MFI FINANCING STRATEGY GUIDELINES AND TEMPLATE

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MFI FINANCING STRATEGY GUIDELINES AND TEMPLATE

Accelerated Microenterprise Advancement Project (AMAP) Financial Service

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AMAP FS IQC, Knowledge Generation

ABBREVIATIONS AND ACRONYMS

ALCO	Asset Liability Committee
AMAP	Accelerated Microenterprise Advancement Program
CSR	Corporate Social Responsibility
FI	Financial Institution
GM	General Manager
GRI	Global Reporting Initiative
IRP	Investor Relations Program
ISO	International Standards Organization
MBB	MicroBanking Bulletin
MFI	Microfinance Institution
MIS	Management Information System
MIX	Microfinance Information Exchange
OSS	Operational Self-Sufficiency
TD	Treasury Department

CONTENTS

INTRODUCTION

Sourcing capital is becoming an increasingly critical element in the microfinance sector's goal of providing billions of low income families appropriate and sustainable financial services. Private capital, both debt and equity, is the fuel that will take microfinance to this truly global scale. How it is sourced and the impacts it will have on the sector are many, and the sooner microfinance institutions (MFIs) begin to systemically plan and search for capital, the sooner the market will be served in a sustainable fashion.

Unfortunately, MFIs have seldom given much strategic thought to financing their operations until they are hit by a liquidity crisis or they reach a size that they must focus resources on avoiding such a crisis. Reacting to crisis is a less than ideal way to structure an institution's financing structure and no matter how modest an MFI's funding needs are, a systematic and disciplined approach to financing is always in order. Some smaller institutions do have informal plans and search capacity based on the personal contacts of the General Manger (or equivalent). Typically, however, plans are opportunistic and scattered, with inconsistent results and large opportunity costs. This informality is carried over to many mid-sized and even some larger institutions.

FUNDING STRATEGY MAXIM NUMBER ONE

"LAYING DOWN THE FOUNDATIONS FOR A STRATEGIC FUNDING PLAN CANNOT START SOON ENOUGH"

There is much that a smaller MFI can do to prepare for and source a diverse range of capital. Considerations include an understanding of the relationships between liability management and funding, setting of strategic fund raising goals, and developing a modest yet effective and efficient investor relations program.

This guide outlines steps that MFIs can take towards developing and executing a strategic financing plan. The document has four parts. Parts One and Two outline a strategic path towards determining an "ideal" financing structure and strategic financing plan. Part Three reviews management structures and practices enabling responsible and strategic management of liabilities. Finally, Part Four guides MFIs in the creation of an Investor Relation Program that supports the sourcing of funds and the maintenance of investor relations.

WHY THE GUIDE WAS DEVELOPED FOR SMALLER MFIS

After three years of research, the AMAP Transition to Private Capital team has learned that very few MFIs have structured financing plans to facilitate a transition to private capital in an effective and efficient manner. This guide and template is aimed at helping MFIs sort options and set strategic directions for that transition. It is written primarily for smaller MFIs wanting to grow and requiring funding far beyond that which they currently source. It assumes that a structured financing plan, like any other business plan, offers a greater probability of efficiently reaching desired outcomes. The guide focuses primarily on debt financing, but makes reference to deposits and equity where appropriate.

SECTION ONE: PLANNING & PREPARATION

Figure One
Business Plan Outline

Background Information
Mission Statement
History
Legal Status and Registration
Owners and Founders
Funding Sources

Institutional Analysis
Mission and Goals
SWOT Statement
Strategic Objectives
Strategic Initiatives
Institutional Performance
Board Management and Staffing
Description of Products and Services
Performance Indicators and Trend Analysis
Operating Systems

Operating Environment
Macroeconomic Analysis
Financial Sector
Microfinance Sector
Market Share
Target Market

Operations Plan
Staffing
HR Development
Credit and Savings Growth Plan
Capital Investments
Operating Systems

Funding
Sources and Requirements
Strategies for Sourcing

Financial Projections
Assumptions
Income Statement
Balance Sheet
Performance Indicators

If you don't plan where you are going, the chances of you ending up where you want to be are very small. This old adage applies to financing MFIs and like all good adages, it makes something complex seem quite simple. But there is nothing simple about collecting and dispassionately projecting the current status of your MFI's business five years into the future -- to say nothing about understanding market conditions and pressures.

BUSINESS PLANNING - BASIC INFORMATION NEEDS

Basic business planning and the creation of a solid business plan is the first and very necessary step towards developing a credible financing strategy. Such a plan must be based on an MFI's long term strategic vision which defines where the institution wants to go. This view must then be translated into future operational and financing needs.

This requires a carefully crafted and quantified view of the future business environment that defines the strategic options for advancing an institution. For example, if the market is large and unsatisfied then a rapid market share growth strategy may be appropriate; or, if competition is strong, a segmented strategy may be in order.

Once the most appropriate strategic option is selected, business goals can be set. To set these, an institution must compare current operating and finance capacities with those required to meet strategic business goals. An operating plan is the result. This plan explains in qualitative and quantitative detail institutional developmental needs and financing capacity required to meet business goals.

The most critical aspects of a plan – the foundation from which all is built – are the assumptions that drive growth, performance, and financing need projections. Some assumptions including inflation, exchange rates, and interest rates will rely on external sources. Others such as average loan size, number of clients, loan officers per client, etc. are determined internally. It is critical that assumptions are carefully constructed with reference to past trends and in anticipation of well reasoned future expectations. A business plan without clear and solid assumptions will neither support investor confidence, nor, more importantly, lead to anticipated results.

Business planning pro-formas should undergo extensive scenario and stress testing before an institution settles on a final quantitative presentation. Stress or performance scenarios testing (e.g., testing the effect of a range of performance outcomes on capital needs) an MFI's capital structure will show the overall fund raising challenge. However, an understanding of the funding volume required is only the first step in analysis. Testing should include analysis of liquidity needs, capital structure ratios, and cash coverage ratios, etc. Scenario testing will suggest a number of strategic financing options that will ultimately help an MFI develop a cogent fund raising plan.

MicroFin remains the software of choice for small financial institutions wanting to test business projections as it is reasonably simple to use and allows for sufficiently sophisticated analysis.[1]

Figure Two
Financial Modeling

Financial modeling is an integral part of a comprehensive business planning process. A well-crafted model:

Provides a template for detailed projections. These projections facilitate strategic and operational planning, performance/variance analysis, and decision making — thereby enhancing an institution's ability to set and achieve goals.

Strengthens the financial planning and management skills of staff which is vital to the successful implementation of an institution's mission and strategy.

FINANCIAL PLANNING

An MFI must undertake a complete inventory of liabilities as an input to capital structure and needs modeling. Table One in Appendix One provides a simple liabilities matrix supporting an inventory. There are three objectives of the inventory. First, while financial modeling focuses on price and term, a full inventory provides a more textured view to funding required to fully understand how current funding of an institution will restrict or facilitate future funding activities (e.g., use of security, term conditions etc.). Second, the full range of funding details affecting price and potential liquidity impacts must be considered in light of future operating expectations. Third, a liabilities inventory allows MFIs to objectively analyze the strengths and weakness of its current funding against the "ideal" capital structure emerging from scenario testing.

While there is no single ideal capital structure, small institutions wishing to grow and become commercially successful should demonstrate a commitment to a full transition to private capital over the long term. Figure Three shows a generalized path towards private capital based on the experience of many MFIs. For most MFIs, the "transition" has been made by using donor funds, specialty microfinance funds, and third party guarantees to lever increasing proportion of private funding.[2]

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[1] See www.microfin.com

[2] See for example Jansson, Tor, "Financing Microfinance," Inter-American Development Bank, Sustainable Development Department Technical Paper Series, Washington, DC, 2003, available at: http://www.iadb.org/sds/publication/publication_3252_e.htm

FINALIZING THE BUSINESS PLAN

Once the numbers are in place, a business plan can be developed. The plan should look five years into the future. This requires MFIs to anticipate internal systems and structures needed as business evolves. Business planning for the asset side of the balance sheet is well documented. There is less "best practice" information available for the liabilities side, but this clearly includes the development of financial management and oversight structures, MIS considerations, funding search budgeting, etc. calibrated to evolve with the size and complexity of an MFI's financing needs.

Specific strategic financing plans are discussed in more detail in Parts Two and Three. Suffice to say here that business plans demonstrating a realistic path towards private capital will have greater interest and credibility with funders than those that do not. Inevitably, unanticipated events will occur ensuring deviation from whatever plan is set in place. The commitment to private capital, as a result, is the most important benchmark an institution's funding plan will have. It will guide funding decisions by informing the short and medium term price and term trade-offs MFIs will inevitably have to make as they adapt to evolving market conditions and as their own capacity development progresses.

EQUITY COUNTS TOO

MFIs need to pay attention to how ownership will support or otherwise influence their future funding structure. A clear, well-articulated governance structure is critical because owners have the ability to influence an MFI's decision making. This is particularly important if there are significant minority shareholder blocks that potentially affect institutional planning and stability.

Owners also have an important capital structuring role. Understanding their commitment to institutional growth via retained earnings versus dividend expectations, for example, is a vital consideration. Owners also represent a source of "back up" capital in the event of an unanticipated liquidity crisis or for ongoing investment needs. MFIs need to know in advance the depth of ownership "pockets" to make good on capital shortfalls if necessary. Investors will similarly scrutinize ownership as part of their risk calculation.[3]

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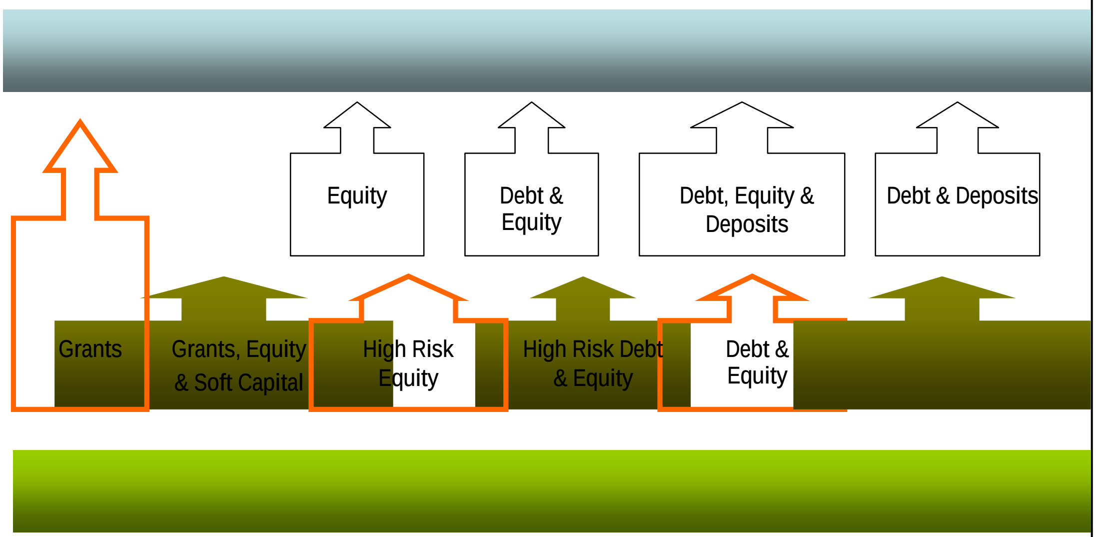
[3] Reddy, Rekha and Elisabeth Rhyne, *Who Will Buy our Paper: Microfinance Cracking the Capital Markets?* Insight No. 18, ACCION International, April 2006.

