



Financing Microfinance: “Transitions to Private Capital” Workshop Proceedings 14 May 2004

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Transitions to Private Capital: Research Objective

Transitions to Private Capital is a two and one half year research project and the first large-scale investigation into the financing of microfinance institutions (MFIs). The project will examine MFI financing needs, trends, and challenges from the perspective of both financial institutions and investors. Managed by the Chemonics International AMAP Consortium with Research Direction provided by Enterprising Solutions Global Consulting, the project’s objective is to produce practical tools and insights to help the microfinance sector gain greater access to local and international capital markets.

Planning Workshop Objectives

A one-day planning workshop was held in Washington, D.C. on May 14, 2004, to achieve the following objectives:

- Discuss, define and prioritize major MFI financing issues;
- Elicit initial sector input to help shape the substance and process of the *Transitions to Private Capital* research agenda;
- Identify ongoing, related activities (research projects, pilot projects, etc...) with potential collaborative synergies.

Participants included a wide range of professionals involved in the financing of MFIs. (See Appendix One -- Workshop Participants.) The workshop followed the agenda shown in Appendix Two and yielded substantive input for the design and direction of *Transitions to Private Capital* research activities. This report describes the workshop discussions in condensed form.

The Main Issues: MFI Transitions to Private Capital

Participants spent two hours discussing how MFIs may achieve greater access to private capital. Eight main issues were identified:¹

Attractiveness of Microfinance as an Investment Opportunity

- The majority of investment interest in MFIs is at the international level; domestic investors are not interested in financing MFIs. But this is less true for debt than equity.
- MFI profitability alone was expected to attract investors but that has not proven to be the case.
- Information asymmetries cause investors to have inaccurate perceptions of MFI risk.
- Investors and lenders can place money in competing investment opportunities much more easily.
- MFI organizational structures are unclear to most investors.
- For social investors, MFIs have not clarified their social and financial objectives.
- Continued dependence on or preference for public funding hampers MFIs' outreach to private capital markets.
- Equity investments in MFIs are limited by:
 - the small scale of equity deals
 - limited returns on equity
 - the prospective difficulty of exiting from an investment, since there are few readily available buyers, particularly at the local level.

Transparency/Information

- Great information asymmetries exist between MFIs and investors.
- There is a need for greater financial transparency in the microfinance industry.
- Investors need better, more readily or easily accessible, and standardized information on MFIs.
- MFIs as a group currently tend to have poor relations with investors and lenders. MFIs must learn to manage increasingly sophisticated liability structures and relationships with a variety of different types of investors.

MFI Internal Capacity

The MFI investment universe generally includes a small number of investment-worthy MFIs (50 to 60, worldwide) and another 200 to 300 smaller, less professional MFIs (so-called "second-tier MFIs") that are less attractive for private investment. To develop greater access to private capital:

- MFIs need stronger management structures and capacity to generate higher profits.
- MFIs have to develop better capacity for long-term cash flow projection.
- MFIs need to have stronger and more sophisticated liability management. This includes better asset-and-liability management and stronger investor relations programs.
- MFIs need better governance and organizational structures, since their current structures are too often underdeveloped and lack the capacity to handle increasingly complex balance sheets.

Transaction Costs

- Transaction costs, such as legal costs, transfer and settlement costs, due diligence expense, etc., are high relative to the typical sizes of loans and investments. This results in high costs (relative to returns) for placing funds.
- Competing investments (e.g. government bonds) are better understood and thus typically less expensive relative to the size and risk of investment.
- Standardization of processes, of legal work (e.g., contracts), of instruments and of reporting for MFI investments is a necessary prerequisite for lowering transaction costs.

Legal and Regulatory Issues

There are significant regulatory barriers between private capital and MFIs. Good regulatory environments are critical but lacking in many countries, both for investment in general and for microfinance investment in particular. Regulation that enables rather than obstructs investment is key to increasing the flows of private capital to MFIs, whether internationally or within developing countries.

- Regulatory environments and conditions in local markets affect MFI access to private capital significantly.
- Inadequate or inappropriate regulatory environment worries investors.
- Private sector investment, whether in debt or equity, cannot be executed in an unregulated environment.
- An effective legal and policy environment governing the mobilization of savings deposits is critical.
- There is a need to understand collateral laws; and what constitutes good collateral laws.
- Guidance on prudential norms and ratios is needed for different corporate types of MFI.
- Non-regulated MFIs need access to private capital markets.

