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MFI Financing Strategies and the Transition to Private Capital

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EXECUTIVE SUMMARY

In many countries, microfinance is now in a position to serve a significant portion, if not all, of the credit-worthy urban poor and a meaningful portion of rural poor. To achieve that level of outreach will require access to capital far beyond that which is currently available from traditional sources of development financing. As many MFIs are now demonstrating, it will take a combination of savings, domestic and international debt, and equity investment, very little of which will come from development agencies. Without consistent access to private sources of financing, it is unlikely that the microfinance industry will grow significantly or achieve broad-based profitability.

The way in which MFIs search for private capital is significantly different from the way the MFIs attract donor funding. Indeed, managing the liability side of the balance sheet, hitherto an under-appreciated part of MFI business strategy, is fast becoming a key ingredient to growth and success. This is as true for debt and deposit management as it is for equity capital, each of which demand distinct, but somewhat overlapping strategies.

Funding and capitalization strategies take place within the context of a sector transforming from one driven primarily by a social mission ethos to one that also responds to the needs and interests of private capital. The transition to private capital is well underway and some MFIs are mostly or entirely funded by private capital. But the transition has been slow and difficult as many MFIs lack the management capacity to attract and absorb private capital. Best practice knowledge, improved regulatory regimes, and stronger sector associations, among other interventions, are having positive effects on the sector's capacity. While improvements vary by country and institution, many MFIs now have or can develop the capacity to profitably employ commercial capital.

To make the transition to private capital, MFIs will have to play by a new set of rules -- those of the private sector. These rules are numerous, but all revolve around profit making, an objective that has not entirely entered the poverty focused lexicon of microfinance. Achieving funding goals also require *structured, professional funding strategies*. Some MFIs have such strategies, unfortunately most rely on rather informal and *ad hoc* approaches to funding. As MFIs grow, adopting professional strategies becomes all the more important, because growth is heavily contingent upon access to funding, which is increasingly only available from the private sector. In the absence of a clearly defined

funding strategy, MFIs typically drift toward the sources they know best, which are often non-commercial in nature. This tendency is amplified by the existence of a good deal of donor and donor-driven funding (e.g., via MFI specialty investment funds and development banks), which offer terms and prices not always in line with what the market would provide. These factors combine to make the transition to private capital all the more difficult.

A. PORTFOLIO FUNDING STRATEGIES

A1. DEPOSIT STRATEGIES

While "best practice" liability management is emerging, it is not well understood on a broad scale. On the deposit side, tremendous steps have been made to create appropriate regulations and transform MFIs. The challenge now is to grow deposits to the point where they become the main funding source for all transformed and transforming MFIs.

But deposit strategies are rarely well planned. Logically, the most often cited reason for mobilizing deposits was that they are generally considered to be the lowest cost and most stable funding available. Unfortunately, very few MFIs seem to know the true cost of deposit taking; while financial costs can be calculated, operational cost are difficult to determine. Some transforming MFIs in Uganda, for example, can only guess at the costs. In markets where commercial banks are entering the lower income deposit market as in Uganda, or in some intensely competitive urban markets, such as in Peru, not knowing costs can cause great strategic funding errors. As an executive in Stanbic Bank in Uganda pointed out "The low-hanging fruit has already been picked" and future growth in the low income deposit market will be more difficult and costly than many transforming MFIs expect. Still, as the same manager points out, there are other reasons for entering the market besides low cost funding, such as the opportunity to cross sell other fee-based services – something MFIs with their limited capacities may struggle to do well.

Despite the challenges and uneven success, MFIs are intermediating deposits, though with a range of strategic approaches. Three main strategies are emerging. One focusing collection of micro-deposits from the low income market. Another strategy is to market to both the low income market for micro-deposits and a higher income market for term deposits. This strategy usually implies term deposits with their lower operational costs bringing down the average cost of mobilization. Finally, there is the "Robin Hood" strategy that focuses exclusively on intermediating larger term deposits from the higher income personal and institutional markets to fund low income market loans.

A2. DEBT STRATEGIES

Even though the majority of microcredit loans are or will be intermediated deposits, debt remains vitally important to the sector. This is particularly true of larger MFIs, which require significant funds for liquidity and interest rate risk management. Because so few MFIs intermediate deposits, and because debt should constitute between 15 to 25 percent of a small financial institution, the global microfinance sector will need an estimated $3.1 billion in debt by the end of this decade. Hence, how it is supplied and sought is critical to the growth of the sector.

The range of debt strategies employed by MFIs is quite varied and generalizations across markets are hard to make. While this is true, there are some commonalities of note, particularly as they relate to the regulatory status, size and maturity of institutions.

Small Unregulated MFIs

Small, unregulated MFIs typically have the least ability to raise debt financing. Their challenges, as with most small businesses, revolve around lack of experience, untested or poor capacity, lack of credit history and poor collateral. Also, smaller MFIs are the least likely to develop formal funding plans and seldom have the sophistication to forge commercial ties with private lenders. Debt funding strategies of small, and to a lesser extent, medium sized unregulated MFIs thus tend to focus on grants, retained earnings, development bank funding, some international finance development agency funding, and, for the more savvy among them, commercial bank loans. [1]

Large Unregulated MFIs

Large, unregulated MFIs have the advantage of well developed funding networks with access to both international and national development agencies. It is less likely, but not all that uncommon, that funding networks extend to the private sector. Being unregulated severely hampers their market credibility, a fact normally exacerbated by NGO ownership – a type of owner that the private sector is unfamiliar with and often distrusts. The result is that most larger unregulated MFIs rely extensively on "development finance markets" for funding. This includes MFI specialty investment funds which are, for the most part, not entirely commercial. Constant maintenance and development of these networks is the primary strategy of largest (and some smaller) unregulated MFIs as their financing needs are significant and ongoing.

Some of these MFIs have successfully used development finance funding to lever commercial finance. Some MFIs use loans and grants from development agencies to guarantee commercial bank loans; similarly, some use foreign denominated loans to do "back to backs" to avoid currency exchange risk. [2] Most subsidized funding is, however, not used to leverage private capital as the perceived cost is too high, despite the fact that several MFIs have demonstrated that establishing a banking relationship leads to better and more flexible funding options in the future.

Unregulated, large MFIs are thus fairly limited in terms of the funding strategies they can pursue, particularly if they are not favorably rated by a commercial rating agency. Their strategies, as a result, tend to focus on getting funds from a mix of development banks, international lenders, some commercial banks, and donors. Retained earnings also play a significant role in portfolio finance, which severely limits capital available for capacity and growth investments. Strategies are, as a result, similar to those of smaller institutions as they rely on many non-commercial sources of capital as well as their own internally generated funding.

Newly Regulated MFIs

Newly regulated MFIs typically have well developed funding strategies from when they applied to transform into a formal financial institution because this is required by financial regulators. Plans typically include a host of debt sources that will supply loan portfolios until deposit collection generates significant funding.

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1 Development agency in this sense refers to any institution that provides financing for development purposes and can include: bilateral and multilateral development agencies, international financial development institutions (e.g. the International Finance Corporation or the InterAmerican Development Bank), foundations, national development banks, government funds, etc.

2 A "back to back" is a loan between two companies in separate countries in which they borrow each others currencies for a specified time and repay the other's currency at an agreed upon maturity or date.

Most MFIs have overly optimistic deposit funding projections and mobilization is typically slower and more costly than MFIs originally plan. As a result, reaching the ideal deposit to debt ratios and cost structures can take many years.

Other sources also figure large into newly regulated institutions. The existence of relatively inexpensive and readily available development bank capital in many countries often causes MFIs to reduce strategic dependence on deposits. MFIs also often have well developed relationships with local development banks and international development funders. Tapping these sources is often easier and cheaper than going to new sources, including the deposit market. Many newly transformed MFIs also have new equity partners specifically chosen for their connections to funding networks. Typically MFIs put in place several larger and longer term loans as a means to provide stable funding during the deposit mobilization start-up period. Private sources of debt mostly become available only once an MFI has proven it can survive the challenges of being a regulated institution. The transparency required and the oversight provided by regulators helps, but capacity, collateral and track record count more among most commercial lenders.

Despite a keener focus on private funding among newly regulated institutions, they still typically rely somewhat on development banks and international funders. In the case of the latter, quasi commercial debt financiers (e.g., specialty MFI funds) become more strategically desirable as they provide competitive terms for fairly large, longer term loans, and, as important, bring a degree of market credibility. [3]

Mature Regulated MFIs

Mature, regulated MFIs usually have well developed funding strategies based on long time funders and strong, or at least, predictable deposit operations. Unlike smaller MFIs, these institutions tend to actively manage liabilities to maximize profitability and minimize liquidity risk. The result is a more strategic selection of liabilities matching an institution's interest rate forecasts with deposit pricing policies.

MFIs at this stage become increasingly tuned to the strategic relationship between operational performance, market credibility, and the cost of debt funding. Increased market scrutiny and competition with commercial banks encourage MFIs to bring asset and liability strategies together in increasingly sophisticated ways, particularly if longer term loans are being extended. This creates asset and liability matching considerations. They thus often have a variety of deposits types. Most also continue borrowing from national and international development agency sources both for the terms (e.g., longer terms and favorable rates), as well as access to technical assistance and emergency liquidity.

Some larger MFIs have also accessed capital markets through bond issues and securitization. These are highly desirable strategies as they tend to offer low cost, long term financing for portfolio funding purposes and, in some cases, institutional investments. Unfortunately, few MFIs will be able to do either bonds or securitizations soon if only because transaction costs are significant and require large issues if they are

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[3] Market credibility may be more in the eyes of the beholder as over 50 percent of all MFIs receiving local private or development bank debt received it *before* international lenders arrived. This does not mean that international debt does not have market cache, it likely does, though the strategic implications of it may be over exaggerated. Clearly, it is in the interest of international lenders to wait until an MFI can take large enough loans to minimize transaction costs as a percentage of the overall loan. Waiting until after transformation also reduces overall perceived risk for the loan.

to be economical. Few MFIs can put large volumes of capital to work quickly enough. Other barriers include such things as issue and institutional credit ratings, and shallow financial markets, which prohibit bond issues.

A3. MFIS AND EQUITY STRATEGIES

Equity capital considerations overlap these portfolio funding challenges to some extent, but pose other unique challenges. First and foremost, equity is a scarce commodity for any industry, but it is entirely more scarce for one such as microfinance that faces so many information asymmetries. This is compounded by MFI owners who, for the most part, prefer like minded investors; that is to say, those who are appreciative, if not driven, by the poverty alleviation mission of microfinance. This further reduces the possible universe of investors to a very small number of players, typically international social investors who have very little funding available.

Key to best practice equity management is to develop strategies for minority shareholders to participate in MFIs in ways that allow them the comfort required to invest, without ceding control to them. MFIs should also target selling shares to investors with complementary businesses (e.g., insurance companies) or with specific know how that will help with growth and profitability (banking technology companies).

Sourcing and employing equity is fast becoming a critical challenge to the microfinance sector. Strategic equity investment is critical to the success of an institution, though rarely the largest source of MFI financing. NGO MFIs transforming into licensed financial institutions typically have the greatest equity investment needs and challenges of any type of MFI. They often face the dual problem of finding new investors to finance transformation and ensuring that new ownership maintains a focus on social mission. These problems reinforce one another as commercial investors have trouble valuing what they often regard as quasi-charitable institutions. Such concerns tend to restrict ownership of transformed MFIs to benevolent parties, depriving the institutions of the value they might gain from the discipline and know-how of commercial owners.

At the same time, local entrepreneurs in many microfinance markets generally avoid minority investment opportunities due to the rational fear that their rights will not be protected. Such investors prefer to have controlling interests in their investments and are much less likely to accept a secondary role than is the case in more advanced economies with better rule of law.

Possible strategies to overcome these equity investment challenges include:

- Demonstrate a credible commitment to returning profits to shareholders (such as through regular payment of dividends);

- Use of valuation experts to ensure fair share price;

- Offer different classes of shares with different ownership rights to keep investor confidence up and MFI mission drift anxieties down; and

- Increase openness to the governance and non-financial benefits commercial investors bring (i.e., do not limit universe of potential investors to social investors).

B. ENCOURAGING PRIVATE SECTOR MFI FINANCING

In the early 1990s, the primary strategy of development agency finance was to "bet on winning horses" or those MFIs that would grow to serve a significant number of poor. This is now a regular, preliminary condition. Development agency finance should have as its prime directive to invest in "winning horses," but do so in a way that increases access to private capital: in essence, yes, bet on the winning horse, but don't ride it to the finish, let the private sector do that.