Figure Three
MFIs' Lifecycle Stages & Typical Funding Patterns



Capital sources listed along the bottom line are those that are predominant at a given stage of an institution's development cycle and are not mutually exclusive to other sources.

BUSINESS PLANNING RESOURCE AND SUPPORT

Key aspects of a business plan are noted in Figure One. The list is not exhaustive but is fairly representative of the considerations smaller MFIs must make. There are a host of do-it-yourself strategic planning tools which can be used or consulted - some of which are referenced in Appendix Two.

A strategic plan should always be written or at least fully guided by management, but the bulk of the work can be delegated to a team of junior managers or outsourced to consultants reporting to management. A good plan costs approximately USD$50,000 to $100,000. The Board of Directors will ultimately approve the plan, so their input is required in one form or another throughout the development process. Many larger MFIs will have the resources to develop a strategic plan in-house, though some parts that require extensive expertise such as market analysis may be outsourced. Having a detached external review by a financial services sector consultant or better yet, a former loan officer, is also often valuable.

SECTION TWO: DEVELOPING A STRATEGY

While competition for international capital is decreasing for larger MFIs, smaller MFIs must still work hard to attract investors and inspire confidence. Access to local sources of private capital, the strategic goal of sustainability, remains as difficult as ever.

The good news about sourcing investment capital is that the single most important factor for attracting capital is in the control of the MFI: good performance. Beyond this, MFIs seeking capital must have a confident financing strategy. Such a strategy must show an MFI knows what capital it needs and that it can demonstrate liability management systems and structures that are appropriate for its size and risk exposure.

Before this can be shown, however, an MFI must decide on an ideal funding structure given current and projected market context and internal capacity. This requires that an MFI make a strategic commitment to shaping its funding structure over the long term.

Figure Four
Believe in Strategy

Most MFI financing strategies are demand driven. This is the infamous "we look when we need money" strategy that often results in liquidity crisis and/or severely limits growth. Having a well defined strategy that is developed early helps MFIs avoid such crises and ensures smooth, manageable asset growth. A plan can also guide important price, term, and capital use trade off decisions which, in turn, can add significantly to institutional funding stability. In short, MFIs must believe in and have the discipline to reap the rewards from a well articulated and executed funding strategy.

CHOOSING A STRATEGY

Many MFIs make the mistake of pursuing the lowest cost funding possible. While important, obtaining the lowest pricing is not a strategy in and of itself. Neither is a strategy about funding volume, cost of funds, diversification and risk exposure goals, although these are important outputs of a well developed strategy.

Rather, a funding strategy in the broadest sense is laying out an institution's "ideal" funding structure. It provides long term guidance for short and medium term decision making. This is particularly important if a full transition to private capital is the final goal, as short term pricing and term trade-offs will pressure or tempt an institution off its strategic course.

BIG DECISIONS FIRST

Most small growth-oriented MFIs face the decision of whether to transform into a deposit taking institution. Several years ago, this was really the only way MFIs could achieve scale. Today there are other funding options that can support rapid expansion, from tapping capital markets to off-balance sheet fund servicing arrangements.

TAKING DEPOSITS

Deposit taking is still considered the most promising long term solution to making a full transition to private capital. This is not a simple decision and should be made only after a lengthy process of institutional, client, market and funding option analysis.

Once a decision to take deposits as a primary source of funding is made, an institution must determine if it will focus on sourcing a few large depositors, turn directly to loan clients and smaller deposits, or a mixture of each. Each option has its own cost and risk implications and the mix of deposits finally targeted should be based on financial decisions that ensure a sustainable product offering and not just the desire to provide a "service" to clients. In the long term, however, the best client services are those that are strategically selected, well designed and contribute to institutional profitability and meet the needs of clients. If savings can not be offered in such a way the simple desire to provide savings services should be seriously reconsidered. This said, some MFIs have developed careful strategies to cross subsidize services and/or total client profitability which seeks to provide a range of services that lead to an institutionally acceptable level of sustainability.

Mibanco of Peru, for example, accepts both demand and term savings, but has a strong focus on long term certificates of deposits which fuels 60 percent of its portfolio. By contrast, Compartamos of Mexico has been eligible to take deposits for over a year but has not rushed to develop retail capacity because it has sufficient funding from equity and the bond markets.

EMPLOYING DEBT

A second approach is to rely on wholesale funders for portfolio finance rather than deposits. In some cases, such as with the EDPYMEs (Empresa de Desarrollo de la Pequeña y Micro Empresa) in Peru, institutions are not legally allowed to take deposits forcing them to seek alternative capital sources. In other cases, MFIs deliberately seek low cost wholesale capital from private markets and/or from development finance institution funding. Womens' World Banking affiliates in Colombia have until recently relied primarily on second tier government owned bank finance. They are now leveraging operational success and development bank credit history into commercial capital bond market success.

Attracting wholesale funding from the capital markets has higher finance but lower transaction costs than demand savings accounts.

MFIs in some countries may not have the option of tapping capital markets, particularly in Africa where they are underdeveloped and/or very shallow. MFIs in these countries face difficult funding challenges as commercial bank finance is typically very expensive and therefore has seldom been used as the basis for long term sustainability. This said, commercial bank lines remain useful sources of rapidly available funding in the case of liquidity shortages. They can also provide an excellent means to transitioning to deposits or other forms of private capital, particularly in markets where competition still allows for wide financial margins. In the absence of other sources of capital, MFIs in Uganda, for example, paid up to 22 percent for bank finance to fuel growth in anticipation of transitioning to deposit taking institutions.

NEITHER DEBT NOR DEPOSITS

Loan servicing arrangements has recently emerged as viable means for MFIs to rapidly expand services to the low income market. Instead of lending its own funds, an MFI is contracted by a third party, often a large commercial finance institution such as a bank, to provide a lending service. Agreements vary, but typically MFIs source, disburse, collect and manage loans on behalf of the third party.[4]

Because the MFI manages someone else's funds, their balance sheet is not affected. This addresses a number of balance sheet issues which can constrain growing MFIs, including liquidity risks and reserve requirements. ICICI Bank has developed such relationships with self help groups in India. A service arrangement still requires high levels of operating efficiencies if an MFI is to remain profitable. Periodic renewal of service agreements also poses some risk to an MFI and its clients as renegotiation of terms can lead to undesirable terms affecting client outreach and/or profitability.

Portfolio securitization is another option for MFI financing strategies. Securitization is when an MFI sells the rights to income from a portfolio of microfinance loans. This removes assets from an MFI's balance sheet and decreases pressure on capital adequacy ratios and frees up capital to leverage new debt. The MFI also typically is paid to administer the portfolio once sold.

A microcredit portfolio securitization requires loans of similar risk be packaged into an offering. In the United States, home mortgages are often securitized as they are relatively homogenous (market risk) and managed by financial institutions in similar ways (operational risk). For MFIs, securitizations represent an emerging opportunity, albeit one with greater promise where capital markets are deep and opportunities for packaging similar loans exist. SHARE in India, for example, has made a small securitization of US $4.3 million sold entirely to ICICI Bank. The securitization relied on a nearly USD

[4] See AMAP case studies on strategic partnerships between banks and MFIs on http://www.microlinks.org/ev_en.php?ID=12673_201&ID2=DO_TOPIC

$325,000 guarantee from the Grameen Foundation as well as transaction technical assistance support.

Most capital market instruments such as bonds and securitizations offer cost effective alternatives for transactions over $10 million. They require, however, highly rated operating capacities. As a result, they represent, for the most part, long term funding options. For smaller MFIs, securitizations and bond issues are far into the future. This said, an MFI will never achieve these goals if it does not have a well laid out long term plan with these options in mind.

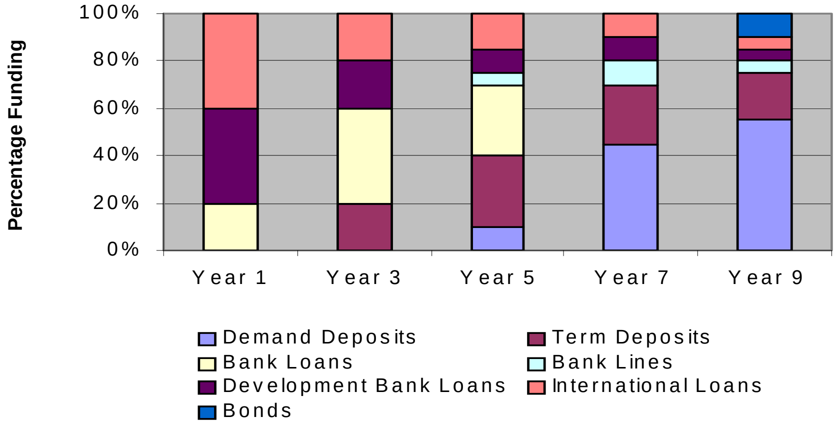
Figure Five
Funding Strategy Scenarios

For example, an MFI in transition to a regulated entity may decide to set a goal of over 90 percent reliance on private capital within five years and in seven years have 90 percent local market funding. It also has the goal of 70 percent of funding from deposits in five years.

To meet this goal it will need to diversify away from donors and development bank sources and establish relationships in with commercial providers. To do this, the MFI anticipates a medium term increase in the costs of funding.

A first step for this MFI may be to use international, donor funding, or development bank funding to guarantee local commercial bank loans. Two to three years after transformation, the MFI can plan a shift from term loans to lines of credit (based on established relationships) as it ramps up medium term deposits from a small number of larger depositors. This will result in higher financing costs if the MFI wants to effectively manage concentration risk exposure. Over time, demand deposits will be grown to lower the cost of capital in step with institutional capacity development investments that are only possible after the transition process has been fully absorbed.

In this scenario, the MFI is trading off higher medium term cost of funds against commercial bank relationships that provide term loans in the short and lines of credit for liquidity over the long term. In the long term, the institution expects a smooth transition to low cost demand funding, with very little overall reliance on but strategic use of foreign denominated loans.



TRANSITION TO PRIVATE CAPITAL: A TYPICAL PATH

Figure Five shows a sample funding strategy based on experiences similar to the path taken by several leading MFIs around the world.

The strategy sets out long term goals of 100 percent private funding and 90 percent local funding within five and seven years respectively. Short term funding is a mix of grants, soft loans, and development bank debt; over the medium term transition funding comes from bank loans along with term deposits to fund liquidity. The relative balance of funding through each stage should also be targeted, as should an average cost of capital.

Over time, the MFI diversifies its funding from three to six types of capital with several sources each. The plan maintains links with development banks and international lenders for diversity purposes but also for possible liquidity needs. Bank term debt is phased out, but lines of credit are maintained for relationship and emergency liquidity. By year seven, deposits consist of 75 percent of funding, and bonds ten percent meeting the goals of over 90 percent private and 90 local capital. In this case, the MFI focuses on reducing reliance on international capital, but maintains links both for strategic access and, given competition in international supply, potentially price advantages.

An MFI sets the targets according to the nature of regulatory regimes, local bank finance options, depth of capital markets, and access to international capital. Understanding one's options is a critical part of a finance strategy and is covered in more detail in Section Four as a part of a structured funding search.

Figure Six
Funding Strategy Discipline at *Compartamos*

Compartamos has a commitment, above all, to a funding strategy discipline. Early in its funding history, *Compartamos* decided to avoid subsidized funding, turning to a variety of commercially priced sources instead. Executives reasoned that although this strategy would likely (and was) more expensive in the medium term, a strong credit history and repayment track record was more important to long term profitability and outreach.

Instead of turning off investors, this disciplined and strategic approach only enhanced their reputation. Today, *Compartamos* has few funding concerns despite exponential growth over the last several years.

