THE DEUTSCHE BANK GLOBAL COMMERCIAL MICROFINANCE CONSORTIUM AND USAID'S DCA GUARANTEE

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FOREWORD

The purpose of this review, funded by USAID's Office of Development Credit (ODC) under the DAI, DCA Support Task Order, was to (i) assess the utility of USAID's Development Credit Authority (DCA) credit guarantee mechanism as a programming tool to help microfinance institutions (MFIs) formally integrate into financial systems, and (ii) document observations that will assist USAID missions improve future wholesale MFI DCA guarantees. This review was conducted in cooperation with USAID's Office of Microenterprise Development (OMD).

These two DCA case studies produced by ODC are part of a larger DCA research effort being conducted through the Financial Services Knowledge Generation Project (FSKG), which has previously produced three DCA case study reports, bringing the total number of DCA case study reports to five. In addition, OMD intends to produce a number of non-DCA guarantee cases studies related to access to capital for MFIs. All of these case study reports will ultimately serve as inputs into a handbook for USAID Missions to be produced by OMD. The objective of the guide is to inform and assist Missions when designing and managing DCA guarantees for MFIs seeking access to commercial funding sources and capital markets.

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ACRONYMS AND ABBREVIATIONS

CDO	Collateralized Debt Obligation
The Consortium	Global Commercial Microfinance Consortium
DB-MDF	Deutsche Bank Microcredit Development Fund
DCA	Development Credit Authority
EBRD	European Bank for Reconstruction ad Development
FX	Foreign Exchange
HP	Hewlett Packard
LG	Loan Guarantee
LPG	Loan Portfolio Guarantee
MCD	Maximum Cumulative Distribution
MDL	Moldovan Lei
MFI	Microfinance Institution
ODC	USAID Office of Development Credit
OMD	USAID Office of Microenterprise Development
PG	Portable Guarantee
NGO	Nongovernmental Organization
SMEs	Small and medium-sized enterprises
SO	Strategic Objective
SRI	Socially Responsible Investment
USAID	United States Agency for International Development

EXECUTIVE SUMMARY

Microfinance, the provision of financial products and services for the poor, has expanded significantly since its early experiences with Grameen in Bangladesh in the mid-1970. While the microfinance industry has been able to demonstrate that it can sustainably provide financial services to the poor, one of the significant barriers to its growth has been that it is difficult for microfinance institutions (MFIs) to access capital. While many of these institutions have relied on donor funding in the past, this funding is relatively small compared to MFI capital needs and has become increasingly scarce. In may countries, taking deposits can take time and significant resources. At the same time, local banks, with conservative lending policies, are reluctant to lend to MFIs. As a result, a number of institutions have been tapping into available funding from international investors including philanthropists, socially responsible investors and to a lesser extent commercial investors.

Deutsche Bank has been at the forefront of microfinance investment funds since 1998, when it initiated the Deutsche Bank Microcredit Development Fund (DB-MDF), a microfinance investment fund that provides loans at subsidized interest rates for microfinance institutions worldwide. In 2004, Deutsche Bank's Community Development Finance Group proposed to leverage its track record and experience in managing microfinance investment funds and proposed the development of a cross-border debt financing facility targeting commercial MFIs. The facility, named the Global Commercial Microfinance Consortium ("the Consortium"), was launched in November 2005 with the objective of helping to overcome market imperfections related to access to credit that MFIs face and to attract private sector debt investment to these financial intermediaries. The Consortium raised US$80.6 million to lend to MFIs at commercial interest rates. In order to attract the greatest number of investors, including commercial investors, it was structured as a Collateralized Debt Obligation. Noteholders, with US$63.35 million in notes bore only 60 percent of the risk through this structure. The CDO included two classes of equity and one grant, held by donors and philanthropic investors who bear the first losses of the facility. Class A shares represented totaled US$9.5 million, Class B shares, which were subordinated to Class A shares totaled US$6.25 million, and a grant, which bears first losses totaled US$1.5 million.[1] Additionally, USAID took a second loss position of US$15 million by providing a DCA guarantee to the note holders. The DCA guarantee played an important role in reducing the risk for the transaction to attract these investors. Additionally, investors cited USAID as bringing "credibility" to the deal that was important for first time entrants into microfinance.

Foreign capital offers opportunities to diversify funding sources and access cheaper interest rates. It also brings with it intangible benefits such as recognition in local and foreign markets and a greater level of investor confidence that may otherwise take years to achieve. Nevertheless, foreign capital can be fickle, and often depends on conditions outside the control of a domestic MFI such as global liquidity factors. Additionally, foreign investment brings with it some risks that more developed corporate sectors in the developing world have confronted at various times. Moral hazard may be one of the principal risks. MFIs may over-finance themselves from commercial investment funds that

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[1] For technical reasons, a portion of the Class A shares were subsequently re-classified as subordinated debt. As they retained the economic and risk profile of the Class A equity, they are collectively refereed to herein as Class A shares.

often have a donor or philanthropic investment, with the assumption that if they are unable to pay, the donor or investor will not let them fail. At best, they may expect a restructuring of their loan, at worst, significant loan forgiveness. If MFIs perceive these facilities to be “soft”, they will be less prudent about managing their leverage and their risks, including foreign exchange risk.

An innovative aspect of the Consortium is that it has played a dual role in bringing both commercial institutional investors as well as local financial institutions to provide access to finance for MFIs. The Consortium has been successful in lending largely through local banks in either local currency or the currency most demanded by MFIs. Over 60 percent of the Consortium’s portfolio is denominated in local currency, while 10 percent of the portfolio represents Euro-denominated loans and another 28 percent is in US dollars, including some effectively local currency loans in dollarized economies such as Ecuador and El Salvador. Given that one of the Consortium’s primary objectives is to provide loans in local currency, it is understandable why it holds over 36 percent of its loans in Latin America and 28 percent in Eastern Europe, compared to only 15 percent in Asia and 8 percent in Africa. There are a greater number of strong second tier institutions, which are those targeted by the Consortium, in these regions. Only a handful of MFIs in Africa and parts of Asia are considered strong enough to access commercial loans, particularly since the average loan size for the Consortium is relatively large at US$2.1 million.[2] Some of the stronger MFIs in Asia and Africa are also accessing deposits, which can be a much cheaper source of local currency funding, and reduce their interest in foreign borrowing. Additionally, Latin America and Eastern Europe offer greater opportunities to hedge currencies as their financial markets are generally more developed. While the Consortium has made impressive progress in developing structures that link MFIs to local financial institutions and local currency lending, it has done so at a cost. New initiatives require time and negotiation, which can frustrate borrowers who are waiting for funds. In the face of a growing supply of investment funds, these are becoming more competitive. Funds are beginning to lend directly in local currency, and hedge (or leave un-hedged) the FX risk themselves in an effort to reduce the time and investment required of MFI managers when borrowing in local currency from abroad.

This Case Study reviews the impact of USAID’s DCA guarantee on the Consortium, USAID’s first guarantee in a global structure and second participation in a collateralized debt instrument. The experience of the Consortium will shed light on the impact of USAID’s DCA guarantees on such assets. As the market for MFI financing becomes increasingly competitive, the lessons learned from the deal will feed future innovation and improvement, ultimately benefiting MFIs with a greater availability of local currency financing at more attractive interest rates and with lower transaction costs. Much of this efficiency will depend on the ability of intermediaries such as Deutsche Bank to offer instruments in scale, which will require an ongoing stream of interest and demand from international investors for their assets.