There are many different things that donors can do to live by this directive. Primary among them is to support conditions for microfinance products and services competition. Access must mean more than access to one institution. The definition must be broadened to mean access to two or more competing formal financial institutions offering microfinancial services, otherwise consumers will not be free to consume by choice and there will be no pressure on MFIs to do better. A second important consideration is to make interventions fit the needs of the private sector rather than the needs of donors. Measuring impact, for example, is important but only in so far as appropriate products are being delivered to a growing market. If the products are deemed to be appropriate (i.e., fit the needs of the poor and low income), then profitability and growth are the only two necessary measures to determine the impact of the product. Any other measure, such as individual asset growth or improved health, might be important to understand but the onus should be on the development agency to measure this, not on the MFI. Requiring MFIs to report on other measures is inefficient and detracts from the goal of massification.

Other important initiatives that complement or contribute to the goal of creating a vibrant sector include: investments in the regulatory framework, public good investments (e.g., credit bureaus, etc.), and sector building activities. In terms of finance, some recommendations include:

- Build more and better programs that lever private capital (e.g., guarantee programs);
- Work with local capital providers to bring down information barriers between capital markets and MFIs;
- Be lenders of very last resort, or better yet, lend to lenders of last resort;
- Fund technical assistance on best practice liability management for MFIs;
- Insist on MFI liability strategies that target private sector capital;
- Work with national development banks to ensure best practice lending;
- Strategically wean MFIs off development agency finance;
- Encourage MFIs to sell shares to commercial investors that bring greater business discipline, specific know how, or complementary business activities; and
- Foster private sector interest in microfinance investments by encouraging greater MFI share liquidity and dividend payments.

Financing strategies touched on in this paper demonstrate that most MFIs are only partly playing by private capital rules. Certainly on the deposit side, tremendous steps have been made in creating appropriate regulations, transforming MFIs and sourcing deposits. The challenge now is to grow deposits to the point where they become the main funding source for all transformed and transforming MFIs.

While best practice liability management is emerging, it is still not well understood. This especially handicaps many small MFIs with great potential, but little guidance for financing strategies. Larger MFI funding and capitalization strategies often also lack the formality and precision required to access purely private capital.

Using development agency funding to leverage private capital is an important strategy for successful funding programs. The sooner MFIs invest in private capital relationships, the sooner the benefits associated with access to large, market priced capital can be reaped. Development agencies use financial and non-financial tools to provide significant access to capital at both the institutional and sector level.

Any exposure to private capital is important to MFIs if they are to forge long term funding relationship in the private sector. This is as true for equity as it is for debt, particularly for those MFIs in need of capital, but searching for “like minded” investors. There simply is not enough of this type of capital available. Introducing new shareholders through minority positions with share class protection appropriate to expected return on investments represents an emerging best practice alternative.

Integration into financial systems is a key part of the development of microfinance. It also necessarily includes *integration into local capital markets*, which are becoming increasingly critical as institutions grow and serve larger portions of the low income market.

INTRODUCTION

Microfinance in many countries is now in a position to serve a significant portion, if not all, of the credit-worthy urban poor and a meaningful portion of rural poor as well. To do this will require access to capital far beyond that which is available from traditional sources of development financing. It will take, as many MFIs are now demonstrating, a combination of savings, domestic and international debt, and equity investment, very little of which will come from development agencies.[4] As argued in *Financing MFIs: The Context to the Transition to Private Capital*, without consistent access to private sources of financing, it is unlikely that the microfinance industry will grow significantly or achieve broad-based profitability.[5]

The way in which MFIs search for private capital is significantly different from the way the MFIs attract donor funding. Indeed, managing the liability side of the balance sheet, hitherto an under-appreciated part of MFI business strategy, is fast becoming a key ingredient to growth and success. This is as true for debt and deposit management as it is for equity capital, each of which demand distinct, but somewhat overlapping strategies.

Best practice *liability management* is only now emerging as important for several reasons. First, early microfinance development necessarily and appropriately focused on best practice asset management. Second, liability management only became complex enough to demand sophisticated management strategies when MFIs reached significant asset sizes, as many have now achieved. Third, increasing competition for market share and capital has created a need for asset and liability management strategies to be more clearly linked. Other reasons, some of which are context specific due to unique institutional, regulatory or market situations, will be brought out in turn during the course of this paper. In fact, *few MFIs have structured, professional funding strategies*, which can help to

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4 Development finance agencies include multilateral and bilateral agencies offering loans or investing capital in MFIs.

5 This report assumes a moderate level of investment and financial literacy. Due to the number of terms that could conceivably require definition, providing a glossary of terms is not included. Rather, readers are invited to go to one of a number of helpful online resources that provide investment and banking terminology. For investment terms, see Investopedia at www.investopedia.com. For banking terms, see: http://www.glossarist.com/glossaries/ economy-finance/banking.asp. For terms specific to microfinance, see the Microfinance Gateway at www.cgap.org/docs/Guideline_ definitions.pdf. For those who prefer paper, Barron's *Dictionary of Finance and Investment Terms* is recommended. For those terms that are highly specific to this paper, readers are urged to examine the definitions in Annex 2 of this report.

efficiently attract the portfolio funding and equity required to grow and survive in increasingly competitive markets.

While there are some examples of clearly thought out and successful MFI financing strategies, most remain *ad hoc* and poorly focused. In Peru, for example, where sector rationalization (i.e. consolidation) is immanent, one would expect to find MFIs with well crafted funding plans. Instead, there are all manners of liability strategies, some very good and others less well conceived. As in all countries with competitive microfinance sectors, access to capital in Peru is fast becoming a critical part of achieving a competitive advantage. As it becomes increasingly scarce, capital will also become more discerning, awarding smart MFIs with funding, denying it to the less savvy. With few best practice points to reference, MFIs small and large are left to develop financing strategies with little guidance. This situation inevitably favors large MFIs over small, because they tend to be better known and have more contacts. This is unfortunate, as many smaller niche players provide valuable services in rural areas or to hard to reach populations. Best practice liability strategies that lead management to seek a range of capital types in an increasingly sophisticated manner are critical to the development of the microfinance sector and to its related impact on poverty alleviation.

Some private and quasi-private suppliers of microfinance capital have responded to this increasingly diverse and sophisticated demand from MFIs. Financing innovations, such as bond issues, tradable certificates of deposits and securitizations, once only distant financing dreams, are now viable options for some MFIs. Thanks to the creative work of institutions such as ICICI, the Grameen Foundtion, ProFund, ShoreCap and Blue Orchard, and MiBanco, among others, MFIs are now able to tap into new and better mine existing sources of private capital.

These innovators are, of course, responding to the opportunities created by successful MFIs and they are both knowledgeable and friendly sources. As microfinance integrates into mainstream capital markets they will necessarily compete for capital not just against each other as they now tend to do, but all other businesses seeking private capital. There, the immutable law of scarcity and opportunity costs apply and MFIs that come unprepared or ignore the rules of private capital do so at their own peril. Gone are the days when portfolio funding was a function of "simply" tapping donors or national development banks – though there remains an incredible residual attraction to such funding even from some of the most successful MFIs. Simply put, donor funding is not now and will never again be as abundant or influential as it once was in shaping microfinance markets. Even among donors, funding and investment conditions are typically more stringent than ever before (with some exceptions among a handful of funders providing inappropriately generous conditions).

There is still a role for donors to play, but MFIs must turn increasingly to private capital markets for their financing needs. From their growing experience, best practice liability management strategies are emerging, providing the sector with a demonstrably improved understanding of how to meet the needs and manage the vicissitudes of private capital.

A. SCOPE AND STRUCTURE OF THE PAPER

This paper is one of three created together as the second stage of "Transitions to Private Capital" research, funded by USAID under Chemonics International's Accelerated Microfinance Advancement Program (AMAP) Financial Services Consortium's

Knowledge Generation task order.[6] The objective of this research was to describe, compare and contrast MFI funding strategies, identifying those that contribute to the transition to private capital and those that do not.

A variety of secondary and primary data sources are used in this paper, including interviews with over forty microfinance sector experts and MFI executives in Uganda, Peru and the Philippines. [7] These countries were selected as a representative cross-section of developed microfinance markets from around the world. This paper does not, however, detail three case studies. Rather, it draws on examples from the three countries to illuminate trends and examples found in other countries as well.

Numerous types of institutions providing microfinance services are considered for this paper, though the focus is on the classic NGO-born MFIs. These institutions receive the most attention because they are unambiguously dedicated to microfinance and because their financing needs are especially challenging. Larger institutions and those which have, or will make the transformation into licensed, deposit-taking financial institutions are also of interest as they have a greater need for private capital and the resources to attain it.

Fully private, for-profit financial institutions offering microfinance services to low income markets are also discussed. These institutions are of interest because they put private capital, rather than ownerless NGO capital, at risk. Moreover, all signs point to commercial financial institutions' eventual dominance of microfinance sector in most countries. Thus, their success in attracting private capital financing is instructive to those wishing to understand capital sourcing in the financial services sectors of developing countries generally.[8]

The paper is divided into two main sections: Portfolio Funding Strategies, comprised of deposits and debt, and Equity Strategies. The paper concludes with a short discussion of incentives and strategies to expand private capital to the microfinance sector.

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6 *Financing Microfinance Institutions: The Context for Transitions to Private Capital* is available at http://www.microlinks.org/ev_en.php?ID=5967_201&ID2=DO_TOPIC Under Theme 5, Access to Capital. The other two papers in this series address the supply of private capital to MFIs and the regulatory environments governing investments in MFIs.

7 Field work missions and other interviews were conducted between April and June 2005.

8 Credit unions and financial co-ops were largely left out of this study because they are member owned. This gives them a variety of unique views on private capital.

PORTFOLIO FUNDING

As MFIs grow and mature, portfolio funding becomes an increasingly complex and multidimensional management challenge. This is particularly so of MFIs which manage deposits and debt funding. The goal of portfolio funding management is to provide the lowest cost capital possible from a good mix of sources to ensure liquidity while maximizing profitability. Cost is a function of financial costs (i.e. interest paid on loans or to depositors) and operational expenses incurred to source and manage loans or deposits.

Ideally, deposits and debt are primarily used for portfolio capital as they lever return on equity, and is generally too expensive for MFIs to use for financing physical assets. As MFIs grow and expand product lines, matching asset and liability terms becomes increasingly important to ensure proper portfolio liquidity: too much liquidity results in higher funding costs than necessary and too little can restrict lending and hence hurt profitability and competitive position in the market place. Funding decisions are, as a result, both complex and time sensitive. In addition, there are other strategic considerations that are hard to monetize, including speed of access, reliability of provider and quantity of funding available. [9]

The following discussion is an overview of portfolio funding strategies used by MFIs. It does not provide a detailed review of the various considerations and strategies employed by MFIs. Rather, it attempts to outline some of the main portfolio funding considerations and financing strategies made by MFI managers. This section is divided into two parts: deposits and debt capital.

A. DEPOSITS

Throughout the *Transitions to Private Capital* research, both the importance and the difficulties of deposit mobilization as an ideal financing strategy were cited by interview subjects and experts alike. MFI managers were generally positive about the cost and stability-related benefits of such a strategy, yet, they acknowledged high start-up costs and management challenges involved, from regulatory approval to product development and successful sales.

[9] Sylvia Wisniski's paper "Microsavings Compared to Other Sources of Funds," provides an excellent overview of the tension between financial and operational costs of portfolio funding. This paper is a must read for practitioners and project officers unfamiliar with portfolio funding complexities (Wisniwski, Sylvia, "Microsavings Compared to Other Sources of Funds", Eschborn, Germany: CGAP Working Group on Savings Mobilization - GTZ – BMZ, 1999).

For managers and owners, the decision of whether or not to pursue a deposit financing strategy was dependent on both internal and external factors. The most important internal factor was the size (or short-term growth plans) of the institution. As Maisch, Soria and Westley point out in their study of 61 Latin American MFIs, deposit mobilization is significantly more affordable for large institutions than for smaller MFIs.[10] As for external factors, the regulatory environment and the general availability of other forms of financing are key. Deposits were generally not seen as a desirable strategy in countries with serious legal barriers (such as in Uganda for medium-sized MFIs prior to the drafting of a new microfinance banking law), or in circumstances in which other forms of financing are plentiful and easier to access (as is the case for many MFIs in the Philippines). In Peru, institutions with the legal right to collect deposits do so with varying degrees of vigor, many choosing to rely in part on other sources of funding.