SUMMARIZING STRATEGY

A strategy is only as strong as the institutional commitment to achieving its goals over the long term. Maintaining a strategic focus is critical as an MFI moves from a position of relative bargaining weakness to having an established credit history, strong lender relationships, increasing funding volumes, and efficient and effective capital management structures. Patience and persistence is key, but beyond this, there are several things an MFI's management can do to help stay the course.

KNOW WHAT YOU WANT AND STICK TO IT

At the broadest level, a strong strategic funding plan can best be summed up by the oft cited phrase: "knowing what you want and on what terms." This simple statement belies a great deal of complexity as executives of most small MFIs feel they are hardly in a position to dictate funding terms when capital seems so difficult to source.

Yet oftentimes, investors prefer executives that know what they want on what terms: this may not facilitate a loan, but if the executive does her or his job well, a solid business relationship for future use is the minimum "win." And if negotiations do start, investors may not always accede to terms but they will *always* have greater respect for a well reasoned funding plan than one -- as is typically the case -- which is driven by opportunity and takes any capital at any cost or term. Having the discipline to walk away from terms that do not work for one's immediate or long term strategic needs usually yields better results than simply being opportunistic.

BENCHMARK PLAN PERFORMANCE

Modifications to a plan are unavoidable, and this is why developing measurable strategic goals are so important. Benchmarks help guide ongoing decision making and keep strategic goals in focus in the midst of making short term "tactical" funding decisions. Compartamos of Mexico, for example, anchored its funding strategy on discipline, refusing to trade off short term subsidized pricing for long term market credibility. This helped them reject development bank funding for the most part, except for tactical use of guarantees to gain access to commercial bank funding during a liquidity crunch. See Figure Six for more information on Compartamos.

BUILD A REPUTATION AND RELATIONSHIPS

Investing in funding relationships is critical and demands constant attention, but particularly and most successfully when capital is not needed. Ongoing and periodic interactions with potential lenders provide the opportunity to brand your institution while personalizing lender-business relations. Relationship building minimizes in advance the need to establish basic business understandings when the time for loan negotiations actually arrives or helps to facilitate lending in times of need.

FUNDING STRATEGY MAXIM NUMBER TWO

"BE TRANSPARENT ABOUT THE POSITIVES AND THE NEGATIVES"

BE TRANSPARENT

Another oft cited phrase in finance which has significant implications for MFIs is *transparency above all*. An MFI can have a great funding strategy, but without great transparency it will not be particularly attractive to potential investors.[5] This means not only showing "the numbers," but opening up to challenges faced and explaining in detail why problems have occurred in the past (if they have) and what the institution is doing to avoid repeat mistakes.

Engaging rating agencies, uploading data and annual reports on the Mix Market Exchange, and sharing information with prospective investors are steps any MFI can take to become "transparent," but at base, transparency should be the outcome of a business culture that

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[5] Complete transparency refers only to that information which a lender needs to make full assessments of an institution. Some corporate information will, of course, remain confidential. Understanding the line between transparent and proprietary information is an important consideration. Legal counsel will be able to help with this distinction.

respects openness to input and honestly facing business mistakes and challenges. Cultivating this kind of transparency and openness within an institution is as much a proven key to performance management as it is for attracting capital.

SECTION THREE: STRATEGIC FUNDING AND LONG TERM LIABILITY MANAGEMENT

Once strategic funding targets have been set, the next step is to consider how the MFI it will meet the demands of managing increasingly complex funding. This will require management structures and procedures that evolve lock step with the complexity of an institution's funding and risk management needs, while maintaining a focus on long term strategic funding goals.

This section lays out this challenge in three parts: Liability Management Structures, Liability and Liquidity Risk Management, and Tactical Funding Decisions.

LIABILITY MANAGEMENT STRUCTURES

Many smaller MFIs do not have formally delegated bodies or individuals to engage in and/or oversee liability management other than the General Manager (or equivalent). Liquidity management and fund sourcing is often considered an important, but small part of a

GM's job – and is detailed in a short line or two in the GM's job description. As result, governing bodies often pay scant attention to this responsibility (until a liquidity crisis, that is) and there is correspondingly little formal support, organization and budgeting for funding oversight and management.

Whatever the size of an MFI, formal structures for the management, sourcing and tracking of liabilities and capital should be maintained. Such a body can come in many shapes, but in any case will be responsible for a range of liability management and oversight responsibilities (e.g., liability projections, liquidity matching, etc.) While some management bodies outlined below are found only in larger institutions, their respective responsibilities are not. Smaller institutions need to ensure that all relevant responsibilities are covered by an appropriate body with clearly defined terms of reference.

BOARD OF DIRECTORS

Funding and capital management must be a regular agenda item on the appropriate Board Committee and at the Board meeting. For smaller MFIs, the Board usually has final authority and responsibility for major financial decisions and for ensuring the sound financial management of the institution. This includes setting funding strategy, delegation financial management responsibilities, supervising financial management, approving financial policy and risk tolerance levels, creating and overseeing relevant committees, and approving all funding decisions.

It is not enough to simply delegate supervision and oversight responsibilities, however. The Board must also establish management, processes and reporting mechanisms that ensure accurate and timely information is fed into an institution's decision making process.[6]

FINANCE COMMITTEE OR RISK MANAGEMENT COMMITTEE

Smaller MFIs should have a Finance or Risk Management Committee of the Board of Directors. This committee is generally responsible for overseeing all financial matters. It delegates and supervises the identification, measurement, monitoring, and management of an institution's financial position and risks. It will also delegate, and in some smaller institutions participate in the sourcing of funding. This committee works closely with the General Manager, who is often a non- voting member, and reports to the Board of Directors.[7]

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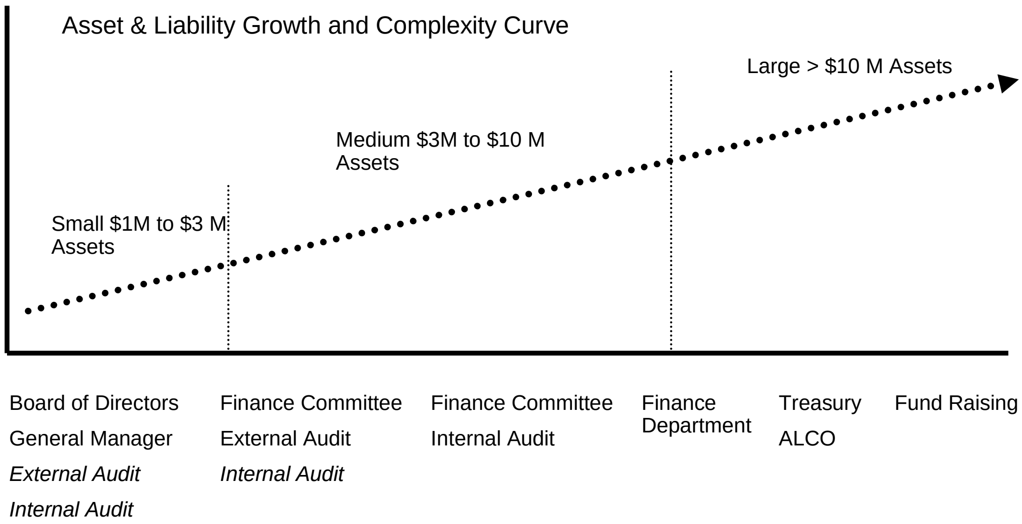
[6] For an equity perspective on Board of Directors see Kaddaras, J with Elisabeth Rhyne, (2004) Characteristics of Equity Investment in Microfinance, Council of Microfinance Equity Funds, particularly Annex 2.

[7] See for example: Rock, R., Otero, M. & Saltzman, S., (1998), Principles and Practices of Microfinance Governance, USAID - Microenterprise Best Practices

FINANCE DEPARTMENT

A Finance Department is typically found in most medium and large MFIs that have more complex financial management demands. The department manages day to day responsibilities for identifying, measuring, monitoring and managing institutions financial position and risks. The Finance Department is typically tasked with forecasting both cash flows and financing needs. In smaller institutions, the Finance Department Manager reports to the General Manager. In larger institutions it may also report to and/or provide support to the Asset and Liability Committee (see below) and/or Finance Committee of the Board.

Figure Seven
Financial Management and Oversight



As the volume and complexity of assets and liabilities increase, the number and type of internal bodies responsible for financial management increases.

There is no set evolution of structure, though that show is typical of many MFIs. The bodies found italicized on the X axis are optional but recommended bodies at this these points in a MFIs development.

INTERNAL AUDITORS

Internal auditors have the responsibility of assessing an institution's risks found in a variety of cash and financing processes and procedures. Auditors check cash management procedures and authorization of investments and borrowings, and ensure the

(MBP) Project or Otero, M. & Chu, M., (2002), Governance and Ownership of Microfinance Institutions, ACCION International.

accuracy of financial transactions, financial reports, etc. These functions are coupled with the complementary responsibility of identifying and reporting on procedural strengths and weakness. Internal auditors usually report directly to the Board of Directors. Many smaller institutions do not have this position and rely on a Finance Manager or equivalent and/or external experts for the internal audit function.

ASSET LIABILITY COMMITTEE (ALCO)

The ALCO is a critical committee for any MFI with a reasonably complex financial structure, and is crucial for those accepting deposits. The ALCO is a Board committee composed of both Board and senior staff. Its major function is to track maturing assets and liabilities with the objective of ensuring institutional liquidity. Critically, the ALCO has the responsibility of assessing new funding proposals and has significant input to funding strategies. As a result, the committee must have a clear understanding of the financial sector, money markets, and the economy in general.

In smaller institutions, the Finance Committee covers ALCO responsibilities. As an institution grows in complexity, however an ALCO is vital. The role of the ALCO changes as an institution grows. Initially it may work very closely with management but it evolves to more of an oversight and supervision role as financing becomes more complex and an institution larger. As such, the committee provides a vital link between the Board and senior managers responsible for the management, coordination, and execution of an institution's funding plan.

TREASURY DEPARTMENT

A Treasury Department (TD) is normally found in larger MFIs, though its functions are critical even in smaller institutions. The TD has specific responsibilities for cash management. Specifically, it is responsible for the receipt, custody, investment and disbursement of funds, borrowings and maintenance of capital accounts. In deposit taking institutions this responsibility can be considerable given the often complex demand of daily cash management (e.g., between branches, head office, banks and bank accounts).

FUNDING MARKETING DEPARTMENT

A Funding Marketing Department is usually found only in larger institutions able to afford a dedicated marketing team and/or sales force. In some cases, a financial department can be fairly large, or in the case of smaller institutions it can be a dedicated portion of a mid-level executive's job. The nature and composition of a financial department is closely tied to an institution's funding plans. Certainly there will be an executing function to the team. If an MFI offers savings, a primary function might be to train tellers; if long term certificates of deposits are important, a dedicated sales force would be needed for the core activity; if an institution relies on term debt, a small staff supporting executive lead sourcing would be appropriate.

Figure Eight
Risks Facing MFIs

Liquidity Risk

Liquidity risk is generally defined as the ability to meet maturing obligations on a timely basis as they come due. It is measured by the gap between maturing obligations and cash required to fund ongoing loans business and deposit withdrawals. A positive liquidity gap indicates more cash will leave an institution than is covered by incoming funding. A negative gap shows a cash surplus that must be invested profitability in low risk investments (e.g., treasury bills) and allows for meeting anticipated liquidity needs.

Market Risk

There are several main market risks, the volatility of which depends on factors external to a financial institution.

Interest Rate Risk

Interest rate risk is defined as the potential for a mismatch between the term structure and the differential interest rate sensitivity of liabilities and assets. Generally speaking, money and deposits respond quickly to changing rates and loans slower to respond.

