CONCEPT PAPER: ALTERNATIVE FINANCING MECHANISMS

Over the past ten years, for many NGO's the primary focus has been on expanding their lending activities to reach a significant percent of the micro-enterprise market. In an effort to achieve this goal and recognizing the limitations of donor monies to fund the desired increase in portfolio, a few NGO's have built links with the formal financial system. During this period they have developed "alternative financing mechanisms"; they have moved away from donor funding into the traditional sources of capital available to the typical corporation: internally generated funds, bank loans and both debt and equity financing raised in the capital markets.

One may identify three distinct stages in the evolution of the financial structure of the NGO's:

- ***Donor-Driven:*** the NGO's principal source of funding is from donations;
- ***Leverage:*** NGO's begin to leverage their equity with commercial sources of funding first with commercial bank credit (often collateralized with a cash collateral account or letter of credit) and over time, with capital market instruments such as bonds or commercial paper;
- ***Full Financial Intermediation:*** NGO's have, for the most part, transformed their institutional charter to allow them to mobilize deposits/savings from the public or to issue bonds and CD's as well as equity shares.

This Research Topic will describe the evolution of the capital structure of NGO's at levels two and three (with a focus on two) and at each level: identify the pre-conditions that must exist for the NGO to have access to these "alternative financing mechanisms"; describe the financing mechanisms; and explore the implications for the institution as the capital structure evolves.

The pre-conditions and implications are primarily in the areas of operational efficiency, asset/liability management, ownership and governance, and credit products.

- ***Operational Efficiency:*** As NGO's move away from donor dependence, and given a more competitive environment for microfinance services, there will be pressure on their financial margins and thus, a greater urgency in focusing on reducing administrative costs. What are the implications of this emphasis on containing/reducing costs for the credit methodology utilized by the institution?
- ***Asset/Liability Management:*** Liquidity management and gap management (interest rates and duration of assets and liabilities) also become important as NGO's move along the above mentioned continuum.
- ***Ownership and Governance:*** As NGO's move into the final stage and establish for profit banks and finance companies, governance and ownership issues need to be addressed if they are to be successful in raising the necessary monies and in establishing a solid governance structure.
- ***Credit Products:*** As the capital structure of microfinance institutions evolves, ther can be implications for the credit services provided by them. Once they have become independent of donor funding, their credit products can be altered substantially. For

example, there could be a broader mix of products such as consumer loans, housing improvement loans, education and so forth in addition to the working capital loans, particularly as longer term funding becomes more available.

(Note: the latter two will be treated in more depth under other MBP topics: Ownership and Governance and Evolution of Credit Methodologies)

The deliverables suggested under this Research Topic will explore the above mentioned stages in the evolution of the financing structure of NGO's, describing the role of retained earnings and commercial bank borrowing to fund portfolio growth as well as the role of debt and equity raised in the capital markets. As regards debt instruments, the focus will be on the issuance of "paper" or debt issued in the capital markets since **Savings Mobilization** is a separate research topic. Three other topics, **Institutional Alternatives**, **Supervision and Regulation** as well as **Ownership and Governance** are very closely related to the subject of **Alternative Financing Mechanisms** but since they will also be covered separately, these areas will not be discussed in an in-depth manner.

Deliverables

1. **Review Paper**: (50% DAI, 50% ACCION, last quarter l997) This paper will look at commercial bank borrowing by NGO's, and the evolution of this relationship over time, analyzed from the perspective of the borrower as well as the lender. The issues of security and profitability as well as flexibility and pricing will be discussed in depth to understand the key aspects for both lender and borrower. Special emphasis will be placed on regulatory issues that impact on the relationship between NGO's and commercial banks. The role of guarantee funds will be also be highlighted in this Review Paper since guarantee instruments have been key in the linkage with commercial banks. This Review Paper will also explore the extent to which the evolution away from donor funding to commercial bank money, has brought with it an understanding and application of asset/liability management as well as an increased emphasis on operating costs. Experiences will be drawn from within the ACCION's network, as well as from DAI's experience overseas (e.g. Haiti, Ecuador, etc.)

2. **Case Study**: (ACCION, first quarter l998) As NGO's continue to grow their micro-loan portfolios, they look beyond commercial bank loans to a more diversified, more abundant and cheaper source of capital which leads to their interest in tapping into the markets directly. We have examples in the industry of NGO's establishing formal banks, finance companies and specialized micro-lending institutions. This Case Study will explore how two institutions, Bancosol and Finansol, have raised the required equity to establish a bank and a finance company respectively. Special emphasis will be placed in describing the recapitalization of Finansol. The Finansol case especially will focus on the sources of equity available to micro-finance institutions at this point in time and the implications of these sources for the ownership and governance structure of these newly created institutions? It will describe the pre-conditions that micro-finance institutions must meet if they are to be successful in tapping into the traditional equity markets and from the perspective of the traditional investor, identify the hurdles that they must overcome if they are to make an investment in a micro-finance institution. The Case Study will also describe in depth the role that PROFUND, the specialized equity fund for micro and small business, has played in the two above-mentioned cases.

3. **Comparative Analysis**: (DAI, first quarter l998) The Comparative Analysis will look at three institutions that have tapped directly into the markets for debt instruments by issuing bonds (e.g. Grameen Bank, Bancosol and Fundacion Paraguaya). The Comparative Analysis will describe the pre-conditions in each case for doing so and the characteristics of the bonds issued. Also, the Case Study will explore the costs and benefits to the institution, both monetary and non-monetary, of raising these monies. In looking at the implications of issuing debt instruments, the Comparative Study will explore the extent to which these institutions are managing the structure and pricing of their assets and liabilities and how the product mix might have changed as a result of this type of funding. For example, does the existence of longer term funding result in the provision of fixed asset or other types of longer term loans?

4. **Review Paper**: (TBD, l999) This Review Paper will describe securitization of a micro-finance portfolio and since this has not happened to date, it will only be written if there is significant advancement in this area. For quite some time, the idea of securitizing micro-finance portfolios has been very appealing to industry specialists who see this as a way of broadening the financing possibilities available to microfinance institutions and also, of "leveraging" the equity of these institutions. At this point in time, there are no concrete examples to review but this might change given the interest that exists in doing securitization of micro-finance portfolios. This topic will describe the transaction and outline the conditions that need to exist for a microfinance institution to securitize its portfolios. The costs and benefits to the institution will be addressed as well as the implications of financing ones portfolio in this manner.