two decades. Having started as a founding industry nurtured by charities, it then won the backing of the big international financial institutions (IFIs), such as the World Bank and the European Bank for Reconstruction and Development. Today it spans thousands of microfinanciers serving 40m individuals. Like Compartamos, many lenders now seek a profit.

Commercialisation is changing microfinance—and stirring debate. Some believe microlenders have no business making money from the poor. In many countries various rules, like interest-rate caps, have been put in place to crimp the industry's growth. This is despite ample evidence that where there is healthy competition in microlending, as in Bosnia and Peru, interest rates tend to drop substantially. Most experts in IFIs and elsewhere believe the for-profit sector must play a role. Microlenders that can attract commercial funds—deposits, loans, the capital markets—have the potential to become self-sustaining, rather than relying on the charitable instincts of others.

Socially responsible investors are already pouring in. And even the purely profit-minded have begun to open their wallets. According to a study of 200 microlenders by MIX, which collects data on the microfinance industry, commercial funding grew to \$7.3 billion in 2005, from \$4.9 billion two years before.

What stands in the way of more for-profit investment from the private sector? Some banks, particularly big, international ones, shy away, fearing that profiting from the poor could smack of exploitation. An obstacle in some poor countries is the lack of a regulatory framework that would help microfinance thrive. In some places microlenders need to raise \$50m or more to become deposit-taking banks, for example. In Venezuela, Argentina and elsewhere the government is making noises about jumping in with subsidised microloans, which could put profitable microlenders out of business.

Paradoxically, microcredit's biggest backers, the IFIs, may also be an impediment to its further evolution, according to a recent controversial study by a microfinance consultancy and MicroRate, a microfinance ratings agency\*. The paper finds that IFIs concentrate their loans on the big microlenders that do not need them, pouring 88% more money into these groups in 2005 than they did in the previous year. This crowds out commercial investors,

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<sup>42</sup> *The Economist*, “Small loans and big ambitions.” March 15, 2007 <<http://www.economist.com/node/8861522>>



argue the authors. Many bankers agree, noting that IFIs often tie other handouts to loans and undercut commercial lenders by up to 3%.

The problem is acute, because only around 300-400 of the world's 10,000 microfinanciers are as yet "investable", argues ACCION International, a microlender. The rest of them lack the capacity and expertise to take investors' cash. According to the Consultative Group to Assist the Poor (CGAP), a consortium of development groups, investors can choose from 74 microfinance funds, which channel investment to the sector. But a quarter of this investment flows into just ten of these funds.

Why would IFIs get in the way? The authors claim that these groups, which have an urge to lend and spend, have grown lazy. Investing in a handful of large microlenders is easier than making dozens of smaller loans to untested, fledgling ones. It is also safer and more profitable. This bolsters the donors' own balance sheets and also strengthens their case whenever they must convince sceptical finance ministries and taxpayers that their largesse does yield results.

### Killing them softly

Not all IFIs are guilty of course—and even the "guilty" ones do good work in other areas. But the problem, says Don Terry of the Inter-American Development Bank, is real. "We and others have proved the model works. Now it's time to move on. Our job is to go where others won't, not where they will." The bank is selling its stakes in successful MFIs. Indeed, it exited the first microfinance debt fund, which it helped create, three years before its ten-year commitment ran out, because there was so much interest from the private sector.

Although the MicroRate paper fingers IFIs, some argue that irresponsible lending by philanthropists is just as harmful. They, too, can crowd out for-profit money and, more importantly, local deposits which provide sustainable funding, and also a safe place for the poor to save. Foreign money, public and private, can provide an "important stop-gap", says

Elizabeth Littlefield, chief executive of CGAP, but "I worry that it is not necessarily catalysing the creation of a sustainable, savings-based financial system in poor countries." Still, the transformation is happening in snippets, particularly in Latin America. Pichincha, Ecuador's largest bank, established a microfinance subsidiary in 1999 with backing from an American development agency. Today the subsidiary contributes 12% of Pichincha's total profits, with arrears of less than 2%—while providing loans to the poor at competitive rates. Citibank houses its microfinance transactions in its bank, not in its community-development group, as others do.

The turning point will come, according to Ms Littlefield, when microfinance is seen not as a new asset class—which "ghettoises" the poor—but as the newest product line for retail banks. The industry has already transformed itself once, from a financial curiosity to a *cause célèbre*. In so doing, it has created millions of micro-capitalists in poor countries. Now it needs to attract throngs of big capitalists from rich ones.

### Success has many financiers

Characteristics of a sample of microlenders (rated by MicroRate)  
2005

	Credit rating			
	Alpha	Beta plus	Beta	Beta minus
Average portfolio of microloans, \$m	50	14	9	11
Average RoE, %	28	22	13	15
Average IFI* debt, \$m	2.1	1.3	0.6	0.1
Average increase in IFI debt, %	88	12	nil	-25

Source: MicroRate

\*International Financial Institutions

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*Role Reversal Revisited: Are Public Development Institutions Still Crowding out Private Investment in Microfinance?* was made possible by the generous sponsorship of Calmeadow Foundation and the Council of Microfinance Equity Funds (CMEF)



**Council of Microfinance Equity Funds**