FIGURE ONE

DEPOSIT TAKING REGULATIONS

The existence of different banking licenses and regulatory policies friendly to micro-banking are important to take into account for those MFIs considering deposits as part of their financing strategy. Whereas the Philippines and Peru have a long history of licensed, commercial banking appropriate for serving poor clients (rural and thrift banks in the Philippines and EDPYMEs, Cajas Rurales and Caja Municipales in Peru), Uganda has only recently developed the regulatory framework for such institutions. Under previously existing banking laws, most of the currently transforming MFIs would have had trouble qualifying for deposit mobilization due to capacity issues and high minimum capital requirements. In fact, only two Ugandan MFIs already had banking licenses before the new law came into place. Clearly, legal and regulatory reform should be an important part of any national microfinance donor strategy.

Whether or not an MFI decides to pursue deposit financing, MFI and bank managers interviewed agree that savings are there to be collected, even from low income markets. Philippines rural banks participating in USAID's Microenterprise Access to Banking Services (MABS) project, for example, have raised twice as much money in micro-deposits on average than their micro-loan portfolios.[11] In other words, micro-depositors are more than financing the credit needs of micro-borrowers in these institutions and are effectively financing other investments as well. Similarly, commercial retail banks in Uganda have successfully adopted a strategy of aggressively expanding automatic teller machine (ATM) networks in order to capture lower income clients with low minimum opening balance savings products.[12]

[10] Maisch, Felipe Portocarrero, Tarazona Soria, Álvaro and Glenn D. Westley, "¿Cómo deberían financiarse las instituciones de microfinanzas?" InterAmerican Development Bank, forthcoming.
[11] MABS project estimates for the first four months of 2005 120 rural banks participated in the project.
[12] With minimum balances as low as the local currency equivalent of USD 5.

Table One **UGANDAN COMMERCIAL BANK ASSETS AND LIABILITIES**	NILE BANK (2004)	CENTENARY RURAL DEVELOPMENT BANK (2003)	CRANE BANK (2004)
ASSETS			
Client Loans	34%	43%	37%
Government Securities	29%	26%	26%
Deposits in other Banks	13%	4%	19%
Cash & Balance with Central Bank	11%	13%	10%
Other	1%	14%	8%
LIABILITIES			
Customer Deposits	74%	80%	84%
Share Capital & Retained Earnings	11%	14%	12%
All other	15%	6%	3%
Source: Bank reports	34%	43%	37%

Banks in developing countries are often overly liquid with deposits exceeding funding needs. This is as true of Ugandan commercial banks (see Table One) as it is of many Peruvian *Caja Municipales*, Philippine rural and commercial banks, and commercial banks in Ecuador, Mexico and Cambodia.[13] In these cases, the primary challenge is not the collection of sufficient deposits to meet liquidity needs, but the productive investment of plentiful cash. At present, a large portion of this liquidity is held in government securities, cash reserves, or placed in overseas investment accounts for lack of attractive local investment opportunities.

In light of this deposit-funded liquidity, it is no surprise that cash-poor MFIs are drawn to deposit mobilization. However, individual strategies used to access this source of funding are several, as are the challenges. Several factors impact deposit collection strategies – cost, availability and reliability, deposit insurance, regulation, compulsory savings, pricing and marketing. These factors are discussed below along with specific examples of how institutions in the case study and other countries have addressed them.[14]

B. DEPOSIT STRATEGIES

B1. COST OF DEPOSIT FINANCING

The most often cited reason for the desire to be financed through deposits was price. Over and again, managers of MFIs making the transformation from unregulated NGO to regulated bank argued that they were doing so to lower the financial cost of portfolio

[13] *Cajas Rurales* are specially licensed financial institutions with limited deposit taking capabilities. In theory, they are meant to operate in rural Peruvian communities, though in practice they provide services in urban areas as well. *Caja Municipales* are deposit taking institutions owned by local municipalities in Peru. They operate primarily in secondary cities, though a number of them have established presence in Lima, the capital city of Peru.

[14] While some operational aspects of these deposit strategies are noted, no attempt to provide definitive best-practice operational guidance is intended.

funding. The current (and striking) rush to transformation in Uganda is clearly motivated by this consideration. MFI managers plainly see that commercial Ugandan banks pay little or no interest on their micro-deposit demand accounts while MFIs borrow from those very same banks at 17-22 percent annually. Similarly, much Philippine MFI financing comes from government-affiliated development banks at 13 percent, while rural banks, which are licensed to take deposits, pay clients between 2-4 percent for savings and demand deposits, and 6-10 percent for time deposits.[15] In Peru, deposit collecting *Caja Municipales* also enjoy financial costs of funds on average 10 times less than specially licensed EDPYMEs, which are unable to take deposits.

The financial costs (the actual interest paid on portfolio funds), however, does not indicate the true total costs of deposit collection. Micro-deposit accounts involve large numbers of very small transactions and require a strong bank infrastructure. The total effective cost of mobilizing savings is thus much higher than the nominal rates of interest paid to depositors. Calculating just how much higher is a difficult and complicated exercise in cost accounting for a small bank.

Very few MFIs in the case study countries had successfully calculated the real cost of deposits, despite being generally convinced that costs would be lower than other borrowings. This is understandable given the complexity of such calculations, but not strategically satisfactory. One Ugandan microfinance expert estimated that the one-time cost of NGO transformation into a micro deposit-taking institution (MDFI) under that country's new microfinance law to be approximately one million USD. Considering that the total equity value of most transforming MFIs in Uganda at between USD 750,000 to 1,500,000, this is a very large and risky investment to be made without a clear idea of resulting financial benefits.

When asked directly about their estimated cost of deposit financing, MFI managers gave varied responses. The Managing Director of one MFI in Uganda, for example, undertook a cost benefit assessment of deposits which estimated initial effective cost of deposits would be 50%, but would then go down to 20% (around the cost of bank loans) in the year after transformation. In contrast, another Ugandan MFI with a less rigorous assessment calculated their cost to be 10%, while another claimed 8% and yet another 5%. The remaining institutions simply and honestly admitted that they did not know what the eventual costs would be, but assumed that it would be less expensive than bank debt.[16]

FIGURE TWO

TECHNOLOGICAL SOLUTIONS

Another transaction cost lowering strategy for micro deposits is the use of Automatic Teller Machines (ATMs) . Commercial banks in Uganda, some Philippine rural banks and a range of financial institutions in Peru are, like others in many developing countries, rapidly expanding their ATM networks in an effort to lower costs and expand services to micro clients. As their prices continue to drop, ATMs can be a very attractive alternative to branch expansion.

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[15] People's Credit and Finance Corporation, the Philippine development bank charges MFIs 12% plus a 1% fee, to be precise.

[16] Richardson, David, "Going to the Barricades with Microsavings Mobilization: A View of the Real Costs from the Trenches," in The MicroBanking Bulletin, Issue 9, July 2003.

This apparent lack of concern amongst Ugandan MFIs is likely related directly to another aspect of their financing strategy. Essentially all of the mid-sized microfinance NGOs providing (or failing to provide) cost estimates are financing transformations into deposit-taking institutions largely with international aid in the form of grants. This means that most of the up-front costs of transformations are being paid for directly by international donors. Their computer system upgrades, physical improvements to branch facilities and a great deal of staff training will therefore never have to be financed through the expected cost savings of deposit intermediation. So, the exact amount of the expected savings are not critical to their decision-making process or funding strategy. The subsidies effectively "lowered the bar" for transformation by removing amortizable one-time expenses from the deposit mobilization cost equation.[17] Accurate cost accounting is thus less critical to these MFIs than it would be if they had to pay for it themselves.

FIGURE THREE

GANANCIA BOXES

Philippine rural banks have reduced the transaction costs of their micro-deposit businesses via the development of "Ganacia Boxes." These small, cardboards boxes are given away to clients at no charge to be used as piggy banks. Clients are encouraged to put their savings contributions into the boxes daily and to only bring them in to the bank occasionally, making for larger and less frequent (and thus less costly) transactions.

B2. AVAILABILITY AND STABILITY

Another reason cited by MFI managers for the desire to be financed primarily through mobilized deposits was their general availability and stability as a funding source. Debt financing (discussed in more detail below) is simply not dependable enough. Loans impose liquidity problems on the financial institution as they inevitably come due in sizable blocks and either need to be refinanced by new loans or paid off by liquidating assets or putting off new investments (such as income generating loans). Deposits, unlike other, less predictable, sources, are not as likely to disappear when governments, donors, development banks or international funds change strategic direction.

Even MFIs that are generally content with their present debt funding (such as many microfinance NGOs in the Philippines) would like the option of deposit mobilization as a hedge against the day when current sources of debt disappear. The combination of CARD NGO and CARD Bank of the Philippines is an interesting example of this strategy. The microfinance NGO, CARD, created a licensed bank and turned over some of its larger branches to it, but has not yet aggressively pursued deposit collections or a full transfer of the NGO's assets to CARD Bank. CARD's management believes that retaining much of its assets in the NGO gives it several advantages (such as lighter tax and regulatory treatment). The existence of the licensed bank, on the other hand, gives CARD NGO clients access to different financial services (such as voluntary savings and term deposits) and also stands ready in case the operating and regulatory environment turns unfavorable to NGOs and deposit mobilization becomes a more critical source of

[17] Interestingly, Commercial Microfinance, the only wholly for-profit MFI in Uganda has benefited much less from international subsidies than have its NGO competition. Part of this is due to the fact that although it is at the same scale as some of the microfinance NGOs, it already has a banking license and so did not qualify for transformation-related funding. Still, it would appear ironic that the new shareholders of transformed microfinance NGOs have benefited from a generous subsidy for converting into for-profit institutions while the one institution that had been operating under a market-based financing strategy all along has not been similarly rewarded. Such is the difficult nature of subsidy provision.

financing. This arrangement creates some duplication of overhead expenses, but the cost is seen as a worthwhile investment. Opportunity International affiliates have a similar two-tiered network of several NGOs and a licensed bank in the Philippines for the same reasons.

But are there really sufficient deposits to be collected? In the Philippines, the market shows few signs of being earnestly exploited by MFIs and appears to contain a fairly large unmet potential. In Uganda and Peru, however, where debt funding is more important and less easily found, unregulated MFIs generally operate from loan to loan. In light of increasing competition, this precarious situation of hoping loans will continue to be renewed is viewed as untenable by most MFI managers. As a result, most mid and large-sized Ugandan MFIs, will attempt to transform under the new microfinance law and EDPYMEs in Peru are lobbying hard for the right to collect deposits. It is not entirely clear, however, that either of these markets can absorb so many new deposit taking institutions quickly, a key, but seemingly neglected part of MFI funding strategies.

As many as six Ugandan microfinance NGOs, for example, have very recently or will soon transform into deposit taking institutions. While there is more than enough room for any one of these institutions to enter the deposit market, all of them joining commercial banks and other financial institutions at the same time will create intense competition, particularly in urban markets. According to Kitili Mbathi, Managing Director of Stanbic Bank "The low-hanging fruit has already been picked" and future growth in low income deposits will be more difficult and costly than many transforming MFIs expect." Stanbic, a commercial bank with a growing network of over sixty branches and over seventy five ATM machines, is already the largest low income deposit collector in the country and aims to expand its operations into the micro-lending business as well. The competitive effect of such large "downscaling" deposit operations were conspicuously absent from the comments of MFI managers when discussing their own financing strategies.

Other microfinance actors in Uganda are more concerned about deposit scarcity, however. Paul Rippey of the United Kingdom's Department for International Development (DFID) Financial Sector Deepening Project is skeptical of the market's

FIGURE FOUR

DEPOSIT INSURANCE

The ability of any financial institution to collect deposits is largely tied to the clients' belief that their savings will be safe. To this end, deposit taking institutions in Uganda, the Philippines and Peru benefit from deposit insurance programs. In the Philippines, depositors are protected up to approximately USD 4500 and in Peru up to approximately USD 18,000. In their respective markets these are significant amounts for low income depositors. In Uganda, depositors in commercial banks (including their micro-deposit demand accounts) are insured up to approximately USD 1700, though this coverage has not yet been extended to include banks licensed under the new microfinance law (putting them at a distinct competitive disadvantage). Deposit insurance is viewed by the market and local aid agencies as very important to the success of deposit collection, especially for small institutions, such as transformed NGOs, which lack the apparent solidity of commercial banks. This is especially true in countries such as the Philippines and Uganda that have recent histories of bank failures. It is an obvious financing strategy for uninsured institutions to lobby for inclusion in such schemes or to create parallel systems for their own use. These very discussions are currently underway in Uganda, but have not yet come to pass.

ability to absorb all of the new entrants. He argues that the potential number of depositors is roughly determined by the following formula: the population of Uganda divided by the number of people per household minus the third of the country that is simply too poor to make use of deposit services (approximately 26 million people divided by five per family, less one-third). This equals approximately three million potential depositors. Of these people, many will be hard to serve rural poor. If Rippey is right, competition for deposits, especially in urban markets, will become fierce in the next several years, which, he asserts, will be a good thing for consumers but not necessarily for deposit-starved MFIs. In light of such examples, market research is clearly an important activity for any MFI considering entering the deposit-taking market.