Public Sector Involvement

- The availability and attractiveness of public money crowds out private investment.
- MFIs continue to depend on or prefer public sources of financing.
- International financial institutions (IFIs) should take some risk (e.g., foreign exchange risk) off the table (e.g., through guarantee mechanisms) to make MFIs more attractive to investors.
- Donor funding should be used to strengthen the enabling environment and facilitate policy change, rather than to fund loan portfolios.
- Donor guarantee activities are too restrictive to facilitate access to private capital.
- As donor money is often not well understood by the private sector, it can hinder access to private capital.

Foreign Exchange Risk

An estimated 7%-10% of capital used by MFIs comes from international sources; indeed, capital from international sources in general is widely viewed as a catalyst for MFI development and a bridge to private-sector capital. Thus, managing foreign exchange is a significant challenge for many MFIs. Hedging mechanisms are required to maximize the amount and effectiveness of international flows of funding.

- Lack of cost-effective hedging mechanisms inhibits private international financing of MFIs (e.g., social investors).
- Exogenous threats to MFI performance, such as currency fluctuations, greatly affect investor interest.
- Current MFI investment funds and asset manager portfolios are too small to employ effective or innovative hedging mechanisms.

MFI Credit Risk

- The kind of MFI financing available is not the type that helps expand loan portfolios (e.g., terms are often not attractive).
- Loan guarantees are difficult to obtain and not universally well accepted by commercial banks.
- Local banks either require cash collateral or letters of credit guarantee (LCs) before lending to MFIs.
- LCs can provide a useful transition mechanism for MFIs as they move toward unsecured borrowing.
- Creative credit enhancements, such as USAID Development Credit Authority loan guarantees are good tools and need to be more broadly applied.
- IFIs could provide a first-loss guarantee as a form of insurance to offset private investor risk.
- International capital can bring legitimacy and leverage local investment.

Who is Investing?

The goal during this portion of the workshop was to build an investor typology to better describe the interests, needs, and limitations of various MFI investors. The group began by defining a funder as “anyone who will put money into an MFI.” Next, participants listed different types of investors:

- Multilateral development banks
- Network service organizations (such as ACCION or FINCA)
- Commercial banks (domestic and international)
- Domestic development banks
- Clients (through voluntary savings, forced deposits, and shares)
- APEX institutions
- Foundations
- Specialty funds
- Private equity investors (individuals and institutions: domestic and international)
- Socially responsible investors (defined as mainstream institutions that invest seek both financial and social returns without compromising one for the other)
- Bilateral institutions (ODA).

Participants then listed indicators that can be used to characterize current or potential MFI investors. The list included:

- Financial instruments used
- Required rate of return
- Public versus private sources of funding

- Desire to participate in governance
- Investment time horizon
- Legal structure
- Geographic coverage
- Investment objective/targeting
- Size of institution

A detailed typology for *Transitions to Private Capital* will take these lists into consideration.

Four Emergent Themes

Four themes emerged from the morning's conversation; although they were not explored in depth, they suggested research directions worth pursuing as *Transitions to Private Capital* proceeds:

1. Is mission drift inevitable as MFIs make the transition to private sources of capital?

There is some concern that, as MFIs seek to become profitable and attractive to private capital (or are pushed by private capital to become more profitable), average loan size will drift higher in an effort to increase margins. Some examples were cited but, in general, participants agreed that the evidence regarding mission drift and private capital is mixed. There is, in fact, no empirical evidence showing the two to be correlated. There is some evidence showing that *median* loan size remains stable within profitable and growing MFIs (i.e., within the range of what is typically considered micro credit), while the average loan size increases. This *could* suggest that clients needing smaller loans are being abandoned. However, it is typically interpreted not as mission drift but as a reflection of a pattern in which original clients, whose businesses are growing, are still being served but with larger loans.