In many developing countries, USAID’s DCA guarantees, structured as loan guarantees, loan portfolio guarantees or portable guarantees have served as a mechanism for MFIs to access credit through local banks. The Consortium represents an extension of these efforts, whereby USAID was able to commit a guarantee in only one transaction, with the fund manager, in this case, Deutsche Bank implementing over 20 local currency loans. USAID missions were not involved in structuring this deal, instead the Washington-based Office of Microenterprise Development (OMD) was engaged significantly. This model may prove cost effective for USAID. While the structure may be cost

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[2] As of December 2006, considering disbursed + committed funds.

effective for USAID, it is also a divergence from USAID's traditional mandate to use DCA guarantees to support the Strategic Objectives of USAID missions. USAID missions proved helpful, nonetheless, in the process of facilitating the Consortium's due diligence in country by providing industry information, MFI information and contacts in many cases.

1. OVERVIEW OF INTERNATIONAL MFI INVESTMENT FUND MARKET DYNAMICS

1.1 INTERNATIONAL MFI INVESTMENT FUND LANDSCAPE

Microfinance, the provision of financial products and services for the poor, has expanded significantly since its early experiences through "The Grameen Bank Project", now Grameen Bank in Bangladesh in the mid-1970. In the early 1990s, microfinance institutions throughout the world, including many that followed the Grameen model, began to demonstrate that they were capable of providing loans to the poor sustainably, and looked poised to expand and increase their scale to meet the unmet needs of poor entrepreneurs throughout the world. One of the significant barriers to this growth was that it was difficult for these institutions, which in many cases were non-governmental organizations, to access capital because they did not have authority to mobilize deposits. While donors showed interest in incubating some of the stronger microfinance models, they also made it clear that this incubation would not be eternal. In fact, the idea of a sustainable model for reaching the poor was very attractive to donors, because it allowed donors an exit strategy once institutions were up and running. Donor involvement was implicitly temporary, with an eye to weaning the sector from donor funds and to more commercial sources of capital.

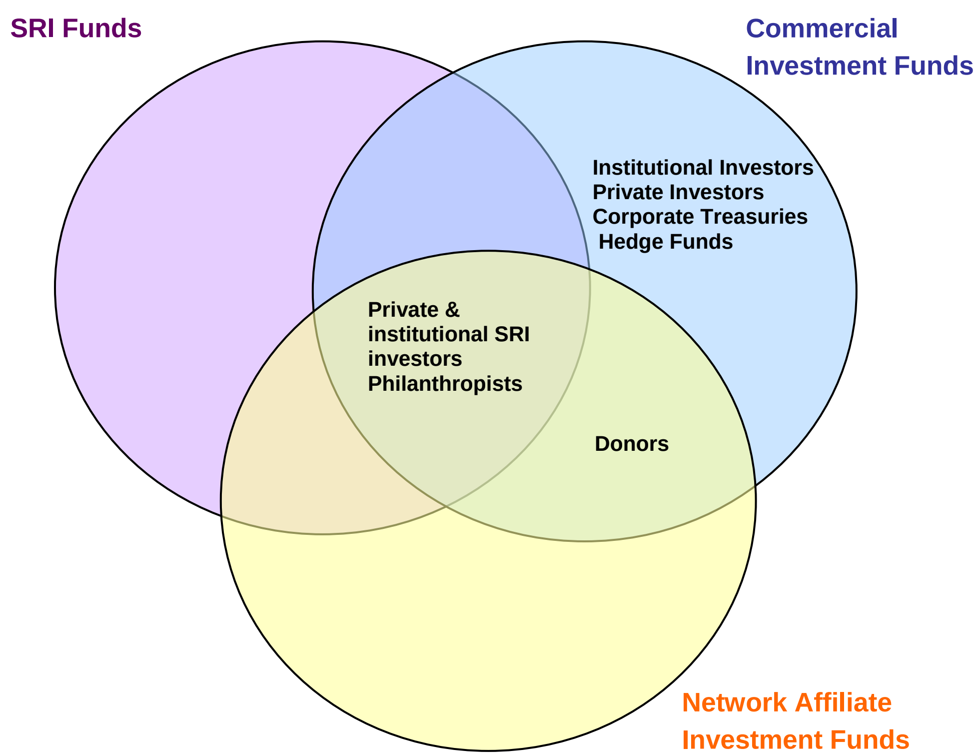
In the late 1990s, a number investment funds were developed with the aim of demonstrating to private investors what the microfinance community had known for some time—that microfinance was a profitable investment. Some of these early funds include the SICAV Dexia Micro-Credit Fund in 1998 and the Latin American Challenge Investment Fund, S.A. (LA-CIF) in 1999. Initially, donors[3] served as the primary source of funding for these structures; however, as the industry matured and evolved, donor funding became increasingly scarce as donors shifted their monies away from capital provision toward technical assistance activities. At the same time, local commercial capital was scarce in many countries, and while some MFIs were able to capture deposits to meet their funding needs, many, particularly those with NGO status, turned to the growing number of socially responsible investment funds to meet their capital requirements. Funds such as the Calvert Foundation's Community Investment Notes, which invest in international microfinance and US sustainable housing efforts, began to link their existing socially responsible investor (SRI) base with international microfinance. In Europe, Oikocredit had been channeling SRI funds from churches and church-related organizations in the Netherlands since the mid-1970s and has one of the largest recorded portfolios of loans to MFIs. International Microfinance networks such as Acción International and ProCredit Holdings also established funds aimed at investing in the debt and equity of their network affiliates to help support their growth. By the end of the 1990s, SRI investors had

[3] La-CIF was USAID's first investment in a regional microfinance investment fund.

become an alternative source of funding from donors. Because these were principally private investments, they were risk-averse, providing primarily US dollar loans to top tier MFIs. International microfinance networks were courting those same SRI investors, philanthropists and donors through their financing mechanisms, highlighting the positive effects of channeling funds in commercial terms through networks as a way to leverage the network knowledge and impact.

By early 2000, the microfinance community began to envision financial instruments that would continue to tap into existing interest from philanthropists and SRI investors but be extended to a new investor base including institutional investors, private individual investors, corporate treasuries and hedge funds. Figure 1 below illustrates that donors, philanthropists and SRI investors that had been showing growing interest in microfinance investment funds could be engaged in structures that would also attract a new set of investors that had previously not been involved in the industry. From this premise, two principal initiatives, one managed by Blue Orchard and another by Deutsche Bank were launched in 2005 with this end. The Blue Orchard and Deutsche Bank structures involved the creation of a collateralized debt obligation (CDO) that would allow more socially oriented investors including donors and philanthropists to "cushion" the risk of a debt instrument by taking a first or second loss position in an instrument that represented a pool of loans to MFIs. SRI investors and more commercial investors would thus be able to purchase the instrument and reduce their risk significantly, making the asset more attractive to these types of investors that have more rigorous risk profiles.