B3. COMPULSORY SAVINGS

Some unregulated MFIs in the Philippines and Uganda have used "compulsory savings" to provide collateral for their otherwise unsecured loan products. While the exact legal status of such cash collateral differs from country to country, the right to on-lend deposits of any sort is generally reserved to licensed banks which have proven (via the licensing process) that they have the capacity to do so responsibly. Most regulators require that this compulsory savings be held in cash or cash equivalents such as in government securities or deposit accounts in other banks. In short, these deposits are not to be put at risk by unsupervised institutions.[18]

This is not always the case in practice. Several Ugandan MFIs reported that part of their previous financing strategy had been to use compulsory savings as cash collateral for loans from commercial banks. This improperly placed the funds at risk of repossession by their lenders. The process of formal licensing has required that MFIs wishing to become formal financial intermediaries stop this practice, as the same funds are essentially being used as two sources of loan guarantee (one for the client's loan and one for the MFI's loan). The success of this mandate is good evidence of the transparency value of regulation.

In the Philippines, many unlicensed microfinance NGOs are directly intermediating compulsory savings. In fact, some are asking the central bank to allow them to do so legally and without additional regulation. The microfinance NGOs argue that *for the most part* clients' compulsory savings are less than their loan balances and so the clients' money isn't really at risked. In other words, the compulsory savings only represents money that is owed by the clients to the MFIs anyway. If the MFI fails and the compulsory savings are lost, the clients can simply stop making payments on their loansand have no net losses. In any case, the Philippine Central Bank is aware that it is happening and is tolerating it for the time being.

These Philippine microfinance NGOs are, in a sense, reaping the benefits of having a bank license without having to bear the costs of regulation. Where the EDPYMES of Peru and the microfinance NGOs of Uganda are preoccupied with securing debt financing, Philippine microfinance NGOs are much less anxious about their funding. With intermediated compulsory savings making up 20–50 percent of their loan portfolios, their need for other sources of financing is less.

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[18] For more on the subject, see "Microfinance Consensus Guidelines Guiding Principles on Regulation and Supervision of Microfinance," Robert Peck Christen, Timothy R. Lyman, Richard Rosenberg, CGAP, 2003

B4. CROSS SELLING AND CAPACITY BUILDING

A final general reason cited for the strategy of deposit mobilization is that the infrastructure necessary for such operations can be leveraged for the delivery of other financial products. Depending on local regulation, a deposit-taking bank might offer insurance, foreign exchange, money transfers, direct salary deposits, telephone air time, utility-bill payment mechanisms and debit card point-of-sale services to its clients. According to Robert Warlow, Managing Director of Crane Bank of Uganda, Crane is pursuing deposit mobilization from lower income clients primarily for their service-fee generation value and only secondarily for their value as a source of funding. In just three years, Crane Bank has gone from serving only corporate and higher income clients with traditional banking services to having a large majority of low-income, non-interest paying demand deposit clients. While these savers supply only 1-2% of the bank's total financing, they are still seen as valuable clients. At least two other commercial Ugandan banks (Nile and Stanbic) are pursuing low-income clients on a large scale, as well.

Table Two

PHILIPPINE MFIs INTERMEDIATING COMPULSORY SAVINGS

(In millions of Philippine Pesos)	MFI A	MFI B	MFI C
Total Loan Portfolio	391.0	290.6	264.0
Compulsory Savings	125.7	63.6	132.0
Percentage	32%	22%	50%

Names of these three MFIs withheld upon request, 2005 data.

Experience in other countries demonstrates, however, that adding products and services can be a slow and incremental process. Many *Caja Rurales* in Peru have been operating for over a decade and still offer a very limited range of savings products.

B5. Products and Marketing

Success or failure of a deposit collection business can hinge on correct product offerings and marketing efforts. This is very true of MFIs that often begin with only term deposits, such as in Peru and Bolivia. In general, term deposits are much less costly to source and manage than are demand and voluntary savings accounts, and they offer a lower-risk entry into the market. Some institutions have, on the other hand, gone in the opposite direction and diversified their product lines in order to cater to targeted saving needs, such as in Uganda and the Philippines. Some MFIs, for example, attract low income clients by offering school savings, motorcycle-taxi savings, and wedding savings products to their clients in addition to regular savings, demand and term deposits. This micro deposit focused strategy differs from that of many Latin American MFIs who focus on wealthy individuals, businesses, and institutions for large, long term deposits. Such a strategy effectively causes the MFI to work in two distinct markets -- low income loans, high income deposit – which react differently to market conditions.

Many MFIs and banks interviewed also offered introductory no-fee periods and even ran new customer lotteries offering large prizes, such as appliances and cash gifts, to depositors. Competitive pricing is very important as well. For example, rural banks in the Philippines generally offer higher interest rates on their savings products than do commercial banks (2.5–4.0 percent as opposed to 1.5–2.0 percent). This is also the case in Peru where commercial banks pay negative interest rates on deposits, and the *Cajas*

Rurales pay significant premiums on savings in order to attract clients. One rural bank in the Philippines is successfully taking advantage of tax breaks on long term deposits with an advertising slogan of "Double your money in six years!" Recently transformed Philippine MFIs have realized that the public doesn't understand that they are licensed banks and are now designing public education campaigns to correct the false impression that they are still "just charities."

B6. DEPOSIT MANAGEMENT

Once an MFI has managed to collect a significant amount of deposits the work of managing terms and pricing begins. For small MFIs with a limited range of loan and savings products, this is a relatively straightforward exercise that requires constant attention but not a great deal of sophistication. In essence, an MFI need only ensure, as it had prior to mobilizing savings, that the institution has enough liquidity to continue projected growth and maintain required reserves, etc. Because most loans are short term (between one and 12 months), matching liabilities to cover sales is relatively simple.

Where it gets complex is when MFIs develop a broader range of loan products with varying term lengths. This requires relatively, though not tremendously, sophisticated matching analysis and more precise fund raising strategies, such as loan sales or some of the marketing programs listed above. Pricing is particularly important for term deposits as term clients are notorious for changing institutions for even slight differences in interest rates. For MFIs with term deposit funding strategies, such as many in Latin American countries, concentration risk (the risk that a number of larger deposits will be lost at the same time) is very real. As a result, pricing must become a strategic science if clients are to be retained and profits maximized.

Deposit pricing and management is highly context- and institution-specific and no trends are readily apparent in the case study countries, with the exception of MFIs with uncomplicated product offerings. Readers interested in this topic are invited to review papers by Maisch, Soria and Westley and Wisniski.[19]

C. COMMERCIAL DEBT

Even though the majority of microcredit loans are or will be intermediated deposits, debt from banks, investors or non-commercial funders will remain vitally important to the sector. This is particularly true of larger institutions that require a significant volume of funds for liquidity and interest rate risk management. Debt in large commercial banks usually ranges from 20 percent to 30 percent of liabilities. In smaller commercial banks, it comprises a smaller portion of liabilities, usually between 5 percent and 20 percent.[20] Debt needs are many but two stand out: i) rapidly available short-term funds; and ii) large quantities of long-term funding. Medium- and long-term debt is particularly important when deposits cannot keep pace with loan demand, or in times of economic crisis.

In microfinance, similar liability patterns are emerging. *Cajas Municipales* in Peru, for example, average around 80 percent deposit funding, with a range from 60 percent to 100 percent of portfolio funds coming from deposits. MiBanco, also in Peru, targets a

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[19] Maisch, Felipe Portocarrero, Tarazona Soria, Álvaro and Glenn D. Westley, "¿Cómo deberían financiarse las instituciones de microfinanzas?" InterAmerican Development Bank, forthcoming; and Wisniwski, Sylvia, "Microsavings Compared to Other Sources of Funds", Eschborn, Germany: CGAP Working Group on Savings Mobilization - GTZ – BMZ, 1999.

[20] Wisniwski, Sylvia, "Microsavings Compared to Other Sources of Funds", Eschborn, Germany: CGAP Working Group on Savings Mobilization - GTZ – BMZ, 1999.

debt to deposit ratio of around 60 percent of its funding portfolio. In many countries, however, MFIs still struggle to achieve their ideal deposit-debt ratios.

Recent research by Anne Miles of Womens' World Bank and Nimal Fernando of the Asian Development Bank, show that many long-transformed MFIs still require significant debt to maintain asset growth and/or prudential levels of liquidity.[21] In fact, among intermediating MFIs, debt comprises around 50 percent of portfolio capital on average.[22]

There are, of course, many MFIs that rely entirely on debt. Their funding strategies are particularly instructive as they effectively pay off one loan with the next. The danger in this strategy is that any lapse can result in serious liquidity problems, including default or sudden interruptions of critical lending or other services to clients. Many hundreds of MFIs around the world face this constant challenge, including several unregulated Philippine and Ugandan MFIs, and EDPYMEs in Peru profiled in the following section.

C1. DEBT STRATEGIES

The range of debt strategies employed by MFIs is quite varied and generalizations across national markets are often hard to make. While this is true, there are some commonalities of note, particularly as they relate to the regulatory status, size and maturity of institutions.

It is important to note that within most markets, there is a fairly standard range of debt sources available to MFIs. Again, while the availability, terms, and quantity of supply varies by country, in general, national development banks, international donors/banks (multilateral and bilateral programs, foundations) provide the bulk of financing. They are followed by international lenders, such as Triodos Doen, Oiko Credit, Blue Orchard and Microvest, and domestic commercial banks. Terms and conditions of lending tend to vary as well. Table Three shows debt funding sources for Peru and Uganda.

MFI access to each source of funding varies by institution, though the general maxim of capitalism applies: those who have capital typically have greater bargaining capacity and tend to get more than those who don't. For the purpose of simplicity this section assesses four categories of MFIs: small unregulated institutions, transforming and/or larger unregulated MFIs, newly transformed MFIs and mature regulated MFIs.[23] As will become apparent, the strategies characteristic of these classes of MFIs overlap, and again, national market context exerts a good deal of influence on both the general and more nuanced nature of funding searches and liability management. (see Table Eight on page xx) for a summary of funding strategy commonalities)

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21 Miles, Anne *Financial Intermediation and the Integration of Regulated MFIs*, MicroBanking Bulletin, Issue 11, May 2005 available at http://www.mixmbb.org; Fernando, Nimal, "Micro Success Story? Transformation of Non-government Organizations into Regulated Financial Institutions," Regional and Sustainable Development Department, Asian Development Bank, June 2004, available at: http://www.adb.org/Documents/Studies/microfinance-success/default.asp

22 de Sousa-Shields, Marc and Cheryl Frankiewicz, "Financing Microfinance Institutions: The Context for Transitions to Private Capital", 2004 for more commentary on commercial pricing of equity.

23 For the purposes of this paper, MFI size classifications corresponds to those found in the MicroBanking Bulletin: in Africa, Asia, Eastern Europe and Central Asia, and the Middle East and North Africa a small institutions have assets of less than USD 2 million, medium have USD 2 to 8 million, and a large over USD 8 million. In Latin America small institutions are less than USD 4 million, medium USD 4 to 15 million, and large greater than USD 15 million. A newly regulated MFI has four years or less of regulation. This classification is somewhat arbitrary, but is based on the amount of time it takes most MFIs to overcome some of the challenges related to developing, launching and managing deposit capacity.

C1A. SMALL AND MEDIUM SIZED, UNREGULATED MFIS

Small, unregulated MFIs typically have the least ability to raise debt financing. They often begin operations with a grant from a development organization and expand via new donations and retained earnings. This financing reality remains until the MFI demonstrates its ability to achieve scale and a performance track record worthy of credit from development agencies or private sources (or the MFI closes due to its inability to do so before donor funding dries up).

In the early stages of operations, borrowing strategies are often linked to the capacity of donor support organizations to source new capital. Strategies are strongly linked to performance and growth. If growth and performance are strong, MFIs can typically develop funding strategies for a wider range of funding possibilities. Otherwise, choice is not an option. In either case, most strategies are fairly informal and traditionally there has been little or no interest in or capacity to attract private sector funding.