Interest rate risk increases when the maturity gap between short term funding (with variable interest rates) and long term lending (with fixed interest rates) increases (i.e., positive gap). Core savings and available liquidity back stops ongoing cash needs but profitability is stressed nonetheless as cost of funding tend to increase faster than income from loan assets.

Concentration Risk

An institution faces concentration risk if a significant portion of its obligations are provided by a few sources. Unless large depositors owners of an institution they are notoriously sensitive to small interest rate changes and will switch institutions as a result of only a few basis points difference in return. Financial institutions depending on a few large funders produces significant pressure on liquidity risk management and interest rate risk.

Foreign Exchange Risk

Foreign exchange risk is expressed as an "unreasonable" balance between liabilities and assets that are denominated in a foreign currency. If a depreciation of the local currency takes place, financial institutions will face lower profits as interest expenses will increase, which, if the mismatch is large can have significant negative impacts on institutional performance. There are a variety of techniques to mitigate or hedge against direct foreign exchange risk, including a variety of financial products that help to redistribute risk. Most of these, however, are too expensive for the relatively small volumes managed by MFIs. To avoid direct FX risk some MFIs simply lend in dollars. Because clients are also often affected by FX risk, MFIs lending in dollars still face indirect FX risk.

Operational Risk

Most MFIs are familiar with operational risk, or those due to inadequate or failed internal processes systems external events so human error. Risk range from poor management, poor planning, inability to raise funding, to out and out fraud.

Credit loss Risk

Credit risk loss is occurs when income from a loan portfolio is smaller than anticipated. This can be the result of poor lending decisions, poor collections, or external events that affect client's ability to repay loans (e.g., drought, economic conditions, etc.).

In any case, this department usually also has the responsibility of collecting and reporting sales management information.

EXTERNAL AUDITORS

To be considered for funding, an institution must have an external audit, preferably for the three most recent years of operation. If liquidity is a key challenge, an institution may want to invest in external audits of past years.

Many smaller MFIs have not yet engaged a credible external auditor. External audits are absolutely necessary to attract external investment. The selection of an external auditor is also an important strategic step from a budgetary perspective as a credible large national or international firm costs much more than smaller local firms. Using a local auditor will not necessarily affect an MFI's ability to raise capital, but ultimately an international firm will give investors more comfort.

RATING AGENCIES

Being rated by a rating institution is a good investment. Employing a rater specialized in microfinance is an excellent first step towards the transition to private capital.

The decision to be rated must be considered strategically. An MFI must be sure that it is sufficiently organized, has strong management, has good portfolio quality, and has an excellent sense of future markets before deciding on a rating.

This is not to say an MFI must be in perfect shape to be rated. Much can be learned from a rater, particularly specialized raters, as they have excellent comparative knowledge of microfinance performance. Many have rated hundreds of MFIs and can objectively point to an institution's strengths and weaknesses.

More aggressive, growth oriented MFIs may want to consider a rating by an internationally or regionally recognized rater, though, caution is in order as such ratings are expensive and raters seldom have the full MFI rating skill set. As a result, ratings may not accurately reflect an institution's position and an overly negative rating can damage the market's long term view of an institution for some time. Usually, MFIs engaging these raters are preparing for capital market activity and are commensurately larger.

REPORTING PROCESSES AND OUTPUTS

The strength of a well defined financial management structure is vested as much in the bodies responsible as in the information processing system that ensures the timely flow of data, analytical reporting, and decision making process in place. It is not within the scope of this document to outline in detail the nature of reporting systems, except to emphasize their importance.[8]

MANAGING LIABILITIES & LIQUIDITY RISK MANAGEMENT[9]

At the simplest level, funding strategies ensure that an institution has sufficient funding available to meet ongoing business needs at a price that ensures sufficient profits to satisfy growth and shareholder needs. Central to good liability management is to proactively manage the risks that can affect meeting this goal. Demonstrating this capacity also inspires investor confidence and facilitates achieving long term strategic funding goals. The types of risks faced by MFIs are described in Figure Eight.

Figure Nine
Signs of Liquidity Problems

Significant Asset – Liability mismatch

Significant Foreign exchange Asset – Liability Mismatch

Borrowing to fund operations

Asset – Liabilities policy does not fit size and sophistication of FI

High level long term assets relative to liabilities

Declining net interest margins

High turnover ratios

Rapid growth of savings

Lack mix of long and short term products

Management or Board reluctant to move rates with markets

Schneider-Moretto, Louise (2006) Tool for Developing a Financial Risk Management Policy, Women's World Banking

LIQUIDITY IS PARAMOUNT

As capital is the sole raw material for financial institutions, a major part of what could be considered "best practice liability management" focuses on liquidity risk. Without sufficient amounts of funding or liquidity, an MFI puts at peril its ability to meet ongoing client loans and savings needs, to say nothing about capital for growth and expansion.

Consequently, managing liabilities is paramount and demands that MFIs have adequate systems and policies in place to manage risks and associated costs. As such, liquidity management encompasses more than just ensuring funding is available, but involves making multivariate funding choices involving finance costs, source diversification, and profitability considerations.

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[8] Readers wishing more information are strongly urged to read Schneider-Moretto, Louise (2006) Tool for Developing a Financial Risk Management Policy, Women's World Banking. This publication outlines both policy recommendations and reporting systems for sound liability and liquidity risk management.

[9] This section draws significantly from Schneider-Moretto, Louise (2006) Tool for Developing a Financial Risk Management Policy, Women's World Banking.

There are many serious implications of poor liquidity management. Liquidity crunches or crises can seriously damage an MFI's market credibility and competitive position. It can also result in unanticipated withdrawals of both deposit and debt capital. This so-called domino effect can lead to or deepen a liquidity crisis, an occurrence that has probably caused more financial institutional failures than insolvency. MFIs surviving such crises can experience significant financial distress -- higher funding costs, decreased access to loans, and extended client, investor, and regulator distrust – that can linger for years even after a fairly small liquidity crisis.

In addition to managing liquidity risk, a growing MFI also will need to respond to the demands of an increasingly complex financing structure. Cash will be required for growth; shareholders will pressure for dividends. Generating sufficient returns to satisfy these needs requires MFIs to fine tune cash investment practice to maximize returns while decreasing the cost of capital where possible. Overriding any price or cost decision, however, should be the *goal of maintaining funding* liquidity, an objective that requires strong planning, finance policies, and flexible, proactive decision making.

MANAGING RISK

Liquidity and funding management is largely about putting in place policies and procedures to manage risk. The main risks are outlined in Figure Eight. Each risk type alone presents unique challenges to MFI funding managers. Together, however, they form a multivariate challenge to institutions, the complexity of which depends to a great extent on an MFI's financing structure. Simple structures typical of small MFIs have less complex risk exposures, while larger institutions have more. Planning for and developing the capacity of managing a more complex risk exposure is key to developing a long term strategic funding plan.

A primary goal of such risk management is being able to anticipate, mitigate and plan for liquidity needs on an ongoing and contingency planning basis. Strong liquidity management is also critical for formulating strategic funding plans as it supports capital needs and provides direction for acceptable funding term and cost decisions. A demonstrably sound management system also improves rater, regulator, and investor confidence, making fund sourcing easier as a result.

There are five broad risk management considerations around which good liability management revolves: identifying risk, monitoring risk, establishing policies to control risk, reporting risk and, developing appropriate risk management decision making. How these are managed within an institution depends on the organization structure and maturity of an institution. In larger institutions task will be managed by several different departments with oversight from a senior manager's desk. In smaller institutions, the Executive Director may be responsible for all of these tasks.

IDENTIFYING RISK

Being fully informed about the nature and potential impact of risk requires good and ongoing information. Market risks such as interest rate and foreign exchange risks are the most difficult for small institutions to assess on a continuous basis. Central banks, government agencies, and international development banks all provide excellent and often free sources of information about market risks. The macro economic environments of most countries are also often extensively assessed by external analysts, many with affordably priced reports and reporting services.

Operational risks are more familiar to MFIs that follow best practice asset management. As with liability management, identifying operational risk requires good MIS, internal control policies, reporting and decision making systems. A host of techniques to assess MFI operational risk resources are available.[10]

MEASURING RISK

Once risk has been identified, planning must turn to assessing/measuring the scope, scale and nature of each risk type and how each might affect your institution.

The first step is to make assumptions about financial impact of key risk variables including interest rate (deposit, loans, and funding), foreign exchange risk (if applicable) and credit loss risk. Based on these assumptions basic *pro forma* planning can be developed to project quarterly financial performance into the future. Analysts will watch for variability of key liquidity ratios (e.g., quick ratio, liquid assets/deposits etc. and related regulatory requirements (e.g., reserve requirements).

Once basic assumptions are applied, an institution needs to stress test performance against a variety of scenarios to assess how potential risks may affect performance. The focus of testing should be on liquidity and profitability in that order. Changes to interest rates, client repayment rates, foreign exchange rates, deposit withdrawal rates, and other changes affecting liquidity, should be reviewed. Stress testing allows institutions to understand the potential impacts of risk on performance. It also underpins sound strategic and contingency planning.

Testing requires a robust MIS that allows multivariate projections and scenario building. Not all systems support this kind of analysis, and, as a result, MicroFin continues to be the standard for smaller institutions (under $5 million in assets). An MIS that integrates financial statements and portfolio management with business planning is the most efficient means for measuring and analyzing risk.

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[10] For a list of publications on MFI best practice management see www.cgap.org/portal/site/CGAP/menuitem.c131ffea57a13c0167808010591010a0/

MONITORING RISK

Monitoring risk is not a passive activity. Nor is it necessarily as simple as capturing and reporting data. Best practice liability management requires risk monitoring as a part of a structured reporting and decision-making protocol. This ensures that information contributes in a timely fashion to ongoing and planning decision making.

A rigorous monitoring system has several elements. The first is the capacity to collect and organize raw data for key risk variables over a period of time. Some data will come from external sources – market trends, inflation rates, etc. – and may require special resources, though often much of the data is freely available. Other data will be sourced from an MFI's management information system. The ability to calculate ratios from this data and to generate trend analysis is important, as is its reliability, credibility and availability. MFIs must also have the analytical capacity to assess and project data to form reasonable projections of risk and how it may affect MFIs' resulting liquidity needs and profitability.

Many small institutions do not fully have this important capacity and should work over time to develop it, for with growth liability management and monitoring becomes increasingly complex.

For example, institutions with savings require information systems that combine analytically rigorous assumptions and portfolio information that can accurately project profit levels based on historical liquidity movements. The system must show the relationship between past loan demand and deposit withdrawal patterns and current market trends. Because funding volatility has been shown to correlate only partly with the funding maturity structures, a clear understanding of funding needs relies on an analysis of the "roll over of accounts on an aggregate basis".[11] Assessments must analyze funding composition with regards to other factors such as the seasonality of transactions and vulnerability to external factors such as interest rate competition, inflation, currency devaluation, etc.

Monitoring interest rates is similarly complex. An MFI must assess maturing obligations and portfolio income against interest rates volatility. Too much of a mismatch can lead to significant interest rate risk unless fixed loan interest rates are off set against fixed debt obligations and vice versa for floating rate products and instruments. The decision to obtain fixed or variable rate loans depends on an institution's view of prevailing interest rate trends stability. Monitoring external conditions affecting interest rate movements is thus critical to strategic funding decisions.

Figure Ten
Equity Diversification

Many MFIs do not have much diversity in their equity base. Some have only one owner or no owner at all in the case of some NGOs. This has many implications for governance in general, but from a capital perspective, lack of diversity may constrain an institution's ability to source growth or liquidity funding. Many owners are simply not able or willing to inject new capital into an institution as needed. Expanding an MFI's capital base is a challenge on many fronts (sharing ownership, maintaining strategic vision, etc.) but may be an important strategic consideration for expansion minded MFIs or MFIs working in difficult economic environments.