FIGURE 1: MICROFINANCE INVESTMENT FUND TYPES AND CORRESPONDING INVESTORS



1.2 THE ROLE OF INTERNATIONAL INVESTMENT FUNDS IN MFI TRANSITION TO COMMERCIAL CAPITAL

A review of the investors listed on the MIX Market[4] currently lists 85 active private investment funds which serve the microfinance industry. Even funds that project commercial rates of return, in most cases, are not attracting traditional commercial investors. Most commonly, the fund investors are foundations; NGOs; religious groups; multilateral, regional, or bilateral development banks; and high net wealth individuals seeking socially responsible investment opportunities. Traditionally, commercial investors have shied away because of the low returns, limited track record, small size and unavailability of ratings in these funds.

The recent CDOs have taken an important step in more efficiently allocating available sources of funds from a varied international investor base as well as in expanding this market. Commercial investors that would not normally be involved in these deals because of their strict requirements regarding the risk/return profile of an investment receive sufficient protection from CDOs to consider these transactions. This structure has provided a vehicle for a significant pool of capital to finance MFIs. Figure 2 below shows a representative sample of 19 funds listed on the Mix Markets and with expected return information published on the MicroCapital blog site.[5] The charting of the size and expected US dollar return (grouped into two categories: under 0-5 percent, and 5 percent+), shows that the majority of investment vehicles that have been able to offer higher returns have been CDO structures including the Consortium, as well as two of three Blue Orchard deals. These funds have also been among the largest, with two notable exceptions, which share the reputation of being successful pioneers in their field. One of these is Oikocredit, which manages over US$120 million in MFI loans. It has been lending to microfinance institutions worldwide for over 30 years and manages funds for a large pool of faith-based investors with a strong social mission. Another exception is ProCredit Holdings, which manages a US$110 million portfolio that has received significant donor funds to make equity investments in its successful network of 19 MFIs worldwide. Many of the larger network funds and other MFI investment funds have begun to structure equity funds to complement their loan funds and to support MFI efforts world wide to transform into regulated financial institutions.

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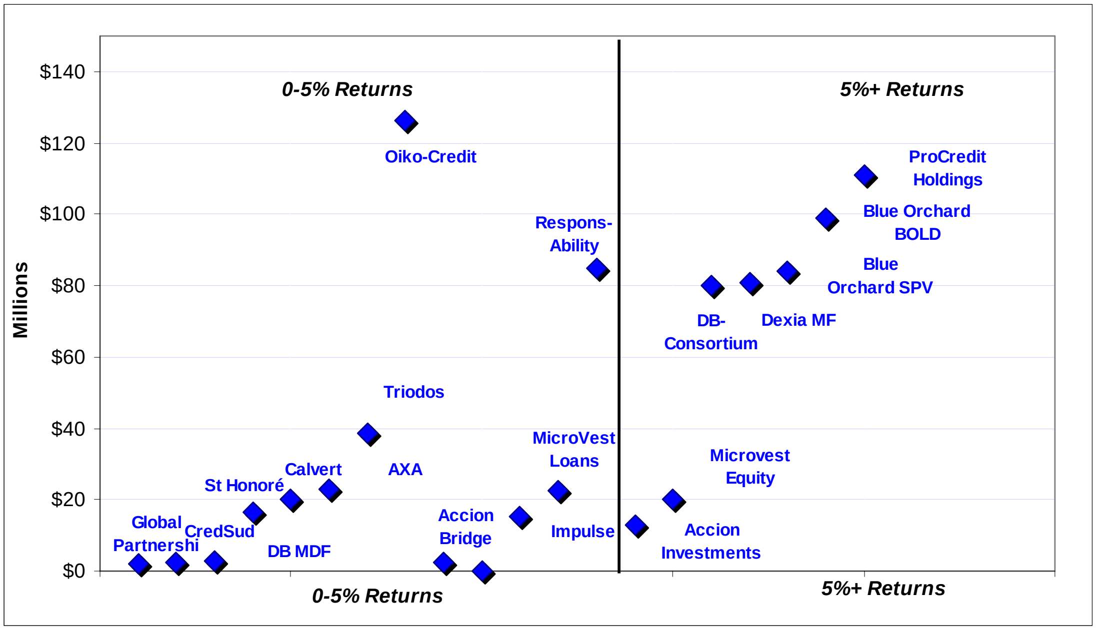
[4] The MIX MARKET ™ is a global, web-based, microfinance information platform available on www.mixmarket.org

[5] www.microcapital.org. The size of each fund is listed with differing closing dates within the past 18 months, depending on when it last reported to the site. The chart above is only shown for illustrative purposes.

FIGURE 2: MF INVESTMENT FUND MATRIX: SIZE VS. EXPECTED RETURN



By offering structures in significant size, the impact of new CDO structures will likely overshadow the impact on MFI funding of some of the smaller funds. These investment vehicles seek to address these concerns responsibly, and donor involvement in these funds will ensure some oversight. The Global Commercial Microfinance Consortium makes a concerted effort to ensure a positive development impact that reaches beyond the provision of finance to MFIs. The Consortium lends to a diverse portfolio of MFIs, including second-tier institutions that may have a harder time accessing commercial funds than top-tier MFIs. While this goal is laudable, many new investment vehicles are taking the same approach. The availability of foreign investment funds for MFIs has changed the supply and demand funding dynamics significantly over the past five or six years. Specifically, stronger MFIs have been offered perhaps more funds that they have capacity to absorb, and second-tier MFIs, which had little or no access to these funds, are being approached by a variety of foreign lenders as well. The role of foreign capital in an MFIs funding strategy is not unlike that of any developing world company or financial institution. Foreign capital offers opportunities to diversify funding sources and access cheaper interest rates. It also brings with it intangible benefits such as recognition in local and foreign markets and a greater level of investor confidence that may otherwise take years to achieve. Nevertheless, foreign capital can be fickle, and often depends on conditions outside the control of a domestic MFI such as global liquidity factors. Additionally, foreign investment brings with it some risks that more developed corporate sectors in the developing world have confronted at various time. Moral hazard may be one of the principal risks. MFIs may over-finance themselves from commercial investment funds that often have a donor or philanthropic investment, with the assumption that if they are unable to pay, the donor or investor will not let them fail. At best, they may expect a restructuring of their loan, at worst, significant loan forgiveness. If MFIs perceive these facilities to be “soft”, they will be less prudent about managing their leverage and their risks, including foreign exchange risk.

The Consortium provides an interesting early attempt at addressing some of the problems of moral hazard by increasing the supply of local currency financing. The Consortium stands out as the CDO with the greatest success in helping MFIs tap local currency funds.[6] Various local currency funding mechanisms used by the Consortium will be discussed in greater detail below. The availability of local currency funding from the Consortium can help MFIs set a precedent for demanding future funding in local currency, even when borrowing from abroad. In many cases, the Consortium has linked MFIs to local sources of local currency funding, and perhaps most importantly, to knowledge and expertise about structuring local currency transactions. The Consortium's structures have also helped MFIs understand the value of local currency funding from their own risk management perspective, and to accept local currency loans at less favorable terms than US dollar loans in exchange for the reduced risk. It is important to note that these mechanisms have not been simple in many cases, and represent significant time and effort by both the Consortium's managers and the MFIs themselves. The efforts have proven important in many cases in opening the door to other sources of local currency lending, which in turn, has improved MFI ability to manage their foreign exchange exposure.

[6] The only other commercial structure with a mandate to lend in local currency is Blue Orchard's BOLD structure, which has approximately 20 percent of its portfolio in local currency (all other loans were in USD and EURO).