Thus, for the most part, growing small and medium sized MFIs favor and seek out term loans from international development finance sources or, if available, from national development banks. Not only do MFIs typically have the well developed networks that can provide access to these sources more than they do to access commercial funding, but price and terms are often more favorable as well. It is worth noting that development bank debt is not always subsidized. In Peru and the Philippines, commercial bank debt, if available, can come at slightly lower interest rates.[24] One would expect this to provide MFIs some incentive to pursue commercial banks relationships, but it seldom does. Ease of access, soft collateral requirements, and the complexity of forging commercial ties often provide strong disincentives to seek commercial capital as a funding strategy for many small and some medium sized MFIs. Of course, in many other countries such as Mexico, Nigeria, and India, development banks have provided in the past or are currently providing highly subsidized debt to MFIs – giving them less incentive to make the transition to private capital.

Another important and often unheeded incentive to source local capital is foreign exchange risk. Many small and medium sized unregulated MFIs take relatively large hard currency loans as a percentage of overall funding. In Peru, for example, many EDPYMEs have as much as 20 percent of their funding liabilities in USD or Euros. In times of financial sector crisis, such as that which caused an over 50 percent devaluation of the Dominican Republic's Peso earlier this decade, has serious implications for institutional solvency. This threat is particularly acute because few, if any, smaller institutions have the ability to hedge against such risk. Institutions are willing to accept this strategic, foreign exchange risk for three reasons. First, and foremost, there are few other sources available to them. Second, some institutions do not fully understand the nature of

FIGURE FIVE

PRIVATE BORROWING JUST IN CASE….

One interesting example of a Philippine MFI that has been successful in using its loan portfolio as collateral for commercial debt is Tulay Sa Pag-unlad Development Corporation (TSPI). Interestingly, TSPI's bank borrowing has been more of a strategic decision to maintain fall-back lines of credit than a source of primary funding. TSPI is pursuing this strategy of deliberately cultivating surplus lines of credit against the chance that development bank debt might disappear or that the central bank clamps down on its intermediation of compulsory savings.

[24] Specifically from the People's Credit and Finance Corporation (PCFC), a major Philippine MFI creditor. In the case of Peru, Agro Bank and COFIDE provide various priced funding around market price (some above, some below) to MFIs.

the risk involved. And finally, because foreign borrowing provides a degree of market credibility it can use to lever other funding.

In both Uganda and the Philippines, smaller and medium sized MFIs expressed a clear lack of desire for hard currency debt. All of the internationally sourced debt encountered in those two countries was either made in local currency or was used as cash collateral for a local currency loan from a local lender in the form of a "back to back" loan, lessening MFI exposure greatly. Despite the added expense of this strategy, MFI managers in these two countries were adamantly against taking on unnecessary foreign exchange risk. This strategy is less common in Peru and in many other countries simply because of the added cost.

Small and medium sized institutions' funding strategies are also limited by their inability to provide collateral or guarantees for commercial bank loans. Portfolios, usually an MFI's largest asset, often have very limited guarantee appeal to commercial lenders unfamiliar with the business of microfinance. A typical commercial bank to MFI loan structure in Uganda (to small and medium sized MFIs) has 40 percent of the principle covered by cash collateral, for example. The balance is then over collateralized by 2 to 4 times with portfolio pledges, leaving the MFI highly under-leveraged, which negatively impacts profitability (and hence potential growth). In many countries, commercial banks will not lend against microcredit portfolios at all. Where available, the cost of loans are sometimes so high that they do not attract much strategic consideration.

Despite the cost, many MFIs have strategically sought commercial bank funding to their long term advantage. XAS Bank in Mongolia, for example, established an early commercial bank credit history, as did ACLEADA Bank of Cambodia.[25] Laying the ground work for access to commercial capital early has helped these two MFI s grow to become major financial institutions in their respective countries and to attract the interest of private equity investors. Similarly, Tulay Sa Pag-unlad Development Corporate in the Philippines has taken a similar strategy of deliberately engaging commercial lenders before a true need arose. (See Figure Five)

[25] See: de Sousa-Shields, Marc and Frankiewicz, Cheryl, *XAC Bank: From the Liability Side of the Balance Sheet*, in MicroBanking Bulletin, Issue 11. Available at www.mixmarket.org.Kooi, Peter, Raising Capital through Equity Investments in MFIs: Lesson from ACLEDA, Cambodia, UNCDF/SUM and UNDP Africa, New York, NY, 2001.

Table Three

SOURCES OF DEBT FOR MFIS IN PERU AND UGANDA*

Peru	Cost	Terms	Other Conditions	Desirability	Percentage Market Share***
National Development Banks	Near Market*	Mid Term	Non Market (e.g., grace periods, non recourse etc.)	Strong due to availability	60 percent
Bilateral MFI Support Programs	Near Market to highly subsidized	Mid Term	Uncollateralized Ranges from market to non Market (e.g., grace periods, non recourse etc.)	Strong due to low price, some aversion to reporting requirements	5 percent
International Development Banks	Near Market	Mid to Long Term	Market terms, collateralized, under collateralized and uncollateralized. Mostly hard currency	Strong due to the terms, loan sizes available and market credibility	10 percent
Donors	Highly subsidized	Short to Mid Term	Unique and sometimes onerous reporting requirements.	More interest among NGO MFIs	5 percent
International Lenders	Near Market	Mid, some long Term	Market terms, some under collateralized deals.	Strong due to the terms, loan sizes available and market credibility	5 percent
Commercial Banks	Market	Short Term	Portfolio pledge, cash pledge or international guarantee.	Medium interest due to higher price, rapid access favorably viewed	2.5 percent
Capital Markets	Market	Mid to Long Term	Market, varies for each instrument.	High interest low participation due to commercial rating requirements and complexity of access.	2.5 percent

Uganda	Cost	Terms	Other Conditions	Desirability	Percentage Market Share***
National Development Banks	Near Market		Non Market (e.g., grace periods, non recourse etc.)	Desirable rates, but low supply.	5%
Bilateral MFI Support Programs	Mainly grants and guarantees at below market rates.	Short to Mid Term	Uncollateralized Ranges from market to non Market (e.g., grace periods, non recourse etc.)	Sought-after.	N/A
International Development Banks			Market terms, collateralized, under collateralized and uncollateralized. Mostly hard currency	Sought after.	
Donors	Mainly grants and guarantees at below market rates.	Short to Mid Term	Unique and sometimes onerous reporting requirements.	Both sought-after.	N/A
International Lenders	Near Market	Short to Long Term	Market terms, some under collateralized deals.	High interest for local currency where available, hard currency used as guarantee for local borrowing.	40 percent
Commercial Banks	Market	Overdraft or Short Term	Portfolio pledge, cash pledge or international guarantee.	High interest because it is the largest source of local currency debt.	50 percent

* The Philippine market was not presented due to the relatively few sources of commercial debt capital used.
** Market refers to prevailing rates offered by commercial sources, such as banks
*** Based on authors estimates.

Other institutions, such as the Womens' World Banking affiliates in Colombia, have used loan guarantees from international development agencies to source local commercial bank loans. Bound by regulatory regimes that make unsecured or partially secured lending to MFIs expensive no matter the risk, commercial banks in some countries have taken guarantees from national or international development institutions, either alone or in combination with cash and/or portfolio pledges, as surety on loans to MFIs. These guarantees are thought to not only provide access to capital, but to also decrease prices and improve terms. The evidence is mixed on the effectiveness of guarantees in reducing overall borrowing costs, but they are often effective at initiating relationships between MFIs and commercial banks, which later lead to independent borrowing

FIGURE SIX

THE COMMERCIAL BANK FUNDING ADVANTAGE

Those MFIs that intermediate savings and are growing more slowly, along with commercial banks downscaling into the microfinance market, tend to finance themselves mostly through deposits and to use debt much more sparingly. Such financial institutions tend to be liquid with deposits and are more likely to lend to MFIs than to borrow to finance their own microfinance activities. Centenary Rural Bank of Uganda, a licensed rural bank involved in the micro, small and medium enterprise lending, is in exactly this position. It would even prefer to slow down the growth of its deposit operations somewhat. It has taken to lending to non-intermediating MFIs in its search for productive lending opportunities outside of its own clients and government securities.

relationships. In Uganda, for example, USAID's Development Credit Authority (DCA) guarantee program has worked with five banks and facilitated ten MFI loans totaling almost USD 2 million of borrowings in recent years. Generally speaking, though, they do not figure as large as they might in the funding strategies of smaller MFIs.

Debt funding strategies of small, and to a lesser extent, medium sized unregulated MFIs thus tend to focus on grants, retained earnings, some development bank funding, some international finance agency funding, and, for the savvy among them, commercial bank loans.

C1B. LARGE UNREGULATED

As one would expect, larger, unregulated MFIs have a greater number of portfolio funding options than smaller institutions. Also, where many smaller MFIs are not thinking about transformation, many larger ones are. While this dramatically affects mid and long term funding strategies, short term strategies remain remarkably similar to that of smaller intuitions.

Larger MFIs have the distinct advantage of well developed funding networks, though typically, they do not extend broadly into the private sector. These networks are extensively developed in what may best be called the development finance market, which includes, national and international development banks and other international funders, whether donors or MFI specialty investment funds. Constant maintenance and development of these networks is the primary strategy of largest (and some smaller) unregulated MFIs as their financing needs are significant and ongoing.

Whereas the demand of smaller MFIs for debt is relatively price inelastic, larger unregulated MFIs, particularly in competitive markets like Peru, are increasingly price sensitive. Similarly, however, strategies are also strongly linked to performance and growth. This is less true for accessing debt from national development banks, where performance minimums are often less exacting and focus more on repayment than growth. International development finance capital is different. Over the last decade, most such capital has been directed by a "pick the winning horse" strategy: or investing in MFIs that will grow to serve a significant number of low income clients. This maxim is not always applied equally by all funders, particularly some bilateral development agencies that continue to support many mediocre to poor performing MFIs, however, for the most part, larger unregulated MFIs need to constantly improve performance and grow to access the amount of capital they seek from these large international development finance agencies.

Of course, MFIs of any size or performance level will target subsidized capital, particularly if the reporting costs are not excessive. FINCA Ecuador, for example, received and successfully leveraged a significant grant from a US governmental agency and is now a regulated financial institution. Subsidized funding is found in the balance sheets and funding strategies of many larger MFIs. Many MFIs use such funding as a means to improve performance and growth, including accessing expert technical assistance, but few use it to lever access to private capital (e.g., to secure commercial bank loans, etc.).

In terms of transitioning to private capital, the existence of lower cost capital is a mixed blessing. For some large and unregulated MFIs, such as EPYDME EDYFICAR in Peru, development finance sources are an important part of their financing strategies, though not always by choice. Without access to deposits, with few collateralizable assets,

and being unable to participate in the Puervian capital markets which have proven so generous to MiBanco, EDYFICAR's balance sheet is comprised almost exclusively of loans from international development financiers and national development banks. Limitations notwithstanding, EDYFICAR has a relatively sophisticated liability management capacity and strategy. EDYFICAR is price sensitive, targets and negotiates long term loans, and as with a small but growing number of MFIs, hedges some of its hard currency loans. Important to the transition to private capital, EDYFICAR also has as much as 10 percent of its funding provided by local commercial banks.

Ultimately, however, unregulated MFIs are limited in terms of the funding strategies they can follow, particularly if they are not favorably rated by a commercial rating agency.

Their strategies, as a result, tend to focus on a mix of development banks, international lenders, some commercial banks, donors, and retained earnings. Retained earnings also play a significant role in portfolio financing, which if used for this purpose severely limits capital and capacity investment potential. Some larger MFIs have also wandered into the regulatory "gray" area of intermediating compulsory client savings. Strategies are, as a result, very similar to those of smaller institutions on a larger scale.

C1C. IMMATURE REGULATED MFIS

Per force, immature, unregulated MFIs typically have well developed funding strategies at the point that they are applying to transform into a formal financial institution because this is required by financial regulators. Plans typically include a host of debt sources that continue to supply loan portfolios until deposit collection can generate a significant proportion of funding liabilities. These sources include significant development bank, international NGO, and multilateral/bilateral institutional support and funding.