From a governance perspective, a well selected and diverse set of owners provides good checks and balances for an institution. Importantly, deep pocketed investors can provide a secondary equity cushion for MFIs. Of course, injection of new capital comes at expense of ownership dilution or shares trading hands. Well thought out contingency planning for rapid cash injection in a crisis situation is critical. An MFI may also want to develop a long term capital plan by networking potential new shareholders well in advance of need for new capital ensuring that when new capital is sought, it can be sourced from the most suitable source.

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

REPORTING RISK

Timely reporting is critical to sound monitoring. Some risk management ratios such as cash management may require daily oversight and reporting. Others such as funding gaps or maturity risk can be reported on monthly or even quarterly, depending on the complexity of a balance sheet.

Reports assist ongoing decision making and planning with respect to changing risk exposure. Unless major risk volatility can be anticipated, which is rarely the case, continuous risk management typically requires minor but frequent impacts on a MFI's fund management, which over time can have significant influence on business planning and strategic funding plans.

As a result, it is critically important for an institution's management and Board of Directors to be continuously informed in a precise and timely manner about risk exposure. Without timely information, an institution's oversight body cannot ensure Management is taking appropriate action. Other stakeholders, including funders, must also be aware of an institution's risk position and of the steps taken to minimize potential risks.

RISK MANAGEMENT DECISION MAKING

Regular and timely risk position reporting is useful only if an institution has an established chain of command for decision making. It is beyond the purview of this paper to provide detailed guidance on such matters, except to say that oversight systems must allow timely and routine assessments of risk. They must also set out processes for dealing with extreme liquidity needs (e.g., overheated growth in demand for loans, rapidly depreciating currency, natural disasters, etc.).

In smaller institutions, Management would have the responsibility of identifying, monitoring and reporting, and planning for liquidity risk management. The Board provides oversight, policy setting and changing, and funding/liquidity management strategy. The Board will also have rather to make policy exceptions which allows for exceptional reactions to given risk events.

Part of a rigorous decision making system is having liquidity ratio "triggers" that, once met or exceeded, call for increased oversight or specific actions. Each liquidity ratio should have a defined "ideal" level and associated range of tolerance (e.g., Quick ratio of 1.2x or Liquid Asset ratio of 20%). The range is set to the amount of risk Senior Management and the Board is prepared to support as part of ongoing business operations and given present and anticipated aggregate risk exposure.

Risk tolerance levels should be stress tested regularly to ensure accurate estimates of the amount of risk an institution is facing and can withstand. Testing yields ongoing understanding of the levels of earning capacity required to compensate for anticipated losses.

FINANCING PLAN AND TACTICAL FUNDING DECISIONS

Each funding decision an institution makes has the potential to facilitate or constrain future funding choices. MFIs need to negotiate each deal tactically, bearing in mind that each term and/or condition agreed to will have both independent and cumulative implications on an institution's ability to maintain their strategic funding course.

There are four main considerations: use of security collateral, diversification, funding flexibility, and cost of funds.

COLLATERAL AND SECURITY

Provision of security collateral against a loan is a common feature of most portfolio refinance loans as few lenders provide capital solely against cash flow. Security can consist of real estate, other fixed assets, a loan portfolio or part thereof, investments, cash, or third party guarantees.

Employing security collateral requires a good deal of strategic thought because collateral pledged for a loan today is unavailable for future use when it may be most required. Careful stewardship of available collateral is critical.

Where possible, an MFI should use its loan portfolio as collateral and avoid pledging non-portfolio assets. A financial institution's portfolio is its primary asset and the sooner it can be used as security the better. Regulations may discourage or simply not permit portfolio as collateral in some jurisdictions, but in many they do. Where they do, the goal of any MFI should be to convince lenders, particularly commercial banks, to lend first on a cash flow basis and, if not, then on the basis of portfolio as security.

FUND RAISING MAXIM NUMBER THREE

"YOUR PORTFOLIO IS THE BEST SECURUITY A LENDER CAN HAVE!"

There are many ways to approach this challenge. Some funders will be willing to entertain cash flow lending with the support of a "negative pledge" on a loan portfolio. A negative pledge is when an MFI agrees not to pledge any of its assets to other lenders so that in the event of insolvency, all lenders have equal access to the MFI's assets. A negative pledge may incur a higher loan price than other forms of collateral, but it will establish a MFI's ability to pay as the basis for cash flow without encumbering a specific part, or all of a loan portfolio. When considering a negative pledge clause, borrowers should ensure terms do not preclude using portfolio as security in the future. Examples are carve-outs or baskets, or loan contract conditions that place a ceiling (or cap) on the amount of money or other property a borrower may pledge as security for future loans - thus restricting the MFI's use of the specified amount of capital for guaranting other loans.[12] These limitations are often justified, but can inadvertently preclude special purpose borrowing that may not materially affect an institution's asset distribution in the event of insolvency. Avoiding these types of constraints ensures the greatest flexibility for future borrowings.

If a lender is not able or willing to lend against cash flow, an MFI may also want to consider offering a blended collateral "pool" that can include cash deposits, third party guarantees, stand-by letters of credit, a mix of real estate and portfolio. A general rule is that the more complex the collateral arrangements, the higher the transaction cost (fees and time to execute, etc.). This makes collateral pools more expensive and complex such that many funders will not consider such offers or will insist on MFIs paying for loan set up costs. This is particularly the case for the relatively smaller loans sought by smaller institutions.

For MFIs wishing to establish a funding relationship, however, the extra cost can be a worthwhile expense. If a funder can be persuaded to take a pooled approach that includes some portion of "portfolio as collateral", a positive precedence will be set. As the funder becomes more familiar with an institution, the percentage covered by portfolio can be increased over time. Another advantage is that non-portfolio assets are less encumbered and will be available for other loans. Finally, the complexity of this approach, with its many variables to work out, will facilitate a lender and borrower relationship -- if only because of the time spent with the lender.

Guarantees are other forms of credit enhancement that can provide security on a loan as they substitute the creditworthiness of a third party for that of the borrower. They can come in several forms including: letter of credit, cash deposit, and promissory notes. Mark Flamming argues in recent CGAP publication that "loan guarantees are superior to direct loans from an international donor or funder only if the guaranteed loan helps the MFI build a competitive funding structure." [13]

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[12] See Commercial Loan Agreements, 2006, CGAP for full treatment of this and other credit negotiation themes.

[13] Mark Flamming (2007) Guarantee Loans to Microfinance Institutions: How do They Add Value, Consultative Group to Assist the Poorest. See: http://www.cgap.org/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Documents/FocusNote_40.pdf

This is because guarantees are relatively expensive compared to simple term loans and deposits. The most useful guarantee is one that provides a capital access value added that justifies the extra cost. First and foremost guarantees can lever capital where an MFI cannot do so on the strength of its own cash flow or collateral. It can also facilitate access to capital by decreasing the cost or improving terms that the borrower can not secure on its own merits. Guarantees can also help to initiate and support important funding relationships. They are often also used to reduce foreign exchange risk, reduce risk to international lenders, and to avoid loan restrictions in jurisdictions where, for example, banks require non portfolio security, or if international loans are not permitted.

DIVERSIFICATION

Diversification of capital sources refers to tapping a range of suppliers and financing types. Diversification is particularly important for small MFIs anticipating growth, as they need to prepare for a variety of financing options beyond pure volume considerations (e.g., emergency loans, longer term loans, subordinated and/or convertible debt, etc.).

Diversification of funding sources is important for many reasons. First, MFIs must avoid dependence on any single supplier. Second, not all suppliers are equal. Even commercial banks with essentially the same loan product will have different approaches to lending and policies that lead to differential security needs, pricing, and terms options. Third, suppliers may face differential constraints affecting their ability to provide funding. These constraints may have little or nothing to do with a borrower's risk profile, but the funder's own liquidity needs, marketing strategies, regulatory considerations, etc. Fourth, some suppliers have geographic and/or sector quotas that may restrict lending activities. Finally, sourcing from more than one provider also provides important negotiation options and tools, as terms from one offer can be used to lever better terms from another.

There is no set of "best practices" for diversification, though a rule of thumb is that small institutions should have at least three to five sources being used or available for portfolio finance. Ultimately, the number of funders depends on the nature of suppliers and the amount and type of capital they can make available as needed. Certainly a mid-sized non-deposit taking MFI (between $5 and $10 million in assets) should have at least five to ten funders, of which at least three suppliers are able to provide portfolio finance in relatively short order (i.e., in less than one month). A deposit taking MFI of the same size would likely need at least two to three back up sources of capital.

While there are diminishing returns to maintaining too many funding sources, some strategic links are often recommended. Many MFIs maintain credit relationships with development banks and international development institutions to maintain links with

Figure Eleven

Fair and Transparent Dealings…

It is important to be transparent and treat suppliers fairly in the negotiation process. Just as you expect and respect such treatment, so do suppliers. This is particularly important if a strong relationship is to be developed and as with any supplier, a good relationship even if a deal is not struck today, is very valuable for future interactions. Also, the finance community is very small in most countries and internationally via the MFIs. And while competitive information is rarely exchanged, informal problematic client "black lists" are: fair and transparent negotiation is, as a result, an extremely important element in any funding strategy. It goes without saying that being transparent and professional is important not only in negotiations, but through the life of a loan. Regular and transparent information is key to supplier relations at all times, especially in times of financial difficulties (see Section Four for Investor Relations Programs).

sympathetic funders in the event of national economic crisis, for example.

FUNDING FLEXIBILITY

Most lenders will consider a range of loan terms or features that allow different degrees of payment, security, and rate flexibility. There are far more flexibility options than we are able to review here, but it is good to know that it is generally true that any degree of flexibility built into a loan agreement will increase borrowing costs. Conversely, giving up flexibility should lead to price concessions.

FUND RAISING MAXIM NUMBER FOUR

"FLEXIBLE TERMS LEAD TO HIGHER PRICING BUT CAN BE WORTH IT!"

Payment or term flexibility can involve the rights to pay out a loan at certain times or at will. Lenders, for example, often want the right to call a loan either freely or under certain given conditions. They may add features or provisions to loans and lines of credit contracts such as an uncommitted facility, calling a facility, cross defaults or accelerations all of which give them the contractual right to demand payment of a loan. Such provisions are often coupled with cure periods, or a negotiated period of time between when an organization can call or demand payment on a loan and when a borrower must begin repayment. While the stipulations for each of these features vary in detail, they afford protection to a lender which should yield to an MFI leverage to apply against price or other loan terms.

Conversely, MFIs can request principal payment grace periods or the right to pay off loans at will. These features normally increase loan costs either at the outset or upon repayment. A higher price may suit a long term funding strategy better when an MFI is seeking source diversification, feels interest rate will drop, or is anticipating new less expensive sources of capital.

Seeking price flexibility is also common practice. Variable rate loans fluctuate in rhythm with the markets and are usually set against a market benchmark (e.g., LIBOR, local Treasury bill rates, or other national standards such as the CETEs in Mexico).[14] Typically, variable rate loans have lower finance costs to offset the risk of volatile interest rates. A variety of features can be added to a variable rate loan including collars (upper or lower rate caps) that limit the extent to which interest rates can rise or fall respectively. These

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[14] CETES or Certificate of the Treasury of the Federation of Mexico (Certificados de la Tesorería de la Federación) are treasury bonds whose price provides a benchmark for debt instruments. Bonds come in 28, 91, 182, 364 terms.

features also typically incur price concessions either on the part of the borrower or lender.