2. Does competition drive financial institutions down-market?

Some participants argued that commercial financial institutions, particularly retail banks, are facing greater competition in high-end markets and will eventually be driven down-market as margins inevitably fall. There was no consensus on this point and nothing more than anecdotal evidence supporting the claim. Clearly, however, broader financial market dynamics (e.g., increased financial sector competition, changing savings patterns etc.) will be increasingly influential as profitable MFIs make the business case for investment in microfinance.

3. How can good MFIs that operate in weak or small domestic banking markets access private capital?

It was suggested that smaller or emergent MFIs will need international equity and debt financing, since weak domestic banking systems and shallow capital markets cannot be easily improved.

4. Which MFIs should be the focus of transition efforts?

Top tier MFIs (50-60 institutions mainly concentrated in Latin America) generally have access to local funding through depositors and commercial banks, although access to equity funding is still limited. While these MFIs should not be entirely abandoned by donors, participants generally felt that donor funding may best be used to accelerate capital flows to 2nd- and 3rd-tier MFIs: i.e., smaller institutions with potential for development and growth. Debate revolved around how 2nd-tier institutions could best be helped to attract private investment (e.g., through support for debt financing in local markets).

“Top Ten Reasons Why Private Capital *Should Not* Invest in MFIs: Experiences with Investment in Community Development Finance Institutions”

In a luncheon presentation, John Wilson, Director of Socially Responsible Investing at Christian Brothers Investment Services, Inc., articulated the top ten reasons commercial investors *should not* invest in Community Development Finance Institutions (CDFIs) or MFIs. He spoke from the perspective of a fund manager who has tried to encourage socially responsible investment in general and CDFI investment in particular.

10. Social justice? Who cares?

At the end of day, financial returns matter as much as social returns. For broad access to social investment markets, financial performance has to be competitive with investment opportunities of similar risk and return profiles. MFIs need to understand the investor rationale. (See also point three below.)

9. We can't trade the securities.

MFI shares are not typically tradable in a liquid market.

8. We can't price them.

Non-tradable securities do not have efficient pricing mechanisms and therefore there is no way to report the net asset value of investments regularly (daily or even monthly), as required by most institutional investors.

7. We can't legally own them.

The Investment Act of 1940 allows fiduciaries to invest in a range of investments that could include MFIs, given certain restrictions for different asset classes. Money market funds, for example, would be exempt. Bond and equity funds would be acceptable, though current practice and other restrictions (e.g., daily valuations) limit the potential.

6. They're not entirely useful

MFI investments do not fit traditional asset investment strategies. For example, MFIs will never represent more than a very small fraction of an asset manager's portfolio (which typically range in the hundreds of millions, if not billions, of dollars), and thus do not help, as some claim, diversify portfolios. The sector needs to come up with another reason for including MFIs in a portfolio (e.g., this asset class is uncorrelated with other markets). Also, because MFI

investments do not match floating benchmarks, an asset strategy cannot be implemented in any case (since their prices do not fluctuate).

5. They're too risky.

The level of financial disclosure is not as formalized as in other types of investment, and therefore it is much harder for asset managers to understand MFI investment risk. This leads to an exaggerated perception of MFI default risk. This combines with the already high perceptions of country risk, currency risk, and various other risks plaguing developing-country investments.

4. Their "guarantees" don't guarantee enough.

There are different types of risk and the guarantees typically provided do not sufficiently hedge against all the risk seen as inherent in MFI investments.

3. We are fiduciaries.

Fiduciaries have legal responsibility to maximize performance. Socially responsible fiduciaries are possible and legal because their investment decisions are based on financial returns that are not sacrificed for social returns.

2. We don't have the expertise.

Investors don't have in-house expertise. They either need to build in-house expertise or outsource this function. At a minimum, asset managers need information to gauge MFI investment performance relative to appropriate benchmarks. Any information supplier must have good credentials and proven analytical techniques. Professionals from the CDFI/MFI sector could serve this function well, since they can answer the kinds of questions typically posed by fund managers.

1. The Great Divide.

In most investment companies, there is an organizational and cultural separation between those who manage assets and those who apply social investment criteria. This is to avoid conflicts of interest between those screening investments and those managing assets. Investment managers are not compensated on social return, and hence have little incentive to incorporate these strategies without an investment perspective.