However, deposit funding is typically slower to materialize and more costly than MFIs originally plan and it can take many years to reach ideal deposit to debt ratios and cost structures. The two Philippine institutions, Negros Women for Tomorrow Thrift Bank and CARD Rural Bank, for example, have both been more successful in growing lending operations than in attracting deposits. They attribute this to a poor savings culture in the Negros region and to a confusion about the NGO/bank status of CARD, respectively. These sorts of troubles force institutions into a limited growth and/or a debt strategy. In Peru, *Cajas Rurales* are in similar situations due to strong competition for deposits in local markets. This has led some to open branches in Lima and other secondary cities with an eye more to deposit collection than to lending. Institutions in the highly competitive market of Arequipa are

> **FIGURE SEVEN**
>
> **LOCAL VS. INTERNATIONAL PRIVATE CAPITAL**
>
> Market credibility may be more in the eyes of the beholder as over 50 percent of all MFIs receiving local private or development bank debt received it before international lenders arrived. This does not mean that international debt does not have market cache, it likely does, though the strategic implications of it may be over exaggerated. Clearly, it is in the interest of international lenders to wait until an MFI can take large enough loan to minimize transaction costs as a percentage of the overall loan. Waiting until after transformation likely reduces overall risk on the loan.

particularly anxious to build a presence in Lima, which while fairly competitive on the loan side is believed to be underserved on the deposit side.[26]

The existence of relatively inexpensive and available development bank capital in many countries causes some MFIs to reduce their strategic focus on deposits. This is exacerbated by the often strong relationships MFIs have with local development banks and international funders. Many newly transformed MFIs also have new equity partners specifically chosen for access to funding networks. The strategy of many is to seek out larger and longer term loans to provide stable funding as they develop and grow savings products. This also gives the MFI time to become accustomed to deposit markets, in particular, getting a sense of pricing, sales fluctuations and resulting liquidity considerations.

At some point during the early deposit taking years, MFIs also begin to cast an eye to rediscount windows at central banks and to taking on commercial bank loans on more commercial terms. New levels of transparency and supervision of a regulated institution alone dramatically improves investor confidence and hence access, particularly to private debt. Opening access to these significantly larger and more readily accessible pools of capital helps an MFI strategically manage liabilities and reduce both liquidity and interest rate risk. Private sources, however, mostly become available only once an MFI is past its initial deposit taking challenges. Forward thinking MFIs who have already established relationships as unregulated institutions have much earlier access to a broader range of commercial and non-commercial funding sources. In cases where access is difficult, MFIs have taken advantage of guarantee facilities from development agencies, particularly in the case of institutions which have not yet developed a commercial borrowing track record.

Despite a keener focus on private funding among newly regulated institutions, they still typically rely to a great degree on development banks and international funders. In the case of the latter, quasi commercial debt financiers become more strategically desirable as they provide competitive terms for fairly large, longer term loans, and, as important, a degree of market credibility.[27] In his study of 10 MFIs in Latin America, Jansson noted that funding from quasi commercial capital suppliers grew in inverse proportion to subsidized capital from (mostly) international suppliers.

This finding has broad implications for MFI funding strategies for the transition to private capital firstly because it seems to be a viable stepping stone from subsidized to private capital, and, secondly, though more negatively, such capital is so scare. In fact, there is only an estimated USD 80 million to 100 million in quasi commercial international capital disbursed annually compared to an estimated global MFI demand for debt of USD 600 million in 2005. This demand is likely to rise to USD 3.1 billion by 2009.[28] Finally, only about 25 percent of this kind of funding is in local currency, which

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[26] That local financial institutions in the provinces are importing capital is a rare and important reversal of standard economic development trends in most developing countries where capital is usually drawn to, not from, the economic center of the country.

[27] Market credibility may be more in the eyes of the beholder as over 50 percent of all MFIs receiving local private or development bank debt received it *before* international lenders arrived. This does not mean that international debt does not have market cache, it likely does, though the strategic implications of it may be over exaggerated. Clearly, it is in the interest of international lenders to wait until an MFI can take large enough loan to minimize transaction costs as a percentage of the overall loan. Waiting until after transformation likely reduces overall risk on the loan.

[28] Estimates prepared by Enterprising Solutions.

implies capital is scarce enough for most MFIs to be willing to accept foreign exchange risk exposure, despite an increasing sensitivity to foreign currency lending.

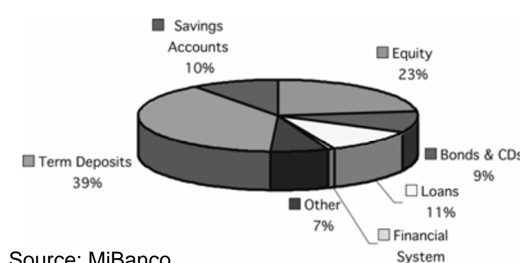
The increasing sophistication of liability management and sourcing also engenders a host of operational changes in most newly transformed MFIs. Often, MFIs form asset and liability committees (ALCO) for the first time. Most have dedicated fund raising staff and many work to improve market credibility with newly designed images and marketing materials or use new marketing mediums.

FIGURE EIGHT

FUNDING STRATEGY AT MIBANCO

An active and well thought out funding strategy, along with some guarantee support from international development financiers, and good loan performance, has allowed MiBanco to lower its average cost of funds from 12 percent to less than 6 percent from December 2003 to December 2004. MiBanco also has a much lower financing expense to financial income ratio than its nearest competitors (12 percent compared to a range of 18 percent to 30 percent).

MiBanco Funding



Source: MiBanco

C1D. MATURE REGULATED

Mature, regulated MFIs usually have well developed funding strategies based on long time funders and strong deposit operations. These institutions, unlike smaller MFIs, tend to actively manage liabilities to maximize profitability and minimize liquidity risk. The result is a more strategic selection of liabilities matching an institution's interest rate forecasts with deposit pricing policies.

MFIs at this stage become increasingly tuned to the strategic relationship between operational performance, market credibility, and the cost of debt funding. Increased market scrutiny and competition with commercial banks encourage MFIs to bring asset and liability strategies together in increasingly sophisticated ways, particularly if longer term loans are being extended. This creates asset and liability matching considerations new to institutions accustomed to very short term loan products. Because there is often less long term deposit and debt capital available in highly price sensitive local markets, mature MFIs often maintain loans from international financiers despite the relatively high financial cost of doing so.

Development agencies guarantee programs also figure in the funding strategies of some of the larger established MFIs. There are some direct loan guarantees, but increasingly, guarantee programs are supporting international debt fund managers who tap large foreign investors for funding, which in turn is invested in MFIs. USAID has provided guarantees, for example, for a new USD 40 million Deutsch Bank fund, the Overseas Private Investment Corporation gave Blue Orchard guarantees on its securitization of seven MFI portfolios, and the Grameen Foundation USA (among others) provided guarantees on the securitization of a portion of Share´s portfolio in India. In the case of all but the former example, foreign exchange risk remains a consideration, though an

increasing number of larger MFIs are actively hedging against this risk.[29] There is a growing general aversion to foreign exchange among larger MFIs, but again, large, medium term loans are attractive given the mix of liabilities required. Blue Orchard, for example, extends debt to some MFIs for seven year terms. Market credibility remains important as well, particularly if loans come from major multilaterals, such as the International Finance Corporation, the Netherlands Development Finance Company (FMO), or *Corporación Andeano de Fomento*.

Access to broader capital market products, such as securitization of bonds, is a highly desirable strategy to finance MFIs' portfolios, and, in some cases, perhaps institutional capital investment as well. The use of bonds, in particular, is a subject that has intrigued many MFIs, though few will soon be in a position to issue them.[30] There are several reasons for this. Many developing country markets are simply not sufficiently developed. Those MFIs that have debt needs are also generally too small to issue a bond of sufficient size to be worth the effort and expense of securitization. Philippine capital markets are better developed, but, as mentioned earlier, larger MFIs (including rural banks providing microfinance services) generally don't need to issue bonds because they are intermediating sufficient deposits and have easy access to other forms of debt. Two particularly fast growing rural banks there are looking into the matter, but the size of the issues they might execute are still fairly small. The fixed costs involved in securitization are high enough that scale of issue is the critical economic factor to be considered in such a strategy.

Bonds can be a useful debt strategy for some institutions.[31] In Peru, for example, the existence of a large pool of private pension funds and other institutional investors with sizable portfolios (in the hundreds of millions USD), makes accessing capital markets an attractive proposition for well run MFIs. [32] Thus far, however, only MiBanco has gone to market, although a consortium of *Cajas Rurales* is said to be bringing an issue out soon.

These more sophisticated instruments could play vital if limited roles in the development of larger MFIs. The case of Mibanco is instructive. Despite the high publicity of its issue, Mibanco bonds constitute only about 10 percent of liabilities, or the same amount as other lenders (e.g., development banks, international lenders etc.). (See Table Seven) Deposits account for over 52 percent of its equity comprises 22.6 percent of funding.

Tradable certificates of deposits have also become important to Mibanco and have grown to provide significant funding to the institution. This important advance has allowed the bank to diversify its funding sources further, sell to a range of corporate, institutional investor, and government agencies.[33]

Key to the development of capital markets for MFI financing is good performance and historical transparency. The sooner the market can judge the long term performance of an MFI, the less difficult it is to assess its repayment potential. Supervision helps

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[29] A CGAP study showed that about 25 percent of MFIs hedged against foreign currency risk. See: Farrington, Todd and Julie Abrams, Inter-American Development Bank, "The Evolving Capital Structure of Microfinance Institutions," in *MicroEnterprise Development Review*, Inter-American Development Bank, Vol. 5, No. 2, December 2002.

[30] MFIs in India, Kenya and Mexico have also performed securitizations of various sorts.

[31] For more commentary on the appropriateness of bonds as an MFI funding source, see "¿Cómo deberían financiarse las instituciones de microfinanzas?" Felipe Portocarrero Maisch, Álvaro Tarazona Soria and Glenn D. Westley, 2005

[32] Regulations stipulate that over 80 percent of their investment be made in Peru where few investment grade opportunities are available.

[33] Figures for March 2005.

investors feel confident about investing, as does rating from an MFI rating agency, but there is no substitute for a rater with capital market credibility. In the case of Mibanco, their bond issue received an issue rating of AA- or better from established local market rating companies (albeit with the support of guarantees from CAF and the IFC).[34] The institution itself only received a B+ rating. Similarly, in Mexico, Compartamos´ first bond issue received an A+ from Standard and Poors without the support of guarantees. While useful for both MFIs, the bond option was an especially appropriate strategy for Compartamos, which is a relatively large, non intermediating institution. For most MFIs, however, bonds and other similar instruments remain far off strategies.

In the meantime, large MFI funding strategies include dedicating more staff training and capacity development to debt sourcing. Often this includes a Chief Financial Officer with a small staff or a treasury department. Mibanco boasts a sales and marketing team which supports institutional sales of CDs and term deposits, makes presentations (including road shows) to private investors, and provides what may be termed investor relationship management services. Larger MFIs have at least established ALCO committees.

D. SUMMARY PORTFOLIO FUNDING

This chapter tried to give a sense of the increasingly complex challenges MFI managers face funding portfolios as their MFIs grow and evolve. Clearly, those institutions with stronger portfolio funding strategies stand a better chance to thrive in the increasingly competitive market for capital, both development agency and private capital alike. As noted, the sooner an institution forays into the private capital market, typically, the better its access to finance in the future. Though it is difficult to generalize across national boundaries, some commonalities exist as observed in this chapter. They include:

- Larger MFIs often have fairly well developed funding strategies and growing capacity to mange them, while smaller institutions typically have *ad hoc* portfolio funding strategies;

- Transformation to deposit taking institutions is a highly desirable strategy for most MFIs;

- MFIs are seldom fully aware of deposit funding costs, and as a result, may not strategically maximize the development and pricing of savings products and services;

- MFIs with large, term deposit funding strategies operate in two fundamentally different markets: low income asset and high income liabilities. These markets react differently to economic events which must be accounted for strategically;

- Debt funding remains important to all MFIs even those intermediating savings;

- Development agency, particularly national development bank, funding remains important to many MFIs and critical to many non-regulated MFIs ;

- National development banks often provide important sources of capital, but do not always encourage the transition to private capital;

[34] Ratings were made by Class & Associates and Equilibrium.

- International MFI investment funds often replaces subsidized funding in MFIs and may be an important bridge to local private capital markets;

- Foreign exchange risk, while minimal in larger institutions with some capacity to hedge, is a problem for smaller institutions;

- Commercial rating agencies provide excellent market credibility;

- Despite probable higher costs, MFIs of all sizes, regulated or not, can access private capital to their immediate and long term advantage, this is particularly true of smaller institutions with the desire to grow;

More sophisticated capital market instruments such as bonds and securitizations are helpful to large, regulated MFIs.