COST OF FUNDS AND PROFITABILITY

The long term strategic funding goal of any MFI should be to seek the lowest cost mix of funding required to meet liquidity needs. Key tools include available security collateral, source diversification, and flexibility trade offs.

As we have tried to demonstrate, the appropriate cost of funds may not simply be a function of the lowest price. Rather, cost of funds should be considered tactically and smaller MFIs need to focus on the lowest price available for each type of funding required to meet their strategic long term needs (or to achieve an ideal financing structure). Price cannot be the sole or, at times, the most important, funding decision variable.

Indeed, establishing funding relations and building credit history in sync with liquidity planning and cash flow projections can have significant impact on how an institution views cost of funds. As discussed above, there are many loan price-feature trade offs that can help maintain current and future funding flexibility and improve sourcing diversification. A strategic view to price for many smaller institutions may necessarily yield cost to achieving longer term strategic funding goals such as diversification or longer term debt.

DIRECT AND INDIRECT COSTS OF FUNDING

Understanding the full cost of funding is a first step to considering possible and appropriate trade offs. There are two costs to funds.

Direct costs are those that relate directly to the cost of raising and paying for capital. They include the cost of sourcing and managing funds, and the financial cost or interest paid. This includes costs related to mobilizing and processing funds and includes such items as product design, marketing, and funding storage and transaction management (in the case of deposits).

Direct costs also include those related to risks embedded in financing decisions and performance results. They include, for example, cost represented by the difference between income/expenses arising from liquidity surpluses and deficits. Many institutions fail to quantify the often considerable cost of fund sourcing. XACBank of Mongolia, for example, found it cost an estimated US $6000 to host a prospective investor or donor. This represents 1.2 percent on a $500,000 loan - not an insignificant amount considering the number of lenders an MFI often attends to annually.[15] Legal, transfer, reporting, and other management costs add significantly to a loan contract price. As a

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[15] Cheryl Frankiewcz and Marc de Sousa-Shields (2005) *XACBank: from the Liability Side of the Balance Sheet*, MicroBanking Bulletin.

result, working to reduce these costs can sharply reduce cost of funding without even considering the overall price of money.

It is notable that few MFIs actually assess the full cost of funding, not because they don't want to but because it is often difficult to do. Dave Richardson, for example, points to the challenge of costing deposit services in the Microbanking Bulletin.[16] Assessments of several MFIs over the course of *Transition to Private Capital* research found considerable lost opportunity costs simply because tellers and loans sales forces have not been trained to sell longer term savings products.

Many MFIs also often fail to assess the strategic value and costs of a few large, long term depositors compared to having many smaller savings, trading off concentration risk costs against having a core of short term funding available potentially at a lower risk. In some cases, pricing and service offerings have been driven by well meaning but financially misplaced decisions to meet the needs of low income clients. Demand deposits should only be offered if an institution has fully costed all available options and the decision to do so makes strong financial sense: otherwise, it may not be able to offer sustainable savings services which in the long run would be more harmful than a few points less in financing costs in the short term.

Other costs of funding are indirect. These costs can be substantial and are often not fully considered by smaller institutions. Indirect costs can include a host of expenses related to the funding management, including costs of hedging, and the opportunity costs of decision making.

It is beyond the scope of this guide to provide details of how to undertake costing assessments, particularly of deposits. Moreover, as Wisniski notes, it is quite difficult to "assign monitoring costs to the aggregate cost of funding" because it is difficult to fully assess opportunity costs among other things. The determination of "risk" costs necessarily requires a combination of quantitative and qualitative analysis, suggesting continuous and robust oversight and managerial capacity is required to fully assess costs and determine a best funding strategy course.[17]

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16 Richardson, David, "Going to the Barricades with Microsavings Mobilization: A View of the Real Costs from the Trenches" in The MicroBanking Bulletin Issue No. 9 July 2003.

17 Readers are urged to read Wisniwski, Sylvia, "Microsavings Compared to Other Sources of Funds", Eschborn, Germany: CGAP Working Group on Savings Mobilization - GTZ – BMZ, 1999. See also a range of savings publications at http://www.cgap.org/portal/site/CGAP/menuitem.66fc96b6fa3d7c0167808010591010a0.

SECTION FOUR: INVESTOR RELATIONS PROGRAM

Funder and investor confidence is a precious resource that must be developed and maintained over time. Most small MFIs do not have a structured approach to fund sourcing, relying instead on the *ad hoc* efforts of the General Manager and/or a Board Member. This approach can be effective, but ultimately anMFI will need to develop a more systematic means to secure and manage funding if it is to grown in size and complexity.

In the world of publicly traded share corporations, many companies maintain a program dedicated to managing investor relations. Often referred to as Investors Relations Programs (IRP), these programs keep investors informed of company activity with the objective of maintaining maximum share price and share price stability. MFIs need to take a similar programmatic approach, albeit with the slightly broader objective of managing shareholder, funder, and stakeholder relationships. More functionally, an IRP can have the dual objective of operationalizing an MFI's strategic funding plans.

Figure Twelve

Fund Source Prescreening Questions

1. Is my institution eligible?
2. What are the basic products offered?
3. What are the basic terms offered?
4. Are there minimums and maximum loan sizes?
5. Do they have specific lending mandates or restrictions?
6. Does the funder understand microfinance?
7. Does the funder understand my operating environment and have they lent here?
8. Do we know anyone at the funder? Do we know someone who knows the funder?
9. Is the lender affiliated with other funds or institutions?

FUND RAISING MAXIM NUMBER FIVE

"DON'T LOOK FOR CAPITAL WHEN YOU NEED IT, BUT WHEN YOU DON'T."

This section provides an overview of the main elements of an MFI IRP and starts with the assumption that the institution has not developed a strategic funding plan. It begins with an overview of how to develop a systemic approach to develop a targeted funding search. Next is an overview of the key elements of an interactive investor relations program, ending with a description of some IRP management tools.

Figure Thirteen
Prioritizing Funding

1. Transition to deposit taking institution
2. Guarantees to back bank loans
3. Portfolio to replace guarantees
4. Reputation and credibility building in key term deposit markets

TARGETING AND UNDERSTANDING FUNDERS

The first step in a successful IRP and funding search is to assess possible funding targets (national and international, public and private) that may meet the institution's short and long term funding needs.

This involves a detailed search and assessment of potential funding sources. This analysis is fairly simple and should focus on matching funder's objectives with an institution's financing needs. Figure Twelve presents a short list of pre-screening questions to assess if a given capital sources is an appropriate target. This pre-screening step is critical if an institution has limited capacity and resources for a funding search and IRP.

FUND RAISING MAXIM NUMBER SIX

"CLIENTS ARE ON BOTH SIDES OF THE BALANCE SHEET"

Figure Fourteen
Overview of IRP & Funding Program

- Background information on target funders
- Profile your own institutions credit worthiness
- Information interviews with target funders
- IRP Information interactions
- Formal loan application

There are several sources to tap for prescreening sources. Domestic sources are typically well known and include the central bank or bank regulator for commercial banks, government sources for development banks, and sector associations for other bank and non bank lenders. Internationally, the most organized and complete source for capital supply is the MixMarket. Current funders, Board members, and other non-competing MFIs (e.g., in other markets or countries) may also be useful sources of information on funders new and/or unknown. A key to moving past existing funders is to look beyond existing networks to new sources and contacts.

TARGET SOURCES

Once pre-screening has narrowed an institution's target funding pool to those financial institutions who are lending or may lend to the selected MFI, deeper analysis is required. Assessments should focus on both the lender's potential as a supplier and the institution's interest in their products and services, and, of course, potential eligibility. Ideally, funder search data should be updated on a regular basis (at least once a year).

Appendix Three provides a sample "funder" analysis matrix which will help determine how much and when attention should be paid to a particular potential source. An institution's strategic plan will suggest which short term target priorities and those that will require time and relationships building for future sourcing.

Returning to the strategic funding plan example in Figure Five, the MFI in question would first focus on making a successful transition to a deposit taking institution. Simultaneously, it could begin a funding search by asking international funders and development bankers to speak with local commercial bankers about possible partial guarantees for term loans or lines of credit (with the idea that portfolio would replace guarantees after some time).

The MFI will also want to start developing an image in larger, long term deposit markets, even if sales are not immediate. This can happen by appointing a Board or Advisory Board members connected to businesses or organizations likely to be looking for large term deposits. Appointing a member connected with capital markets may also be in order, though likely not immediately, if a bond issue is planned for the future.

Prioritizing a funding search will permit an efficient, systematic search, minimize time investment and maximize success rate over both the short and long term.

Figure Fifteen
Consistent Communications

Understanding your institutions strengths and weaknesses is key to developing frank and transparent investor relationship.

Being able to communicate an investor relation message in a consistent manner is also critical. A recent experience by this author undertaking a due diligence of an international MFI investment fund is illustrative of this point. When questioned about the strength and weaknesses of its selected management team, ShoreCap responded from the very top of its executive team to the bottom, with the same well reasoned response. The organization had clearly anticipated the question and developed a cogent and frank response keying correctly on anticipated investor queries. Both the response and the management ability to communicate in a consistent manner inspired confidence.

FUNDER NEEDS AND INTERESTS

Gaining insight into the mind of an investor/funder is a fundamentally important part of accessing capital. You know what you need, but do you know what they need? Certainly they need to invest their capital to make income, but they may also have other imperatives. What are their constraints and what are their needs? Not just of the institution but of the executives and loan officers that serve a funder.

MFIs need to invest time finding out what drives a funder. Moving through a prioritized list, an MFI needs to get detail on the target: know who they have lent to, who they have not, and why. Seek to understand their institutional needs and interests. Normally the prescreening research will provide direction on how to put together a funder profile, but typically, a full pre-screen requires greater detail including reviewing websites, promotional materials, news stories, and/or contacting basic information sources at the funder institution itself.

FUNDING RAISING MAXIM NUMBER SEVEN

"INVESTORS HAVE VERY SHORT ATTENTION SPANS UNTIL DUE DILIGENCE BEGINS"

Once management has gained as much information as possible on the targeted funder(s), an *informal* informational interview can be requested. Informational interviews with a funder are simple ways to gain insight to their lending process and, in effect, is their opportunity to pre-screen an MFI. This is also an excellent opportunity to begin a relationship with an institution without the formalities implied by a loan request. The central objectives of the information interview is to assess the appropriateness of their products for your consumption and to gain some idea of what they think of an MFI both generally and compared to competing interests on their capital.

Conferences, sector events, or other similar gatherings are good venues for short informal meetings. Business meals or after work hour meetings in appropriate venues can also provide effective informal meeting places. The key to a good informational interview is to be prepared with questions aimed at understanding the business opportunity an MFI represents to an investor and to understand what constraints they may have lending to an MFI.

Ultimately, the objective of "preparing the groundwork" is to have an established relationship with a lender long before a formal application is made for funding.

Figure Sixteen
Making the Pitch

This guide simply cannot anticipate all the different ways in which funders formally engage in lending their lending business. Ideally, an institution should have an established relationship with a funder long before any formal application is served. Some ideas for how to do this are found below when we detail an IRP calendar approach to preparing the ground work. If possible, arrange to take an existing funder, Board Member or other executive to preliminary negotiation sessions.

Be sure to approach several funders at the same time if possible (e.g., in the case of commercial banks). This way you may gain some leverage on points of flexibility related to loan terms (see discussion in Part Two and Three). Legal counsel will be necessary once a term sheet and/or initial terms have been outlined.