2. USAID SUPPORT OF INTERNATIONAL MFI INVESTMENT FUNDS

2.1 USAID DCA GUARANTEES

Deutsche Bank has been at the forefront of microfinance investment funds since 1998, when it initiated the Deutsche Bank Microcredit Development Fund (DB-MDF), a microfinance investment fund that provided loans at subsidized interest rates for microfinance institutions worldwide. In 2004, Deutsche Bank's Community Development Group proposed to leverage its track record and experience in managing microfinance investment funds and proposed the development of a cross-border debt financing facility targeting commercial microfinance institutions (MFIs). The facility, named the Global Commercial Microfinance Consortium ("the Consortium"), was launched in November 2005 with the objective of helping to overcome market imperfections related to access to credit that MFIs face and to attract private sector debt to these financial intermediaries. Unlike the DB-MDF, this facility was designed to lend at commercial interest rates and to be structured as a Collateralized Debt Obligation in order to lend at competitive interest rates, while compensating investors for their risk appropriately. Over the past two years, the availability of loans from international investment funds has improved the negotiating position of MFIs, which are not willing to borrow at high interest rates and are seeking longer term loans, when possible, in local currency. As a result, lenders have little room to increase returns on debt funds, and must instead consider ways to reduce the perceived investment risk to attract commercial investors.

The facility called for $40 million in senior notes to institutional investors and other private investment funds, but was increased to US$63.35 million in 2006 in response to strong demand for the deal. In order to reduce credit risk to the noteholders, Deutsche bank approached USAID to request a US$10 million DCA partial loan guarantee to guarantee some of the exposure of the noteholders. This was expanded to US$15 million in 2006 when the Consortium size was increased. The structure was further strengthened by $9.5 million of Mezzanine Notes ("Class A") sold to multilateral organizations and philanthropists, another $6.25 million in Junior Notes ("Class B"), and a US$1.5 million grant from DFID.[7] Class A & B investors bear the first losses up to $17.5 million (21 percent). USAID bears the second loss for up to US$15 million (19 percent). Noteholders bear the residual, 60 percent risk on their US$60 million. The chart below depicts the structure, under which USAID is subordinate to the noteholders and senior to the facility's Class A & B interests.

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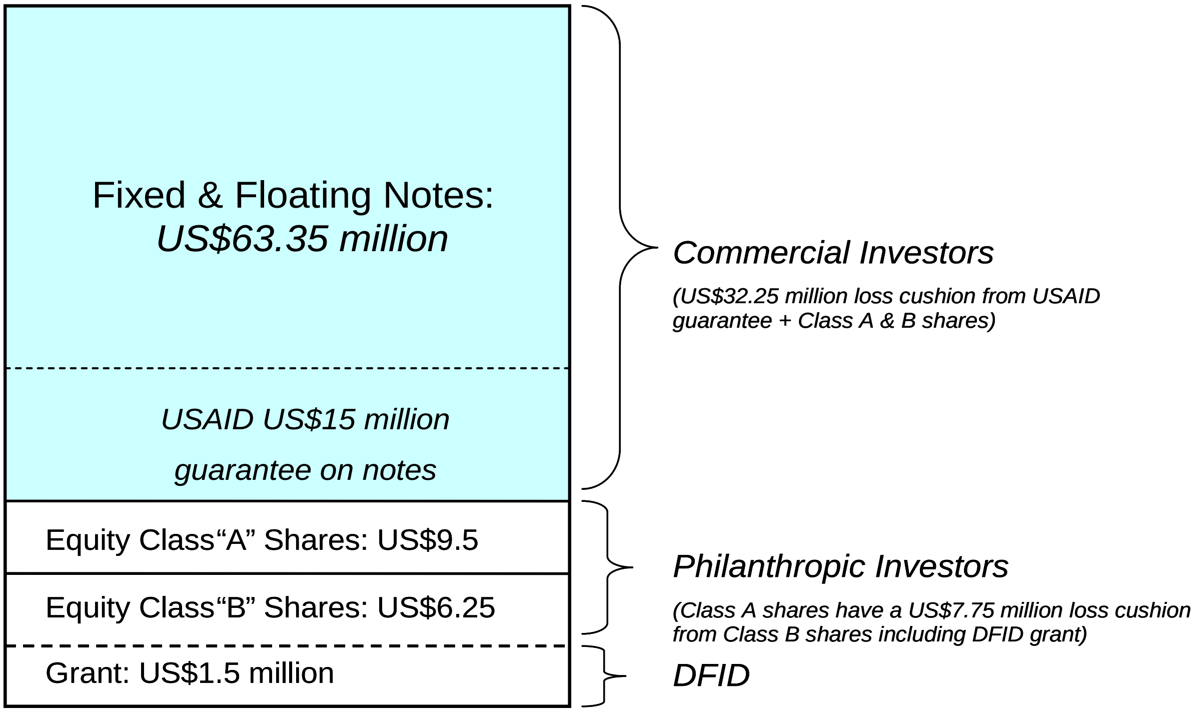
[7] For technical reasons, a portion of the Class A shares were subsequently re-classified as subordinated debt. As they retained the economic and risk profile of the Class A equity, they are collectively refereed to herein as Class A shares.

FIGURE 3: GLOBAL COMMERCIAL MICROFINANCE CONSORTIUM STRUCTURE



USAID’s position in the Consortium is different from its other DCA structures in that it is not sharing losses with noteholders but taking losses before them. Historically, USAID DCA guarantees have been structured as partial guarantees (often 50 percent) with a risk sharing component, where USAID and the lender will share any losses amounting to up to 50 percent of the loan amount for USAID and USAID is reimbursed 50 percent of any amount of the loan that is recovered from those losses. In the case of the Consortium, USAID is liable only after US$17.25 million in losses, taken by equity holders and grants. However, USAID is not sharing risk with noteholders, instead taking losses before them amounting to US$15 million of the US$63.35 million in notes (24 percent).

USAID’s rationale for participating in the facility was fourfold. The Office of Microenterprise Development (EGAT/PR/MD) was interested in exploring mechanisms that would support local currency financing of MFIs. Deutsche Bank, with its own worldwide branch network and prior expertise working through local bank branches was well positioned to exploit its expertise and relationships to develop a variety of mechanisms for local currency lending. The facility also would expand this access to second-tier microfinance institutions, which have greater constraints to access to finance than the top tier institutions that had been borrowing from the early international investment funds. Additionally, the facility was innovative in that it was structured as a CDO in order to attract commercial investors who would be otherwise limited from investing in an unrated loan fund in a relatively new and unknown market. Finally, USAID’s Office of Development Credit (ODC) has been interested in exploring new structures that can leverage their guarantees beyond their traditional loan and portfolio guarantee structures. These include bond guarantees and guarantees for securitized structures such as the Consortium.

3. DCA IMPACT

3.1 DCA IMPACT ON ACCESS TO INTERNATIONAL COMMERCIAL CAPITAL

As was mentioned above, one of the important contributions of the Consortium to the microfinance industry has been its ability to develop a structure that is attractive to institutional and other commercial investors who have not otherwise been involved in the sector. The CDO structure is able to efficiently allocate investments from a broad range of investors efficiently according to their own risk/return profiles. Investors with a higher risk appetite can buy equity in the deal, and take a greater risk. These investors may also receive the highest returns if the fund performs well. More risk averse investors, instead, take notes, which offer the greatest protection. Finally, donor funding is leveraged significantly. With US$1.5 million, DFID is able to leverage US$80.6 million in loans to MFIs. USAID also leverages its DCA structure by guaranteeing only US$15 million for an US$80.6 million portfolio of loans. As was mentioned earlier, USAID would typically guarantee 50 percent of the losses of a local bank loan, while in the case of the Consortium; the guarantee represents less than 19 percent of the total loan portfolio.