Table Eight

MFI DEBT FUNDING STRATEGIES

	Strategies	Price	Collateral and Leverage	FX	Tactics
Non Regulated Small	Any source will do, usually undirected , Mix of funding donor and or grant funding (e.g., International NGO, UNCDF) some development banks, some commercial banks, and retained earnings.	Relatively price insensitive.	Physical assets, rarely portfolio. Generally low leverage results.	Typically non hedged and not concerned, some use of back to backs from commercial banks.	Network through affiliate organizations (e.g., international NGO supporter). Little view to private capital for lack of collateral and performance issues.
Non Regulated Large	Developing strategy based on increasing price sensitivity and funding expanding options. Larger loans and longer terms needed which focuses strategy on larger suppliers such as international development lenders (multilaterals or quasi private funds) Mix funding development banks (size access), International lenders (credibility), some commercial banks, donors, retained earnings.	Increasingly sensitive with some bargaining power if performance is good or funders have strong institutional interest or financial position.	Guarantees – physical assets, occasionally portfolio, development agencies guarantee programs (e.g., *Corporacion Andeno de Fomento*, USAID Credit Development Authority, etc.).	Increasing sensitivity to foreign currency lending but still strong incentives to take unhedged risk. Some use of back to backs but price sensitivity limits this practice. Market credibility of international debt is a desirable factor in decision making. Size of loans makes back to backs more difficult and expensive	Rated by microfinance rater, network through affiliate organizations, international funders. Access to private capital improved, beginning price sensitivity and access to other funding sources mutes interest, as does limited collateral.
Newly Regulated	Usually well defined strategy based on some known (e.g., previous debt funding experience) and unknown (e.g., deposit collection success) factors. Strong operational cost price sensitivity, focus as a result on term deposits over demand. Ideal non deposit loans larger and longer duration focuses strategy on larger suppliers such as international development lenders (multilaterals or quasi private funds). An eye cast to private markets. Mix funding development banks (size access), International lenders, deposits, some commercial banks, donors, retained earnings. There is a need and a desire to maintain strong links to established funders, particularly international funders who have perceived market credibility, as there is to national development banks.	Strong price sensitivities despite poor cost to benefit understanding of deposits versus debt.	Guarantees - portfolio, assets, development agencies guarantee programs (e.g., *Corporacion Andeno de Fomento*, USAID Credit Development Authority, etc.).	Increasing sensitivity to foreign currency lending but still strong incentives to take unhedged risk. Market Credibility of international debt is a positive factor. Size of loans makes back to backs more difficult and expensive	Typically newly regulated MFIs have strong local and or international networks. Most are rated by microfinance rater. Many have new equity partners specifically chosen for access to networks. New level of transparency and supervision as regulated institution improves access, particularly to private capital. Some institutions have ALCO committees. Most have dedicated fund raising staff. Improve market credibility (e.g., market materials, image etc.).

Mature Regulated	Usually well defined strategy based on long time funders. Relationship between institutional performance and funding price is a significant driver in strategy. Reasonably sophisticated debt to deposit calculation. Increased used of deposits over debt, with continued demand for international debt (multilateral and quasi private funds. Strong or developing access to local sources of private capital (dependent upon depth of capital markets) Mix funding deposits, development banks (size access) and international lenders, some commercial banks, donors, retained earnings. There is a need and a desire to maintain strong links to established funders, particularly international funders who have perceived market credibility, as there is to national development banks. The most advanced institutions are tapping national capital markets for debt. Some are tapping international markets with Blue Orchard's securitization issue.	Extremely price sensitive. Demand driven, responsive deposit pricing strategies.	Portfolio and performance, some assets, development agencies guarantee programs (e.g., *Corporacion Andeno de Fomento*, USAID Credit Development Authority, etc.).	General aversion to foreign exchange but large loan size and access to international funders are attractive and important long term considerations.	Use of MFI raters, increasing use of capital market rater (e.g., Fitch, Standard and Poors, or local equivalent). Dedicated funding staff, some form of treasury department, ALCO committees. Strong sales staff and demand driven, responsive deposit pricing strategies. Increasingly sophisticated matching strategies.

EQUITY IN TRANSITION

Although equity makes up a relatively small portion of the total financing available to most MFIs, it is arguably the most important financing consideration. Equity investors are the owners of the institution and as such control its ultimate purpose and direction. Equity is also the main long-term risk capital of any business and is therefore more appropriate than debt or client deposits for larger, long term infrastructure investments.

Financial institutions making the transformation into deposit-taking banks typically need large cash infusions in order to upgrade their capacities to levels necessary for regulated operations. As noted earlier, transforming Ugandan MFIs will sometimes double or even triple their total equity base for the purpose. These are (mostly) long term investments such as buildings, computer systems and vaults and should therefore be financed with long term

liabilities. Indeed, it was just these sorts of transforming MFIs that reported the strongest demand for new equity investment. Almost all other licensed banks interviewed were content to grow with retained earnings. The only exceptions to this rule were those refinancing out of near-insolvency, those attempting exceptionally rapid expansions and those seeking strategic alliances via the equity participation of new parties.

Transforming and transformed Ugandan and Philippine MFIs looking for new investors have primarily kept to a strategy of pursuing socially inclined investors.[35] These include international microfinance funds, charitable organizations, churches and to a much lesser extent, local businesspeople including managers and directors of the MFIs themselves. U-Trust of Uganda is fairly typical of transformed NGO-MFIs in its ownership breakdown. (See Table Eight)

[35] Social investors are different from other investors in that they seek both financial and social returns on investments. Social investors are not a separate class of investors. In fact, almost all (99.7 percent) of the $2.8 trillion social investor funding worldwide is bound by the same fiduciary and securities laws that govern conventional investments. Social investors are often characterized, however, for the very small number of investors willing to forego significant financial return in exchange for social or environmental return. In microfinance these would include some NGOs, some church organizations, and individual investors, as well as some foundations and other charitable institutions

Table Eight

OWNERSHIP OF U-TRUST

Shareholder	Percentage Share Capital
Local Parent NGO	30
Investisseur et Partenaire pour le Développement (France)	15
East African Development Bank	17
OikoCredit (Netherlands)	20
Staff	10
Founders (21 individuals, largely local businesspeople)	8

Transforming microfinance NGOs rarely receive investments of private, for-profit capital. While there may be many reasons for this from the perspective of the private, for-profit investors themselves, the fact remains that many institutions do not desire such financing.[36] The culture in these institutions and in their NGO owners is frequently so mission oriented that owners and management often fear private, for-profit investors will cause the institution to cease serving the poor effectively. While much was said in interviews with MFI managers about the need for a "business orientation" and "sustainability," it generally stopped short of a full for-profit orientation. MFI owners in Uganda and elsewhere speak frequently of their desire for "like minded," "mission oriented" and "double bottom line" investors. In doing so they make it clear that they wish to attract "suitable" investors who prioritize the social mission of the institution, sometimes at the expense of profits. One major Asian MFI, for example, has had and turned down numerous equity offers including one from a prestigious real estate company able to help develop a budding national mortgage market for this reason.

To avoid perceived difficulties related to minority shareholders, some Peruvian MFIs have issued shares according different rights. CARE International and Microvest, for example, owns 80 percent and 10 percent of class A voting shares in EDPYME EDYFICAR respectively. Private investors own another 10 percent of non voting B shares and employees own 10 percent of class C shares. Another alternative used by a few MFIs is subordinated debt. Such debt acts as quasi-equity because its holders have access to the institution's assets in the event of bankruptcy only after the demands of other debtors have been satisfied. Due to the high risk involved, commercial investors will demand a high return on subordinated debt and will often insist on third-party guarantees such as those issued by non-commercial microfinance funds.

[36] See de Sousa-Shields, Marc and Cheryl Frankiewicz, Financing Microfinance Institutions: The Context for Transitions to Private Capital is available at http://www.microlinks.org/ev_en.php?ID=5967_201&ID2=DO_TOPIC Under Theme 5, Access to Capital. for more commentary on commercial equity investment in MFIs.

Table Nine **SUMMARY OF MFI EQUITY DEMAND BY TYPE AND COUNTRY**		
Country	**Type of Financial Institution**	**Equity Demand and Strategies**
Philippines	MFIs	Owned mainly by NGOs Low demand for new equity investment. Strong preference for charitably-minded investors.
	Rural Banks	Mainly family owned. Low demand for new equity investments.
Uganda	MFIs	Owned mainly by NGOs Due to several transformations into licensed banks, equity demand is currently high. Strong preference for charitably-minded investors.
	Mainstream Banks	Privately owned. Little demand for new equity investments.
Peru	EDPYMES –Special Licensed MFI	Owned mainly by NGOs Attracts social and/or "family" investors
	Caja-Municipalities	100% owned by local municipal governments. Some talk of privatization but managers and owners are hesitant to cede control to private sector investors.
	Caja Ruales	Privately owned small banks, private individuals or businesses. Capital strategy is to tap "family" investors or attract social investors.
	Commercial Banks	Privately owned, single and multiple shareholders.

These strategies can preserve majority ownership control of voting shares in the hands of a small number of owners, while a larger number of owners invest in non-voting shares. Another strategy, though seldom used, is to sell shares broadly on a stock market. BancoSol listed itself in Bolivia in the late 1990s, but its shares, like most shares on this thinly traded market, have not seen much liquidity, making it difficult to value them on a daily or even monthly basis. Other larger MFIs, such as ACLEDA Bank in Cambodia and Mibanco in Peru, have also contemplated listing on national exchanges but are admittedly a long way from doing so.[37]

[37] In the case of Cambodia, of course, an exchange needs to be created.

The equity strategy used by Philippine rural banks offering microfinance services provides an interesting counter-example to the case of transforming microfinance NGOs. These institutions are dominantly family owned and operated. They are also generally very liquid with deposits, development bank borrowing and retained earnings. As a result, they rarely seek additional outside equity investment at all. When extra investment is needed, however, the family itself is by far the most likely source. The only cases of significant minority ownership encountered among institutions of this type resulted from situations in which the original owner family ceded majority control due to insolvency at the orders of the central bank. In each such case, it was another wealthy family which recapitalized and took control of the distressed institution.

FIGURE NINE

NOT JUST CAPITAL

Like many other financial institutions with significant microfinance activities, Uganda's Centenary Rural Development Bank's ownership structure is dominated by charitable institutions, including eighteen dioceses and secretariats of the Roman Catholic Church in Uganda. Combined, church organizations own 70 percent of the bank with the balance belonging to international funds. Centenary is searching for new equity investors among foreign financial institutions for the purpose of benefiting from their know-how and technical assistance capabilities. However, profit-oriented investors are likely to be wary of investing in an MFI controlled by such social investors. If successful, Centenary expect this strategic alliance strategy to benefit them in ways that money alone could not.

In a similar vein, Mibanco of Peru recently sold shares to a national insurance provider. Mibanco, which has majority NGO owners, sought the partnership to take advantage of complementary products and services, with the new insurance partner providing products and services and Mibanco the sales force and sales outlets.

Dr. William Kalema, a prominent member of the Ugandan investor community, explains this developing world equity strategy eloquently. He emphasizes that in industrial countries minority investors have legal recourse should the business have problems. In developing countries, however, such protection is much less certain. Minority ownership is therefore a much riskier thing in these countries, motivating the investor class into a strategy of owning enterprises outright rather than portfolio investing. The data in Table Ten, showing the delays and costs involved in business bankruptcy procedures and investment recoveries in various countries is an interesting illustration of Dr Kalema's argument. In this light, tight control of an emerging market financial institution appears quite logical and may largely explain why so few local commercials investors buy minority stakes in MFIs anywhere.

A common challenge related to selling shares, however, is realistic equity valuation. Among the MFIs interviewed valuation strategies varied and were generally weak. This is a complicated and under-studied aspect of microfinance.[38] It is simply difficult to value a semi-charitable financial institution. While many transforming microfinance NGOs have adopted the simple strategy of selling their equity to non-commercial interests at accounting book value, others admit that they simply do not know how to value their institutions.[39] A few institutions, however, have adopted strategies designed to assign their shares an actual market value.

A strong commitment to the payment of dividends is one possible solution to the valuation problem. A steady stream of dividend income can be measured and valued by any investor, giving the shares a reasonable market value. CARD Bank of the Philippines

[38] See de Sousa-Shields, Marc and Cheryl Frankiewicz, "Financing Microfinance Institutions: The Context for Transitions to Private Capital", 2004 for more commentary on commercial pricing of equity.