It is highly recommended that you take your time and consider any offer carefully and never accept first terms. Instead, always seek trade-offs in your favor, be they on security collateral issues, pricing, or other flexibility related terms (see Part Two for more details). As per earlier discussion, be strategic in the features and terms you accept or concede to, always laying down a path for long term funding goals.

INTRODUCING AN MFI

Once an MFI has collected information on target funders, it is time to introduce the institution in a significant way. Before starting however, an MFI needs to ensure that it knows its reputation, strengths and weakness.

FUND RAISING MAXIM NUMBER EIGHT

"IT TAKES A LONG TIME TO GAIN A GOOD REPUTATION BUT ONLY A MOMENT TO LOSE IT"

These are not rhetorical questions. Understanding what others, particularly lenders, think of an MFI is critical for fund searches and brand management. Rigorously pursuing the opinions of others is the only way to truly understand an MFI's reputation and market credibility.

One of the fastest means to understand what others think of an institution is to hire a qualified consultant. The ideal consultant will have serious institutional analysis experience and good knowledge of funds and funders. Their objective will be to review performance numbers, assess management, and gauge future markets related to strategic funding plans. Their output should be to give *unqualified* opinion as to the institution's strengths and weaknesses as a funding target.

The advantage of an outside consultant is that they are not biased by the history of an institution or too close to the daily management to see the "bigger picture". If one cannot afford outside consultants, there are lower cost alternatives available. One is to undertake internal and external stakeholder information interviews. Interviews are an excellent way to discuss specific funding needs and gain insights to your institution's strengths and weaknesses. Key to interviews is to discuss risks associated with the business and business plan in the short, medium and long term.

Asking stakeholders if they would invest in an MFI is a good litmus test and means to facilitate a frank conversation about an institution's risk profile. Stakeholders with knowledge of an institution may cite specific institutional risks; external stakeholders are more likely to provide insight on market conditions and competition that affect investment decisions. Stakeholders that can be interviewed include:

- Existing and past funders;
- Shareholders past and present;
- Board members;
- Funders who have recently rejected funding proposals;
- Non-competing MFIs; and
- Development finance agencies.

Information gained from interviews and market research can be fed into the IRP to ensure that all the questions potential funders may ask are anticipated and addressed in marketing and IRP support materials. Managers should also be briefed to ensure consistent messages.

Figure Seventeen
Basic IRP Investor Report Table of Contents

1. Introduction
2. Macro economic context
3. Financial sector context
4. Market context
    a. Market position/segment
    b. Competition
5. Future performance expectation
6. Performance report
    a. Growth
    b. Efficiency
    c. Performance
    d. Social Impact
7. Benchmarking
8. Financing sources and needs
9. Managing challenges

THE INVESTOR RELATIONS REPORT

Once a list of targeted investor list is settled upon and information interviews completed, it is time to develop investor relations tools, primary among them is the IRP Report. The objective of the report is to keep targeted and current investors apprised of an institutions performance on an ongoing basis. The report must be a concise overview of activities and performance presented in a professional, easy to read format. It must be sent regularly to investors, even when a targeted investor is not currently being courted for funding.

The ultimate goal of the IRP Report is not just to inform investors but to establish the MFI's investment brand by putting it on the investment community's map: a community that is small and, like any other community is full of gossip, rumor, and information exchanges. Managing an institution's image or brand is critically important because if the management doesn't do it, someone else will.

Regular periodic updates with frank and concise information, also demonstrates the discipline investors like to see in MFIs and word will get around. Even current investors with their unique reporting preferences will appreciate additional reports which, if appropriately designed, can be shown to others including their own share and stakeholders. So always ask investors for contacts to send copies to!

SEMI ANNUAL INVESTOR REPORT

There are two fundamental types of information investors will want. The first is a simple update on MFI performance and prospects. This report can come in the form of a semi annual email report sent to targeted investors. The contents of the report will vary by institution, but should include some of the following information found in Figure Seventeen.

The report should provide the basic performance data, with longitudinal or trend data. Including five year trends for important performance indicators is ideal. Simple pro-forma expectations are also important. These need to be accompanied by assumptions based on robust analysis of future market and operating conditions. Using credible government, financial sector, central bank or other similar sources is critical for credibility.

FUND RAISING MAXIM NUMBER NINE

"RAISE CAPITAL ALL THE TIME"

Numbers should be matched with commentary explaining what the numbers mean and not just reiterating what they say. Reporting must highlight why an institution met or missed targets and must honestly account for past and future challenges: in two words, the report must be concise and precise. It is particularly important to relate MFI performance projections to assumed future business environments, explaining how an institution plans to manage future challenges and opportunities.

These considerations are important because busy funders have a short attention span until engaged in due diligence, and the more one can anticipate and credibly explain their concerns the more respect and interest an MFI will command. Indeed, a well crafted IRP Report can significantly reduce the not so insignificant variable cost of pipeline development that strongly affects funder profitability (or, in the case of non-commercial donors, operating capacity). In fact, a report that includes audited statements and rater reports can go far beyond prescreening, particularly as an increasing number of investors relying more than ever on written materials. Some investors, in fact, do not even undertake onsite due diligence. This makes any written material all the more critical.

BENCHMARKING PERFORMANCE

Investors will want to assess the organization's risk relative to the performance of others in the sector. They will want to use the most relevant benchmarks possible to do this. Savvy microfinance funders use MicroBanking Bulletin (MBB) benchmarks as it provides a range of key performance and characteristic benchmarks indicators available by size, financial condition, and geographic peer groups. Local lenders may not know of the MBB or may use other financial system benchmarks that may or may not be applicable to MFIs (e.g., commercial bank performance benchmarks). An IRP report that knows and responds to benchmarks performance variations is critical to positioning one's institution and the risk it poses to a potential funder.

DOUBLE BOTTOM LINE

There is increasing pressure on MFIs to maintain and report on issues of corporate social responsibility (CSR) that go beyond the traditional sector concern of mission drift (or moving away from serving low income people). How MFIs treat staff, what rates they charge clients, levels of dividend payments to shareholders, and other considerations are being scrutinized.

Unfortunately, there is still little direct best practice guidance for MFIs on double bottom line considerations. A small number of MFIs have engaged the Global Reporting Initiative (GRI) which helps businesses develop annual double and triple bottom line CSR reports. Another emerging resource is the International Standards Organization (ISO) social impact standards. Both of these systems offer relatively simple to use social and environmental indicators to assess and report on an institutions performance.

If an external system is beyond the current means of MFIs, there are a number of very simple things an institution can do to develop a modest, step by step CSR program and profile. An obvious starting point is ensuring compliance with local labor and environmental laws, and offsetting air and office carbon emissions. Appointing an executive responsible for CSR, making CSR an item on senior management and Board meetings, and promoting CSR among staff are all simple starting points that inevitably lead to more activities.

However modest, whatever CSR initiatives undertaken by an MFI needs to be reported in the IRP Report. Care must be taken to ensure that reporting does not over amplify accomplishments in the CSR field as analysts are extremely sensitive to "green" washing or painting a brighter picture in marketing materials than can be reflected in practice. This means reporting facts only and if possible, using measurable indicators with which to judge future performance.

VETTING AND CIRCULATING THE IPR REPORT

The contents of a draft IRP should be developed with the input from a range of internal and external stakeholders (including existing and potential investors if possible). Text should be professionally edited by an editor whose native language is that which the report is presented.

The report should be updated and sent to investors/funders on a semi annually or quarterly basis depending on input and institutional capacity. The discipline to update regularly is key to keeping investors informed and to demonstrate institutional commitment and planning capacity. There is nothing more impressive than receiving a concise informative IRP report every six months on the same day. And while this kind of reporting and discipline may seem excessive for a small MFI, the rewards will be rich when capital demands and stakeholder interests are more intense as the institution grows.

THE INTERACTIVE IRP ACTIVITIES

The second role of the IRP should be to facilitating feedback from current and targeted investors. Truly effective IRPs must also regularly solicit and assess investor feed back on a regular basis, preferable on an annual basis. There are a number of simple interactive options MFIs can consider alone or in combination.

An annual "road show" with local investors where the General Manager and select Board members meet with current and targeted investors is a classic IRP activity. The road show should include a simple presentation (either on paper or power point presentation). More importantly, presenters should be well prepared to answer questions anticipated from information gathered during prescreening and informal interviews.

The road show is a proactive means to put an institution in front of investors on an informal basis and to solicit feedback. Other venues can include less formal interactions at social events, conferences, or meetings with targeted investors spread across the year. The advantage of a road show approach is that it requires a short burst of attention from senior executives who are more likely able to concentrate on this important issue for a short period of time.

Webinars are another tool for presenting IRP reports and undertaking "road shows." This tool is handy for busy executives and an excellent means for reaching international investors at a very low cost. Like other mechanisms, special and period information reporting must be professionally done and *size appropriate*. That is, investors do not expect a small MFI to have a "glossy" big company image. Instead, focus on simplicity, transparency and a clear presentation of the facts.

However delivered, the IRP team must ensure that all feedback is properly recorded, assessed, and reported in a concise and clear form to the appropriate decision making bodies (see Section Three).

INVESTOR RELATIONS PROGRAM CALENDAR

Best practice IRP have an annual agenda or calendar of activities set as part of an annual business plan. Table One shows an illustrative agenda for a small MFI. A regular Investor Report and an Annual Report is pretty much considered the *minimum* amount of investor communication required. As noted above, local investor week or special event can also be planned as part of a reasonably modest IRP.

Table One

Investor Relations Program Calendar

January	Annual IRP planning
	IRP target setting
February	IRP Semi Annual Report preparation
	Annual Report sent to stakeholders and target investors
March	IRP Semi Annual Report approval
	Target investor data base updated
April	IRP Semi Annual Report sent
	IRP Report follow up
May	
June	
July	IRP Semi Annual Report preparation
August	IRP Semi Annual Report approval
	Target investor data base updated
September	IRP Semi Annual Report sent
	Begin planning for Interactive Investor Activity (e.g., road show or webinar)
	Scheduling investor participation
October	Interactive presentation drafted and approved
	Public relations support developed
	Executive training
November	Interactive activity executed
	Interactive activity follow up
December	Annual IRP Evaluation

This calendar assumes a financial year end of December 31 and is synchronized to reporting semi annual performance figures.

The IRP Calendar should provide sufficient detail about main activities including decision making/approval points, when documents should be produced, how they will be distributed, what targets are being set, and to whom authority and responsibility has been delegated.

BUSINESS TARGETS

As with any business activity, an IRP should have a set of targets. These are largely driven by funding and capital needs, but can and should also be set to meet other targets.

Simple targets can include number of potential funders contacted, how many times and when. Number and timeliness of reports, special information events, etc. are all measurable IRP activities, as are inquiries from investors and stakeholders related to capital sourcing. In the end, however, the ease at which your MFI achieves its funding goals is the only true measure of a successful IRP.

INVESTOR PROFILE RECORDS

As with any sales activity, good records of contact and interaction with funders need to be maintained. A simple Investor Profile file should be created for all funders. These records should include all background information on each investor: contact information, records of interaction (with whom and when) along with explanatory or summary notes.

INVESTOR RELATIONS PROGRAM RESOURCE NEEDS

Setting and meeting the IRP agenda is critical and like any activity within a business will require strong, executive level staffing commitment. The IRP must have dedicated human resources with the delegated authority to manage the plan. Depending on the size of institution it can include:

- General Manager (or equivalent);
- General Manager (or equivalent) with dedicated administrative support;
- General Manager (or equivalent) with IRP management delegated to junior officer (often Marketing Manager);
- CFO with appropriate support;
- Treasurer with appropriate support; and
- Dedicated junior executive.