USAID has been essential as a key guarantor in the structure, through a DCA guarantee. The Consortium's roster of investors is impressive,[8] including a broad range of donor agencies, such as DFID, private philanthropists and foundations, SRI investors and European and US institutional and corporate investors. Over the course of this research, six investors were interviewed,[9] two which hold equity tranches and four noteholders. While the equity holders are subordinated to USAID's guarantee, and thus did not explicitly factor the guarantee into their investment decision, they did perceive USAID's involvement as a validation that the Consortium's investment criteria and principles were sound. Noteholders, however, made a point of underscoring the importance of USAID's guarantee in their decision making process.

3.1.1 IMPACT OF THE GUARANTEE ON INVESTOR MIX

The reviewer spoke with Deutsche Bank as well as a small number of investors in the Consortium to determine the impact of the guarantee on the Consortium's investor mix. It is important to note that some investors asked that their comments remain anonymous; others were not interested in participating in this review. This reflects a number of factors. For some investors, this was the first foray into the microfinance sector, and will serve as a test to determine future involvement. As a result, they prefer not to call attention to themselves in the community as yet to avoid having to reject

8 According to Deutsche Bank's Web site and marketing materials, the Consortium comprises: Agence Française de Développement, AXA Group, Calvert Social Investment Foundation, CNP Assurances, Deutsche Bank, Geisse Foundation, General Board of Pension and Health Benefits of the United Methodist Church, Gray Ghost Fund, HP, Kaminer Foundation, Left Hand Foundation, Merrill Lynch, MMA, Munich Re, Rauenhorst Foundation, Standard Life, State Street Corporation, Storebrand, The Church Pension Fund, The Co-operative Bank Plc, U.K. Department for International Development, U.S. Agency for International Development, David Fitzherbert, Elizabeth and Steve Funk, Deepak Kamra and Janet A. McKinley. See http://www.deutsche-bank.de/csr/en/pool/Soziales_3247.htm

9 Some investors interviewed have requested to remain anonymous.

new requests for funds. Others prefer to maintain confidentiality on behalf of their funding sources; still others may see a competitive advantage in remaining anonymous.

Based on our limited investor interviews, as well as discussions with Consortium management, the DCA guarantee ensured that a broad range of investors could participate. The guarantee was seen as providing two important benefits. The first was a greater level of subordination to the structure, which protected noteholders from risk. The second was a greater level of credibility. In the Case of Storebrand, a Norwegian financial conglomerate that manages over US$25 billion in life insurance, pensions, and mutual funds, USAID's participation in the Consortium was a "pre-requisite". Storebrand's representative noted that without a guarantee, the institution could not have been an investor. In the case of Hewlett Packard's (HP) corporate Treasury, which manages a US$19 billion portfolio, the guarantee was important in that it provided the structure with sufficient risk cushion. Their focus was on the overall risk coverage, however, and they did not feel strongly about whether this needed to include a guarantee or could instead be provided by a larger portion of equity in the structure. Nevertheless, as HP's first commercial investment in microfinance outside the Corporate Affairs group, the evaluation of the Consortium took significant amounts of time, and USAID's support added "credibility" to the structure. Other investors echoed HP, noting that the USAID DCA guarantee was a big part of the structure's subordination, and that the existing 20 percent equity position would not have provided sufficient subordination to the deal. Another investor[10] noted that USAID's involvement reflected that the structure was not an "insufficiently thought out transaction".

3.1.2 IMPACT OF THE GUARANTEE ON CREDIT RATING

Both Deutsche Bank staff and some Consortium investors who now serve on the Board spoke about the difficulties in obtaining a rating for the Consortium. Costs for such a rating were cited as prohibitively high, while some investors noted that regardless of cost, raters would not have been able to rate the structure at its inception. Some commented that more recently, traditional ratings agencies have become increasingly interested in microfinance and might consider the task. While the CDO was not rated, investors "benchmarked" the structure to alterative investments and in some cases, gave the structure an internal rating. Equity investors generally benchmarked the investment off of grants or soft loans they provided to MFIs directly, while noteholders generally benchmarked the structure against CDOs with BBB- ratings, which were seen as generally comparable. The implicit rating is a minimum investment grade rating, which would be difficult to obtain in an international MFI portfolio without a guaranteed component. A summary of this benchmarking is provided in Table 1.0 below. The table illustrates that the Consortium was able to create an attractive risk/return structure. The Consortium reduced risk and improved social returns for investors vis-à-vis their benchmarks. With regard to financial returns, direct loans to MFIs were seen as higher but carried more financial risk.

[10] Some investors interviewed have asked to remain anonymous.

TABLE 1: ILLUSTRATIVE RESPONSES ABOUT BENCHMARKING ON THE STRUCTURE

	Equity Investor	Noteholder	Either Investor
Internal Rating	None	BB/BBB-	n/a
Benchmark Asset Class	Grants	BBB-CDOs	Direct Loans to MFIs
Benchmark Return	"0"	Libor +150	5-10 percent
Consortium Financial Return vs. Benchmark	Greater	Same	Varies
Consortium Financial Risk vs. Benchmark	Lower	Same	Lower
Consortium Social Return vs. Benchmark	Greater	Greater	Greater
Consortium Social Risk vs. Benchmark	Lower	Greater	Lower

3.1.3 IMPACT OF THE GUARANTEE ON SRI

Despite the investor mix, investors and noteholders alike who were interviewed, perceived the investment as "social" to varying degrees. In the case of noteholders, these performed a risk-return analysis of the structure that was consistent with policies and procedures for evaluating any instrument. Nevertheless, in all cases, there was also a social interest in the Consortium that drove investors to spend time on due diligence and in some cases to learn about a new field that did not necessarily justify the investment in terms of financial returns. This time may be amortized, however, if the Consortium performs well and encourages investors to continue financing this market going forward. In fact, two noteholders that were interviewed are also holders of other MFI debt instruments. Philanthropists who were interviewed were extremely enthusiastic about the Consortium and their role in the deal. They perceived the structure as offering a lower risk than direct lending to MFIs because of its diversification, as well as an actual investment return, unlike grants they might make elsewhere. Additionally, they noted that the Consortium allowed their funds to be leveraged in order to reach the greatest number of beneficiaries, as the 21 percent in equity backs over 79 percent in notes.