Most asset managers have an investment background and, coming from that perspective, believe in efficient markets. They assume that if MFI investments are not already desired by asset managers they are not valuable assets. The CDFI/MFI professionals do not typically speak the language of asset managers, leading to confusion and difficulty working together and, ultimately, difficulty establishing the value of CDFI/MFI investments. The key is to learn to speak the language of asset management and to devise products that fit an investment strategy, as well as a social mission.

Debate: Will Private Capital Replace the Lion's Share of Donor Funding (grant, debt and equity) in the Majority of Markets Within Five years?

Participants were divided into two groups to debate the above statement.

The Con side argued that the main issue is outreach. The microfinance industry is a large and rapidly growing industry. Citing CGAP statistics for 2003, the *Con* team estimated the number of microfinance borrowers world-wide to be between 50 and 70 million with total outstanding loans of \$15 billion. Yet only 7% of this portfolio (or \$1.05 billion) is funded by foreign direct investment. Of this, 90% (or \$945 million) comes from donor or government sources. To replace this funding with private capital is an enormous task that will not be possible to do in five years. This is particularly true given that the bulk of private capital is expected to come from deposits; and to mobilize deposits, most MFIs will first need to transform into regulated institutions. This may be possible, but a complicating factor is that many countries do not currently have appropriate regulatory frameworks in place. Experience shows that it can take years to establish good regulatory regimes, even when governments are keen to create the proper enabling environment.

The Pro side agreed that the microfinance industry is already very large and is growing, but argued that this is not because of donor funding. MFIs are growing because of private money; in fact, only 4% of their funding is from donors. Donors may have had their day, but donor funding is no longer the industry driver. The microfinance sector is growing so fast that donors cannot keep up. Future growth is going to be financed mainly through deposits and commercial debt. Commercial banks already lend to MFIs in some markets and savings are the main source of financing for many institutions. Why focus on international financing when MFIs are already overwhelmingly locally funded? Only NGOs, which are a tiny percentage of the total microfinance portfolio, tend to be funded by foreign donors. Besides, even if the NGOs take some time to transform, they can serve as intermediaries between commercial banks and savers until they are able to directly mobilize deposits themselves.

Verdict The judges found the savings-led growth argument compelling but were skeptical that commercial funding would outstrip public funding within five years. They remained skeptical of the notion that a large number of very small savings deposits could cost-effectively finance the kind of outreach that the industry aims to achieve in the next five years. It seems that MFIs that have successfully financed themselves with savings have done so with the support of large institutional deposits and not just small savings clients. It is unknown what the dynamics of the deposit markets will be over the next five years. It is also unclear what the impact of declining donor support will be, considering that donors currently provide a not-insignificant 7% to 10% of microfinance funding.² The judges also questioned whether the current, catalytic role of donor money could still be relied upon by the private sector, five years hence.

Additional Comments The clarity of the debate was limited by a lack of citable empirical data and a lack of clear, standardized MFI investment terminology. Additionally, the debate raised several other issues:

- Typically, concern about enabling environments focuses on barriers to entry, but it is also important to address the impact of weak MFIs that are regulated. Do MFIs have the tools to

be stronger and take deposits? How do we deal with poorly performing MFIs that are taking deposits?

- There is a credit crunch in emerging markets as commercial paper (particularly government bonds) saturates domestic debt capital markets, which makes it more difficult for MFIs to access local private capital.
- Donors need to develop exit strategies.

Participants generally agreed that there is a horizon of ten years to make the microfinance industry stand on its own. It is possible, but donors often want to do something significant with immediate impact. Transition work is slow, requiring education, communication and patience. The financing currently available to MFIs is not necessarily the most appropriate kind. It will take some time to change the use of funds currently available and to facilitate access to new sources.

The Main Issues Revisited: MFI Transitions to Private Capital

In all, workshop participants emphasized several priorities to consider in transitioning MFIs to the private sector:

- Focus on local markets in addition to international debt and equity.
- Stimulate the enabling environment in select countries that are ripe.
- Strengthen local associations to facilitate ongoing advocacy (e.g., in the area of anti-usury laws).
- Address accounting standardization, disclosure, transparency and reporting issues.
- Strengthen internal MFI capacity.