In smaller institutions, any IRP will be modest and require only part of an executive's time. No matter the time required, IRP responsibilities should be detailed in the job description of the responsible officer as per any other activity. It is advisable that an executive close to or sitting in the Finance Department (or equivalent) is delegated responsibility.

Wherever the person sits, s/he should have extensive knowledge of the financing needs of the institution, a deep understanding of regulatory issues affecting capital and funding, and strong understanding of the institutions operational challenges. S/he should be adept also at developing and managing relationships with investors and stakeholders.

IRP BUDGET

A well managed and disciplined IRP should have its own budget which should be considered in the annual budgeting process of an MFI. This includes not only regular report production, executive time, special events, but also recalling the XAC Bank example, the time and expense of managing investor visits. Taking the time to detail an IRP budget will ensure it can be effectively executed.

SUMMARY

This guide has tried to impress upon readers that, just like asset management, MFIs must also commit to "best practice" funding management and sourcing if they are to access the private capital required to meet their growth and sustainability goals.

Taking a strategic approach to funding is stressed, as is executing and managing funding plans with discipline and a vision fixed on an ideal capital structure. Just as with any other business planning activity, a strategic approach must be based on strong assumptions of future performance and operating environment. As a result, setting funding goals is critical and smaller MFIs must develop strong business planning capacity. Meeting funding goals also requires management structures, procedures and policies matching the complexity and volume of liabilities, without which an MFI will neither be able to properly manage risk exposures nor inspire the confidence of investors (or regulators!).

Similarly, a highly structured approach to fund sourcing through an Investor Relations Program is the most efficient and effective way to ensure source capital. No matter how modest an MFI's capital needs are at present, a structured IRP will yield better results and lay the foundation for efficient funding in the future. As such, it is a key part of any funding strategy.

Those MFIs who plan and execute funding search and management in a disciplined and structured manner will improve their ability to access private capital, which is clearly becoming a key element in the struggle to serve billions of poor around the world with appropriate financial services.

FUNDING STRATEGY CHECKLIST

This check list outlines key considerations for developing and maintaining a strategic approach to managing and sourcing funding. Details for some of the items can be found in this document and/or other references cited.

Business Planning

- Operating Environment
  - Macro Economic Environment
    - GDP
    - Money supply
    - Interest rates
    - Foreign exchange
    - Others
  - Market Environment
    - Market penetration rates by segment
    - Market needs
    - Market competition
    - Others
  - Regulatory Environment
    - Current
    - Expected changes
  - Internal Operations
    - Performance indicators
    - Efficiency indicators
    - Profitability
    - Funding and Capital Needs
      - Debt
      - Deposits
      - Equity
      - Other
    - Human Resource Needs

- Systems Needs
- Governance
- Other

Future Expectations Summary

- Pro forma projections
  - Income and Expense statements
  - Balance sheet
  - Cash flow
  - Funding structure
  - Risk Exposure
    - Liquidity
    - Interest rates
    - Concentration
    - Foreign exchange
    - Operational
    - Credit loss
    - Other

Analysis

- Match business and operating environment projections
- Describe funding needs as a result and ideal funding structure

Funding Strategy

Funding needs and targets based on business planning results

- Debt
- Deposits
- Equity
- Off balance sheet
- Other

Ideal funding structure graphic

Describe funding strategy towards ideal structure

Management Considerations

- Describe existing funding management structures and bodies
- Describe required structural and procedural changes as funding structure evolves the ideal
- Describe funding management
  - Policies
  - Reporting mechanisms and frequencies
  - Decision making processes and risk tolerance triggers
- Describe Tactical Funding priorities
  - Use of collateral and security
  - Need for funding flexibility
  - Diversification
  - Cost of fund priorities

Information Needs and Transparency
Annual reports
Mix Market profile
External Audits
Ratings
Benchmarking
MicroBanking Bulletin
Other (describe)

Investor Relations Program

Describe IRP responsibilities
Investor relations only
Investor relations and fund strategy management

Fund Management Strategy
Investor pre screening
Investor targets and priorities
Investor information collection
Investor information interview
Investor information interview follow up
Organizational information interviews
Target investor list (short and long term) developed with rationals

Investor Relations Report
Develop target list data base
Determine content
Operating environment statistics (see business planning above)
Trend and pro forma data
Capital structure plans
Benchmark performance comparison and variation explanations
Operating strengths and weaknesses
Management
Processes and Policies
Risk Exposures
Capital structure
Capacity development needs
Management
Processes and Policies
Risk Exposures
Capital structure
Summary needs

Investor Interaction Program
Determine vehicle and frequency
Road show

- Webinar
- Other
- Interaction event planning
  - Target funders
    - Scheduling
    - Pre meeting information
    - Meeting presentation (power point/handouts)
    - Follow up
- Interaction preparation
  - Public relations
    - Press releases
    - Promotional activities
  - Communications
    - Consistent message re: needs, strengths, weaknesses, challenges and plans
    - Executive message training
  - Follow up activities

Investor Relations Program Calendar
- Workplan developed
- Outputs described and scheduled
- Executive approvals scheduled

Investor Relations Program Targets
- Performance Indicators set
  - Investor target list developed
  - Number of interactions with investors
  - Investor target analysis report
  - Interaction with investors
  - Reports developed and sent on time
- Evaluation
  - Frequency
  - Targets

Investor Relations Program Budget and Resources
- Human resources
  - Capacity needs
  - Terms of Reference
- Budget
  - IRP Report
  - Interaction Activities
  - Investor hosting
  - Materials
  - Contingency
  - Other

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APPENDIX ONE : LIABILITIES MATRIX

Table Appendix One - 1.0 Liabilities Matrix						
Types of Liability	**Source**	**Term**	**Average Finance Cost (including fees)**	**Administrative Cost**	**Security Collateral**	**Other Terms and Conditions**
Equity						
Soft Loans						
Promissory Note						
Term Loan						
Demand Loan						
Overdraft Facility						
Revolving Line of Credit						
Guarantees						
Demand/ Pass-book deposits						
Fixed Deposits						

APPENDIX TWO: FUNDING PLANNING RESOURCES

BUSINESS AND FINANCIAL PLANNING

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National Investors Relations Institute (USA): www.niri.org/

APPENDIX THREE: FUNDER MATRIX

Table Appendix Three – 1.0
Basic Funder Analysis Matrix

Funder	Size of Fund/Funding	Products Available	Min./Max. Term	Geographic Limitations	Security Collateral Required	Terms	Conditions	Due Dilligence Proceess Details	Information Require-ments	Time to Disbursement

APPENDIX FOUR: DEBT CHARACTER-ISTICS

TABLE APPENDIX FOUR DEBT LIABILITIES: COMMON CHARACTERISTICS						
Types of Liabilities *	**Liquidity**	**Flexible Features**	**Financial Cost**	**Fees and Transaction Costs**	**Condition Features**	**Security in order of *general* desirability**
Soft Loans	No fixed term, typical 1-3 years in microfinance	Paid to a maturity date	Low	Low, typically at cost or free	Payment options to fit cash flow: principle grace, bullet, regular principle and interest payments	Cash Flow, Portfolio, Negative pledges, Partial Collateral (real estate securities etc.), Collateral carve out/baskets, Third party guarantees, Cash set offs
Promissory Note	No fixed term, typical 1-3 years in microfinance	Some legal disadvantages due to lack of contract	Medium	Low	Payment options to fit cash flow: principle grace, bullet, regular principle and interest payments	Cash Flow, Portfolio, Negative pledges, Partial Collateral (real estate securities etc.), Collateral carve out/baskets, Third party guarantees, Cash set offs
Term Loan	No fixed term, typical 1-3 years in microfinance	Paid to maturity date	Medium	Medium, depends on security required	Payment options to fit cash flow: principle grace, bullet, regular principle and interest payments	Cash Flow, Portfolio, Negative pledges, Partial Collateral (real estate securities etc.), Collateral carve out/baskets, Third party guarantees, Cash set offs

Demand Loan	Some liquidity risk, lender can call at any time	Due at any time at lenders discretion, can negotiate cure period	Medium	Medium, depends on security required	Payment options to fit cash flow: principle grace, bullet, regular principle and interest payments	Cash Flow, Portfolio, Negative pledges, Partial Collateral (real estate securities etc.), Collateral carve out/baskets, Third party guarantees, Cash set offs
Overdraft Facility	Rapid Access short term, renegotiated at end of agreement limits liquidity attractiveness	Uncommitted facility, Calling off the Facility risk immediate repayment	High	High, recurring fees at end of each agreement period	Fixed term agreement that needs renegotiating at end of period	Set-offs common, other forms required as per above
Revolving Line of Credit	Open access to maximum limit, longer term borrowing, longer term than Overdraft	Disbursed funds can be repaid and re-borrowed to facility limit during life of agreement	Medium to High	Medium, depends on security required	Fixed term agreement that needs renegotiating at end of period	Set-offs common, other forms required as per above
Guarantees	No fixed term, typical 1-3 years in microfinance, some risk on short term loans that guarantee will not be available to renew at maturity	Guarantor can provide a percentage of coverage to fit need of MFI (e.g., less if as commercial relationship is established	Medium	High, pay fees to guarantor and lender	Guarantor may provide on a percentage of coverage. Various types available	N/A

* Does not include accounts payable, leases, other non-portfolio finance liabilities. , Adapted from CGAP, Commercial Loan Agreements (2006); Wisniwski, Sylvia, "Microsavings Compared to Other Sources of Funds," Eschborn, Germany: CGAP Working Group on Savings Mobilization - GTZ – BMZ, 1999.

TABLE APPENDIX FOUR
DEPOSIT LIABILITIES: COMMON CHARACTERISTICS

Types of Liabilities *	Liquidity	Flexible Features	Financial Cost	Fees and Transaction Costs	Condition Features	Security in order of general desirability
Demand/ Pass-book deposits	Core demand deposits relatively stable source of funding	Risk of unanticipated withdrawals	Low	High	N/A	Strong market brand and credibility
Fixed Deposits	Term fixed, but no guarantee of renewal, concentration risk possible	Rate sensitivity decreases availability in volitile or competitive rate environment	Medium	Low	N/A	Strong market brand and credibility

* Not including payables, leases, or non portfolio liabilities. Adapted from CGAP, Commercial Loan Agreements (2006); Wisniwski, Sylvia, "Microsavings Compared to Other Sources of Funds", Eschborn, Germany: CGAP Working Group on Savings Mobilization - GTZ – BMZ, 1999.

TABLE APPENDIX FOUR
CAPITAL MARKET LIABILITIES: COMMON CHARACTERISTICS

Types of Liabilities *	Liquidity	Flexible Features	Financial Cost	Fees and Transaction Costs	Condition Features	Security in order of general desirability
Commercial Paper	Rapid access, for short periods of time, general market liquidity /availability	Very short term	Low	High	MFI typically needs supervision and often a rating	Cash flow
Commercial Bonds	Depends on capital market depth. Long terms available (e.g., three to five years is not uncommon)	Structure fairly set	Depends on rating, with enhance-ments low	First time quite high, medium to high depending on volume thereafter	Issue and MFI requires ratings	Cash flow
Portfolio Securitization	Depends on capital market	Takes assets off balance sheet improving capital ratios	Very high first time, high there after	High at beginning less over time as administration system adapts	Requires large portfolio with loans of similar risk and ability to administer	Able to underwrite and administer well performing portfolio

* Not including payables, leases, or non portfolio liabilities. Adapted from CGAP, Commercial Loan Agreements (2006): Wisniwski, Sylvia, "Microsavings Compared to Other Sources of Funds", Eschborn, Germany: CGAP Working Group on Savings Mobilization - GTZ – BMZ, 1999.

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