3.2 DCA IMPACT ON ACCESS TO LOCAL COMMERCIAL CAPITAL

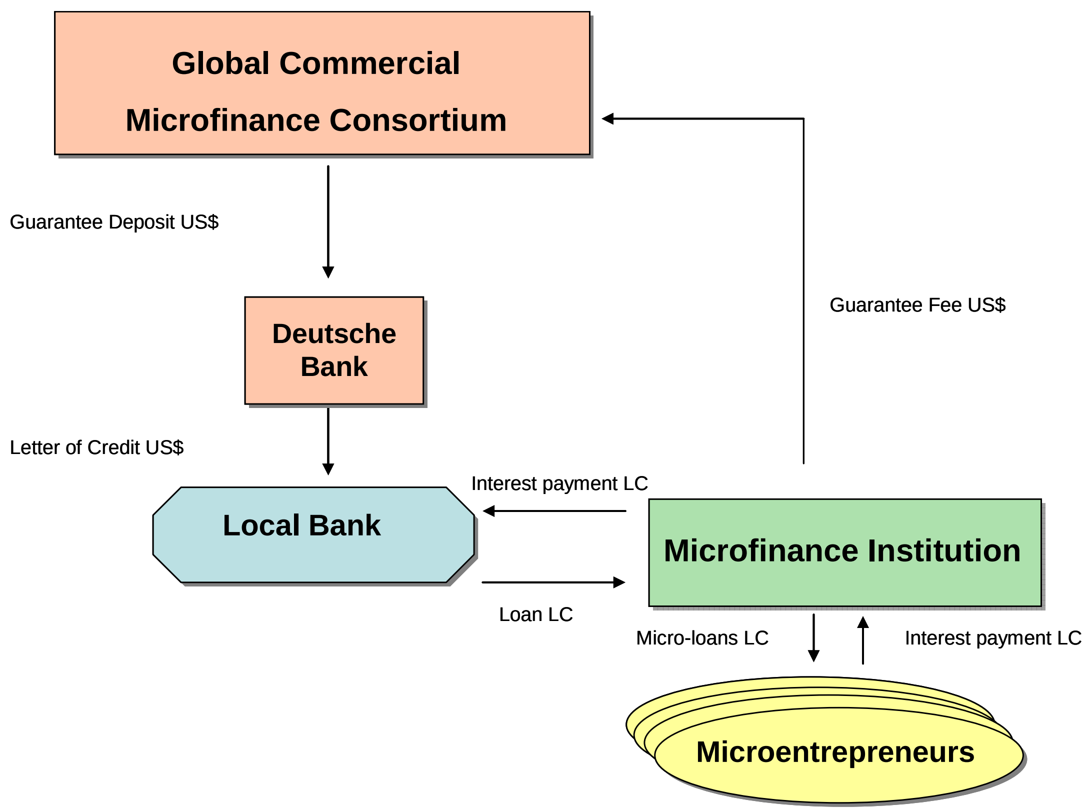
3.2.1 GENERAL ASPECTS

The Consortium has made significant strides in developing mechanisms for lending in either local currency, currency of choice or proxy currencies. It has done this through a variety of structures, depicted in general terms in Figure 4 and summarized below:

- **Co-lending:** In this case The Consortium either purchases an interest in a loan from a local bank to an MFI or enters a back-to-back lending agreement with a local bank. In both cases, the local bank lends to an MFI in local currency and pays interest to the Consortium in US dollars, thereby taking on FX risk.
- **Deposit Structure:** The Consortium lends directly an MFI, which in turn deposits the proceeds in dollars as collateral with a local bank. This bank will then issue the MFI a local currency loan. In many cases, this structure can be leveraged to provide a larger amount of a loan to the MFI by the local bank if it does not require 1:1 collateral.

- **Guarantees / Standby Letters of Credit:** The Consortium put up collateral that is used to generate a guarantee or stand-by letter of credit by a local or off-shore bank.
- **Direct Loans:** In the case of Deutsche Bank providing loans in either US$ or Euros, these are executed as direct loans from Deutsche Bank New York or London. Euro loans are hedged internally through Deutsche Bank's foreign exchange desk.

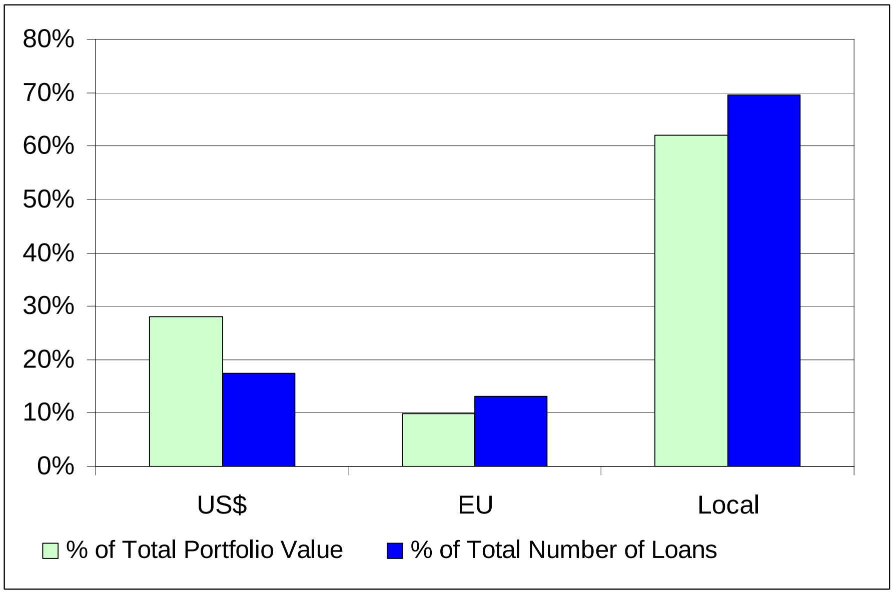
FIGURE 4: GENERAL STRUCTURE OF CONSORTIUM LOANS TO MFI BORROWERS



The structures used by the Consortium to lend in local currency (LC in the chart above) have the added benefit of reducing MFI exposure to foreign exchange risk as well as of developing stronger relationships between local commercial financial institutions and MFIs. Additionally, by lending in local currency, the Consortium is able to reduce its credit risk, although it does take on foreign exchange risk. Foreign exchange risk is an important element of the risk of lending to MFIs internationally because it can quickly translate into credit risk when MFIs or their clients are unable to service dollar loans. Foreign exchange risk at the MFI level can quickly turn into credit risk for the lender when an MFI has a large exposure to foreign currency denominated loans or if it is not managing its risks prudently.

Overall, the Consortium has been successful in lending in either local currency, or the currency most demanded by individual MFIs. Figure 5 below shows that over 60 percent of the Consortium's portfolio was denominated in local currency. Some of the Consortium's larger loans were in US Dollars, as a result, the number of loans in local currency represent some 70 percent of the total loans in the portfolio. About 10 percent of the portfolio represents Euro-denominated loans in Eastern European countries whose currencies are effectively indexed to the Euro, such as Bosnia, Moldova, and Serbia. Another 28 percent in US dollars represents loans in El Salvador and Ecuador two dollarized economies, as well as in Nicaragua and Georgia. One MFI in Georgia received two US dollar loans and one in local currency. In Nicaragua, one of the three MFIs lends primarily in US dollars and thus did not suffer from an asset/liability mismatch from the loan. Other MFIs in Nicaragua lend in local currency but with a devaluation premium as well as an interest rate differential, thus offering some cushion from currency risk. The exposure to FX risk of their clients, however, is less clear because although the economy is highly indexed to the dollar, it is not fully dollarized.