[39] Specific examples of poor equity valuation practices will remain anonymous at the request of the MFIs.

and Centenary Rural Development Bank of Uganda are both MFIs that provide investors with reliable dividends. Centenary has even hired an accounting firm to assist in determining a reasonable price for its shares. Likewise, Faulu of Uganda plans to provide returns to investors upon transformation and has hired Price Waterhouse Coopers to assist it with the valuation question. EDYFICAR in Peru has also paid dividends. Paying dividends not only keeps existing investors happy but lays the groundwork for future investors, as was the case in XAS Bank in Mongolia, which began paying dividends after only two years of operation.[40]

able Ten

CLOSING A BUSINESS:
TIME AND COST OF INSOLVENCY PROCEEDINGS

Region or Economy	Time (Years)	Cost (% of estate)	Recovery Rate (cents on the dollar)
OECD (High income Countries)	1.6	6.8	72.2
Canada	0.8	4	89.1
Sweden	2	8	73.2
Uganda	2.1	38	35.5
Peru	3.1	8	31.1
Philippines	5.6	38	3.8

Source: Djankov, Simeon, Hart,Oliver, Nenova, Tatiana, and Andrei Schleifer, *Doing Business* and *Efficiency in Bankruptcy* an ongoing research project by World Bank, 2005.
http://rru.worldbank.org/DoingBusiness/ExploreTopics/ClosingBusiness/CompareAll.aspx

The case of for-profit MFIs is different. Commercial Microfinance, the one truly for-profit MFI in Uganda, has had minority stakes change hands several times and has used market pricing to do so. The market in this case was a fairly limited number of international business people, but was based on real commercial valuation and negotiated by profit seeking owners. After five years of disappointing financial performance some shareholders sold their stakes at a significant loss at the end of 2004. Other owners with higher estimations of the future prospects of the institution bought them out at the reduced prices and then further recapitalized the bank with new investments. The bank is now under new management and hopes to succeed in turning its fortunes around.

Several *Cajas Rurales* also have fully private ownership. *Nueva Visión*, an Arequipa based institution has nine private investors from individuals to corporations, including one of the largest dairy suppliers in Peru. After several years of mediocre performance, the investors are now pushing the institution harder as competition has dramatically increased. In addition to more strategic portfolio funding planning, owners are considering contributing new capital investment, retained earnings not being sufficient

[40] See de Sousa-Shields, Marc and Frankiewicz, Cheryl, *XAC Bank: From the Liability Side of the Balance Sheet*, in MicroBanking Bulletin, Issue 11. Available at www.mixmarket.org.

to grow the MFI and compete effectively. Having deep pocketed owners with strong contacts to the local market is a strategy that few MFIs have pursued.

SUMMARY

Sourcing and employing equity is fast becoming an important challenge to the microfinance sector. Strategic equity investment is critical to the success of an institution though rarely the largest source of MFI financing. It is the seed money for future growth and its owners ultimately control the institution. In comparison, the interests of lenders and depositors are much narrower.

NGO-MFIs transforming into licensed institutions typically have the greatest equity investment needs and challenges of any type of MFI. Typically, they face the dual problems of finding new investors to finance their transformation and ensuring that the new ownership structure will maintain their focus on social mission. These problems reinforce one another as commercial investors have trouble valuing such quasi-charitable institutions or are even actively avoided by the NGOs as undesirable investors. Such concerns tend to restrict ownership of transformed MFIs to benevolent parties, depriving the institutions of the value they might gain from the discipline and know-how of commercial owners.

At the same time, local entrepreneurs in many microfinance markets generally avoid minority investment opportunities due to their rational fear that their rights will not be protected. Such investors prefer to have controlling interests in their investments and are much less likely to accept a secondary role than is the case in more advanced economies with better rule of law.

Possible strategies to overcome these strategies include:

- A credible commitment to returning profits to shareholders (such as the regular payment of dividends);
- Use of different classes of shares with different ownership rights;
- The use of valuation experts; and,

Increased openness to the governance and operational value commercial investors can bring (i.e., do not limit universe of potential investors to social invest).

CONCLUSION: INCENTIVES AND STRATEGIES FOR TRANSITIONING TO PRIVATE CAPITAL

Microfinance is in the process of transforming from a sector dominated by a mission-driven ethos to one responding to the needs and interests of private capital. The microfinance sector must make this transition if it is to access sufficient capital to be able to expand and provide a significant number of poor with access to financial services.

The transition to private capital is well underway and some MFIs are mostly or entirely funded by private capital. But the transition has been slow and difficult as many MFIs lack the management capacity to attract and absorb private capital. Best practice knowledge, improved regulatory regimes, and stronger sector associations, among other interventions, however, have had strong positive effects on sector's capacity. While improvements vary by country and institution, clearly many MFIs now have, or can develop the capacity to profitably employ commercial capital.

To make the transition to private capital, MFIs will have to play by a new set of rules, those of the private sector. These rules are numerous, but all revolve around the objective of profit making, a theme that has not entirely entered the poverty focused lexicon of the world's MFIs.

Financing strategies touched on in this paper demonstrate that most MFIs are only partly playing by private capital rules. Certainly on the deposit side, tremendous steps have been made in terms of creating appropriate regulations and transforming MFIs. The challenge now is to grow deposits to the point where they become the main funding source for all transformed and transforming MFIs. In addition, MFIs are working to improve liability management through effective deposit management, as well as debt management, to maximize profitability in the face of increasing competition between

each other and, more importantly, with commercial retail banks who are increasingly entering the market.

This will require *structured, professional funding strategies*. This paper argues that some larger regulated MFIs have fairly well developed funding strategies, but most MFIs do not. Most strategies, in fact, are rather informal and *ad hoc*. As MFIs grow, adopting such strategies becomes all the more important, because growth is heavily contingent upon access to funding, which is increasingly only available from the private sector. In the absence of a clearly defined strategy, MFIs typically drift towards the sources they know best, which are often non-commercial in nature.

While best practice liability management is emerging, it is still not well. This lack of and inaccessibility of information especially handicaps the many small MFIs with great potential that are left to develop financing strategies without little guidance. This is unfortunate as many smaller MFIs provide valuable services to niche markets, including in rural areas and to hard to reach populations. Some also represent the next round of "winners" who will push the market to innovate and evolve, and whose development are essential to the development of a healthy, competitive microfinance marketplace.

Both small and large MFIs alike are still often strategically tied to development agency capital. Strong relationships forged by years of interaction make the ties between these sources of capital and MFIs very strong and can act as a disincentive to developing private sector funding sources. However, the key to the transition to private capital is to use development agency funds to lever private capital.

The microfinance sector has made some progress in accessing private capital to fund their portfolios. This is despite the fact that options, such as guarantees and back to backs, are proven means to help MFIs lever significant volumes of private capital. The sooner MFIs take full advantage of these and other strategies, the sooner best practice liability management will emerge and MFIs will learn to fully abide by the rules of private capital allocation. This will hopefully lead to smarter foreign exchange risk management and diversification of local capital sources. It will likely also create strong incentives for more sophisticated liability strategies that will lead to the demand for and accessing of more varied sources of capital.

Equity capital considerations overlap these portfolio funding challenges to some extent, but pose other unique challenges. First and foremost, equity is a very scarce commodity for any industry, but it is entirely more scarce for one such as microfinance that faces so many information barriers. This is compounded by MFI owners who, for the most part, prefer like minded investors; that is to say, those who are appreciative, if not driven, by the poverty alleviation mission of microfinance. This further reduces the possible universe of investors to a very small number of players, typically international social investors who have very little funding available.

Key to best practice equity management is to develop strategies for minority shareholders to participate in MFIs on a commercial basis which will allow them the degree of comfort required to invest, but not cede them undue control. More MFIs should sell shares to private sector investors with complementary businesses or with specific know how that will help with growth and profitability.

SOME TIPS FOR DEVELOPMENT AGENCIES TO ENCOURAGE PRIVATE SECTOR MFI FINANCING

In the early 1990s, the primary strategy of development agency finance was to "bet on winning horses" or those MFIs that would grow to serve a significant number of poor. This is now only a necessary condition. Development agency finance should have as its prime directive to invest in "winning horses", but do so in a way that levers access to private capital: in essence, yes, bet on the horse, but don't ride it to the finish, let the private sector do that.

There are many different things that donors can do to live by this prime directive. They include a number of investments in the regulatory framework, public good investments (e.g., credit bureaus, etc.), and sector building activities. In terms of finance, some recommendations include:

- Build more and better programs which lever private capital (e.g., guarantee programs);
- Help local finance innovators innovate;
- Work with local capital providers to bring down information barriers between capital markets and MFIs;
- Be lenders of very last resort, or better yet, lend to lenders of last resort;
- Fund MFI best practice liability technical assistance;
- Insist on MFI liability strategies that targets private sector capital;
- Work with national development banks to insure best practice leading;
- Strategically wean MFIs off development agency finance;
- Support national deposit insurance schemes for MFIs, or inclusion in established schemes;
- Encourage greater commitment paying dividends;
- Encourage greater MFI share liquidity; and
- Encourage MFIs to sell shares to commercial investors that bring, for example, greater business discipline, specific know how, or complementary business activities.

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ANNEX 2: DEFINITIONS

Commercial or private capital refers to all private sector financial resources available for use. In the case of investment, this includes monetary capital that is privately owned and invested directly by its owners or via intermediaries. Commercial capital expects to make positive rates of return relative to risk. This includes owner remuneration for use of their capital *plus* a) the fee, if any, incurred by an intermediary for placing and managing funds on behalf of an investor; b) the cost to the intermediary, if any, for mobilizing capital; and c) a profit to the intermediary, if used. In other words, commercial capital is that which can be pooled, invested and paid for with a profit to any intermediating parties that may be involved in the process.

Development Agency and Development Agency Finance are public investors and development institutions are public bodies, such as bilateral agencies (such as USAID and the Swedish International Development Agency) and multilateral financial institutions (such as the World Bank and the Inter-American Development Bank), which provide funding and financing to development projects and businesses, including microfinance institutions, among other activities.

Developing countries or emerging markets, according to the World Bank definition, are those countries whose gross domestic product per capita is less than approximately USD 10,000 annually.

Developed countries, according to the Word Bank definition, are countries whose gross domestic product per capita is greater than approximately USD 10,000 annually.

Microfinance institutions (MFI) are defined as a single organization (for example, a non-governmental organization or a credit union providing microfinance) or a unit whose primary business is microfinance within a diversified institution (for example, a microfinance unit within a commercial bank).

Non-commercial capital is that which is not commercially viable according to the above definition of commercial capital.

ANNEX 3: CASE COUNTRY OVERVIEWS

UGANDA

Uganda is a poor country with a rapidly growing economy. This economy is fueled by internationally supported economic reforms and generous foreign aid (half of the national budget is currently supplied by donor countries) and hindered by corruption and a lack of democratic institutions. Uganda's microfinance sector is more or less dominated by the recent passage of a law that has created a new category of licensed financial institution specifically designed for microfinance. All sizable MFIs in Uganda that are not already licensed as banks are rushing to become licensed under this new law, the chief effect of which will be to allow them to intermediate savings from the general public. At the same time, commercial banks are increasingly offering financial services to the poor as well as lending directly to non-deposit taking MFIs.

PERU

With its myriad of large and small, good and poor performing MFIs, Peruvian MFIs are increasingly responding market pressures, particularly as well capitalized commercial players enter the market. While penetration rates are high in some urban markets, few benefits of an improving and fairly stable macro economy have accrued to the poor, despite good overall economic performance over the last three years.. Microfinance is still critically needed, though sector rationalization is immanent in major urban markets. The existence of three types of regulated financial institutions with microfinance activities is partially responsible for this market dynamic. Funding for MFIs in Peru is increasingly critical. A range of funding sources are being tapped from deposits to capital markets through bond issues or for tradable certificates of deposit. National development banks, however, still figure large in the financing of MFIs, though and again, use of deposits and other forms of private capital is rapidly increasing.

THE PHILIPPINES

The Philippines has lagged its "Asian Tiger" neighbors in economic growth for decades under a corrupt political dictatorship, followed by a democratic period plagued with

continuing governance problems. The government has a long history of populist, politically motivated interventions in the country's credit markets. Almost all Philippine NGO-MFIs make generous use of these programs to fill their funding needs. There is also an abundance of small, private, rural banks which have always served relatively poor clients and which are (with USAID's help) increasingly embracing uncollateralized lending and micro-deposits markets. The most interesting aspect of the Philippine microfinance sector from the point of view of this study is the lack of any great unmet demand for capital amongst its MFIs.

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