What the Microfinance Sector Needs to Know about MFI Funding to Advance the Goals of Sustainability and Outreach

In closing, workshop participants made several suggestions for *Transitions to Private Capital*:

- Find and share success stories of private capital transitions that might be replicable (e.g., Uganda model or the ICICI partnership model in India).
- Build on successes that are geographically diverse and describe the conditions in which they occurred.
- Identify the regulatory and legal barriers to private capital access. Should these issues be addressed on a country by country basis?
- Identify the demand for private sector capital from the next generation of MFIs.
- Identify what kinds of institutions can transition to private capital; segment the microfinance market to better understand the issues for different types of MFIs (e.g., examine NGOs, postal banks, community development banks, loan funds, agricultural banks, etc.).
- Identify what happens when transformation is not an option.
- Propose how to accelerate the transition to private capital, which is already occurring but inevitably takes a long time.
- Identify how donors can best offer added value in assisting with the transition to private capital. How should they allocate scarce resources?

Endnotes

¹ Although this report provides supporting text or data in a few instances, for the most part it simply presents the points made in the discussions among workshop participants. Statements or statistical claims made by participants have not been verified. Thus, the opinions expressed in this document are those of the participants.

² Statistics between the *Pro* and *Con* teams due to citations of different statistics. The veracity of either citation has not been verified.

Appendix One - Workshop Participants

- Isabelle Barres, The MIX Microfinance Market
- Deborah Burand, FINCA
- Sandra Darville, Multilateral Investment Fund
- Marc de Sousa-Shields, Enterprising Solutions
- Kate Druschel, IRIS
- Cheryl Frankiewicz, Chemonics International
- Guatam Ivatury, CGAP
- Barry Lennon, USAID
- Kate McKee, USAID
- Ann Miles, Women's World Banking
- Terence Miller, USAID
- Zan Northrip, DAI
- Alex Silva, ProFund
- Julie Stahl, Grameen Foundation
- Sherry Sposeep, Chemonics International
- Didier Thys, The Mix Microfinance Market
- Damian von Stauffenberg, MicroRate
- John Wilson, Christian Brothers Investment Services
- Glenn Westley, Inter-American Development Bank
- Gary Woller, Chemonics International

Appendix Two - *Transitions to Private Capital* Planning Workshop Agenda

9:30 Welcome

9:30 Introduction of participants

9:50 Brief introduction to project and agenda

Objectives of Workshop

- Promote discussions on one of the most important topics for microfinance industry development;
- Elicit initial sector input to help shape the substance and direction of the *Transitions to Private Capital* research agenda;
- Define and prioritize the major MFI financing issues;
- Identify ongoing, related activities (research projects, pilot projects, etc.) with potential for collaborative synergies.

10:00 The main issues: MFI transitions to private capital funding...

What are the three most important issues related to the use of private sector funding by MFIs?

11:00 Break

11:10 Who is funding MFIs and Why?

Who Invests in MFIs and Why? What are their risk and return interests? And how do they impact MFIs – positives and negatives.

12:00 Lunch Speaker: John Wilson, Christian Brothers Investment Services

“Top Ten Reasons Why Private Capital *Should Not Invest* in MFIs: Experiences with Investment in Community Development Finance Institutions (CDFIs)”

CDFIs have a long history of accessing pure private capital as well as private capital that is pooled with the encouragement of supporting regulatory and policy interventions. John will talk about how private social investors view this fairly mature experience and what they find works and does not work.

13:00 Can private capital replace donors as the primary (non-savings) source of MFI funding? And if so, how and when....

Group discussion.

14:15 Break

14:30 Conclusions

15:00 What does the sector really need to know about MFI Funding to advance the goals of sustainability and outreach?

- What does the sector need to know, in order to better fund itself?
- What should *Transitions to Private Capital* do to contribute to these needs?
- Is it possible to collaborate with existing projects or activities?
- Who are the key people to contact?

15:30 Future opportunities to provide input to *Transitions to Private Capital*

16:00 Concluding comments

Financing MFIs: *Transitions to Private Capital* is a USAID-sponsored research project managed by the Chemonics International AMAP Consortium, with research direction provided by Enterprising Solutions.

For more information, contact Marc de Sousa-Shields at mdess@esglobal.com.