FIGURE 5: CURRENCY COMPOSITION OF LOAN PORTFOLIO



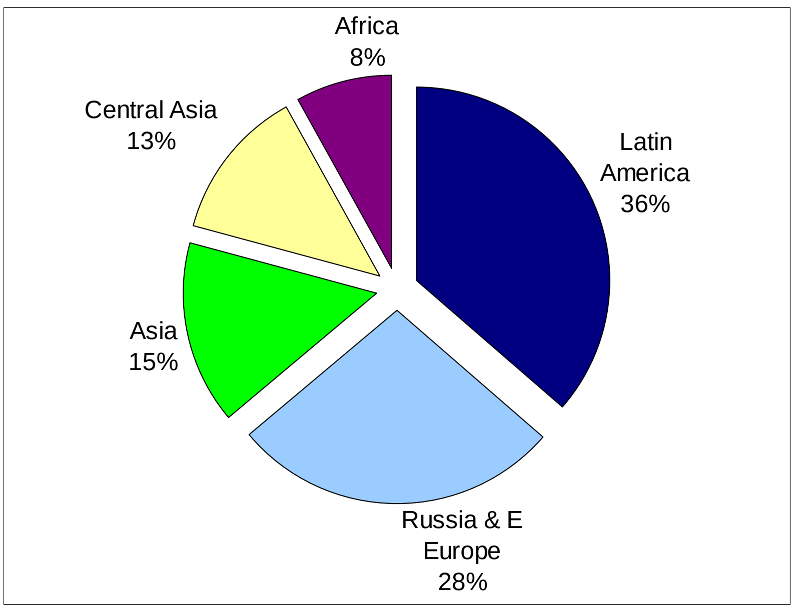
The Consortium's goals to lend in local currency have been most successful in Latin America, where a large part of its portfolio is concentrated. There are a greater number of strong second tier institutions, which are those targeted by the Consortium in these regions. Only a handful of MFIs in Africa and parts of Asia are considered strong enough to access commercial loans, particularly since the average loan size for the Consortium is relatively large at US$2.1 million.[11] Additionally, in Africa and Asia, many MFIs that might be considered as viable investments by international funds are less interested in pursuing these loans because they are able to access deposits more cheaply. In Latin America and Eastern Europe, many MFIs are still limited from taking deposits and thus are more interested in reaching out to a broader range of funding sources. Given that the majority of the Consortium's loans have been made to MFIs that either cannot take deposits or have only recently begun to take deposits,[12] it is important to note that these non-deposit taking institutions have a greater demand for such funds, and are perhaps less price sensitive than deposit taking institutions when considering borrowing from abroad.

[11] As of December 2006, considering disbursed + committed funds.

[12] The list of institutions is not publicly available. However, it was reviewed over the course of the research.

Additionally, Latin American and Eastern European financial markets are more sophisticated, offer hedging products as well as the opportunities to swap currencies at various maturities. Compared to many parts of Africa, where hedging products are either inexistent or prohibitively expensive, it is understandable why the Consortium holds over 36 percent of its loans in Latin America compared to only 8 percent in Africa. Figure 6 below illustrates a breakdown of Consortium loans by region. Interestingly, not all loans in Latin America reflect greater access to local currency instruments. In fact, just over half the Consortium's loans in Latin America are denominated in US dollars. These are primarily in lesser-developed and dollarized markets such as El Salvador, Ecuador and Nicaragua. The former two are dollarized economies where there is no currency risk. In the latter case, currency risk is effectively passed onto clients by MFI's, whose loans are either in US dollars or indexed to the US dollar. While this mitigates the Consortium's foreign exchange risk, it poses a risk to its credit in the case of domestic currency instability. In discussions with Consortium management, it was explained that this risk was considered and has been correspondingly priced and regarded in the Consortium's lending strategy.

FIGURE 6: LOAN PORTFOLIO DISTRIBUTION BY REGION



One of the drawbacks to the Consortium's focus on local currency loans has been its limitation in providing leverage for these funds through local institutions. Unlike in the DB-MDF, where loans to MFIs were required to be leveraged by at least 2:1, in the case of the Consortium, there have been few cases where funds were leveraged even modestly. In fact, in more than one case, over collateralization was required. This is especially interesting in that it reflects the extreme challenges and high costs to providing access to local currency loans to MFIs in many developing countries. Nevertheless, as foreign commercial lending becomes increasingly available, it will be an important part of MFIs' risk management structures to avoid taking on excessive exposure in foreign currency. The Consortium's initiatives to link MFIs to sources of local funds can play an important role in beginning to link sources and mechanisms for local currency funding to MFIs, especially when these are not able to take deposits. These benefits have not come without costs. Primarily, the funding mechanisms and structures can prove expensive for MFIs.

3.2.2 MFI EXAMPLES

As was mentioned above, most MFI borrowers have been either non-deposit taking or only recently began taking deposits. Consortium loans have met borrower needs by developing structures that adapted local financial conditions. Depending on their individual constraints, and local financial conditions, these MFIs have obtained differing benefits from the structure. Some examples of these loans include:

- **In the Philippines,** the Consortium made a peso loan to TSKI. The Consortium provided US Dollars as collateral for a guarantee issued by Deutsche Bank London to Deutsche Bank Manila. Deutsche Bank Manila then provided a local currency loan to TSKI.

- **In Nicaragua,** high local currency interest rates, coupled with the fact that some MFIs lend in US dollars and others lend at local interest rates that have some dollar indexation, led three Consortium borrowers to request that their loans be denominated in US dollars. Two borrowers interviewed (ACODEP and Findesa) highlighted that the Consortium's primary value added was the relatively large size of the loans and also noted that the prestige associated with Deutsche Bank's lending would significantly improve their ability to access a broader range of funds going forward.

- **In Russia,** the Consortium was able to arrange two US$2 million loans to FINCA Samara Russia in Rubles . Samara Russia had been borrowing significantly in US dollars to finance expansion and wanted a local currency loan. The Consortium deposited funds at Deutsche Bank in London, which then used these funds to guarantee a ruble loan from Deutsche Bank Moscow to FINCA. Deutsche Bank Moscow ended up with currency risk, but no credit risk. The transaction was somewhat complex and took time and additional fees to structure because of the various countries and currencies involved.

- **In Colombia,** the Consortium combined its investment as a 100 percent participation in a loan and a cross currency swap. The transaction was executed through a Panamanian intermediary. This enabled the Consortium to work around restrictions to lending in local currency without a local bank license.

Overall, borrowers cited that the Consortium's interest rates were lower than local bank loans, and competitive in terms of other commercial investment funds. Nevertheless, most MFIs are still borrowing at lower rates from donors or SRI investment funds. It is important to note that in countries where government funded APEX institutions or second-tier lending institutions play a large role, the interest rates offered by the Consortium look relatively expensive.

Example: MICROINVEST, LLC Moldova

MICROINVEST was established in 2003 by the Soros Foundation Moldova and the Moldova Microfinance Alliance ("MMA", NGO) to provide development finance to small business initiatives in rural and urban areas in the Republic of Moldova. The MFI has 9 branches, a loan portfolio of US$3.4 million and 1,500 clients. Its average loan size is US$2,248.

Approximately 60 percent of MICROINVEST's liabilities are from commercial sources, all from abroad. The MFI is not permitted to take deposits. In early 2006, MICROINVEST applied to the Consortium for a loan. The Consortium's investment shows a true commitment to reaching smaller MFIs with a limited track record but with strong potential for growth. Because the Consortium's management was familiar with the MFI following a prior investment by the DB-MDF, and because MICROINVESTS' loan was relatively small in the Consortium, all due diligence for the EU$750,000 loan was conducted by phone. The MFI noted that this was quite more rapid and effective than the process would have been through any local counterpart. The deal structure was negotiated over a six month period. MICROINVEST noted that this was about the same amount of time as other structures.

When MICROINVEST applied for a Consortium loan, there were no local currency loans available in Moldova. MICROINVEST requested a Euro loan from the Consortium as a part of its policy to hold a diversified portfolio of currencies. The structure proved somewhat speculative, as ultimately, MICROINVEST kept the Euros on deposit at a local bank as collateral for a local currency loan. Today, MICROINVEST has been able to borrow directly in Moldovan Lei (MDL) from another foreign investment fund, which is taking the foreign exchange risk itself. Additionally, it is negotiating a deal with the European Bank for Reconstruction ad Development (EBRD). The MFI stated that having a loan with the Deutsche Bank name was an important factor in the interest of these new investors. Going forward, MICROINVEST will be looking to borrow more in local currency from international funds, which appear to be more willing to hedge FX risk themselves.

4. CONCLUSIONS AND RECOMMENDATIONS

An increase in the availability of foreign investment funds for MFIs has changed the supply and demand funding dynamics significantly over the past five or six years. Specifically, stronger MFIs have been offered perhaps more funds that they have capacity to absorb, and second-tier MFIs, which had little or no access to these funds, are being approached by a variety of foreign lenders as well. The role of foreign capital in an MFI’s funding strategy is not unlike that of any developing world company or financial institution. Foreign capital offers opportunities to diversify funding sources and access cheaper interest rates. It also brings with it intangible benefits such as recognition in local and foreign markets and a greater level of investor confidence that may otherwise take years to achieve. Nevertheless, foreign investment brings with it some risks that more developed corporate sectors in the developing world have confronted at various time. Moral hazard may be one of the principal risks. MFIs may over-finance themselves from commercial investment funds that often have a donor or philanthropic investment, with the assumption that if they are unable to pay, the donor or investor will not let them fail. At best, they may expect a restructuring of their loan, at worst, significant loan forgiveness. If MFIs perceive these facilities to be “soft”, they will be less prudent about managing their leverage and their risks, including foreign exchange risk. The Consortium provides an interesting early attempt at addressing some of the problems of moral hazard by increasing the supply of local currency financing. The availability of local currency funding from the Consortium can help MFIs set a precedent for demanding future funding in local currency, even when borrowing from abroad. In many cases, the Consortium has linked MFIs to local sources of local currency funding, and perhaps most importantly, to knowledge and expertise about structuring local currency transactions. The Consortium’s structures have also helped MFIs understand the value of local currency funding from their own risk management perspective, and to accept local currency loans at less favorable terms than US dollar loans in exchange for the reduced risk. Below we review some of the important lessons and considerations from the experience of the Consortium to date.

4.1 ENVIRONMENTAL CONSIDERATIONS

- Microfinance investment funds have become larger and more sophisticated over time, and have been able to more efficiently capture funding from various segments of investors including donors, philanthropists, socially responsible investors and commercial investors.
- Historical performance measures and ratings, which are now not available, will likely evolve. USAID’s involvement in CDOs today may be setting the stage for a broader variety of instruments and mechanisms to finance microfinance in the future.
- Despite the interest and potential for significant international commercial financing of MFIs, global markets can be fickle, and external conditions such as global liquidity conditions can divert international investors from emerging markets securities, including microfinance investments. MFI funds are an attractive complement, but not a replacement for local sources of funding.

- MFIs continue to face restrictions to access to local capital. The Consortium has made an important attempt to bridge this gap and provide access to local currency financing. While Deutsche Bank's branch network provided the Consortium with an advantage in structuring these deals, they have not always been easy or attractive because of the transaction costs involved. In the case of Russia, the MFI complained of high fees and a complex transaction. In Nicaragua, the cost of a local currency loans was a barrier for MFIs, which preferred to take FX risk and borrow in US dollars. In Africa, local currency loans are expensive, and in many cases unattractive vis-à-vis deposits.

- When lending in local currency, the Consortium, was able to leverage its loan funds only in a few instances. This is in contrast to the experience of Deutsche Bank's DB-MDF, which made loans to MFIs in US dollars, and in which all loans were leveraged. In the case of the DB-MDF, Deutsche Bank loans were typically used as cash collateral at local banks for loans. Local banks would then lend a greater dollar amount to MFIs, often with 1:2 or 1:3 leverage. In the case of the Consortium, because local banks were already taking FX risk on dollar deposits that were used as collateral, they were less likely to add to this cost of provisioning for additional credit risk.

- Borrowers cited that the Consortium's interest rates were lower than local bank loans, and competitive in terms of other commercial investment funds. Nevertheless, most MFIs are still borrowing at lower rates from donors or SRI investment funds. Additionally, in countries where government funded APEX institutions or second-tier lending institutions play a large role, the Consortium's rates can seem expensive. There is no evidence that the Consortium has played a role in reducing funding costs for MFIs. To reduce funding costs, USAID may need to either take more risk in this type of structure or consider structures that target SRI investors who might be less return sensitive.

4.2 STRUCTURAL CONSIDERATIONS

- CDOs allow for the efficient allocation of investments from a broad range of investors according to their own risk/return profiles. Investors with a higher risk appetite can buy equity in the deal, and take a greater risk. These investors may also receive the highest returns if the fund performs well. More risk averse investors, instead, take notes, which offer the greatest protection. Finally, donor funding is leveraged significantly. With US$1.5 million, DFID is able to leverage US$80.6 million in loans to MFIs. USAID also leverages its DCA structure by guaranteeing only US$15 million for an US$80.6 million portfolio of loans. By tailoring a CDO to a broad range of investors, the Consortium has been able to achieve an interesting scale. USAID guarantees can play an important role in a variety of CDO structures, in microfinance and other sectors, in that these structures require relatively large guarantees in order to reduce investor risk.

- USAID has traditionally used its DCA guarantees to facilitate bank lending to sectors of interest for its strategic objectives. Despite the evolution of the microfinance industry, many MFIs continue to lack access to finance, particularly in local currency. In many developing countries, USAID's DCA guarantees, structured as loan guarantees, loan portfolio guarantees or portable guarantees have served as a mechanism for MFIs to access credit through local banks. The Consortium represents an extension of these efforts, whereby USAID was able to commit a guarantee in only one transaction, with the fund manager, in this case, Deutsche Bank implementing over 20 local currency loans. This model may prove cost effective for USAID.

- While the structure may be cost effective for USAID, it is also a divergence from USAID's traditional mandate to use DCA guarantees to support the Strategic Objectives of USAID missions. USAID missions were not involved in structuring this deal, instead the Washington-based Office of Microenterprise Development (OMD) was engaged significantly. This represents an interesting model for collaboration between ODC and OMD. USAID missions proved helpful, nonetheless, in the process of facilitating the Consortium's due diligence in country by providing industry information, MFI information and contacts in many cases.
- When supporting CDOs, USAID should consider the additionality of its guarantees both in terms of the risk cushion it is providing as well as the credibility USAID brings to a deal. In the case of the Consortium, both were critical. While including more equity investors such as individual philanthropists and donors might have provided sufficient risk cushion in the deal, many investors that were new to microfinance relied on the expertise of USAID in the microfinance field and were heavily swayed by USAID's involvement.