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microNOTE #9

MFI Financing Strategies

Transition to Private Capital

Using development agency funding to leverage private capital is an important strategy for successful funding programs.

Introduction

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

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

Funding and capitalization strategies take place within the context of a sector transforming from one driven primarily by a social mission ethos to one that also responds to the needs and interests of private capital. The transition to private capital is well underway and some MFIs are mostly or entirely funded by private capital. But the transition has been slow and difficult as many MFIs lack the management capacity to attract and absorb private capital.

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Best practice knowledge, improved regulatory regimes, and stronger sector associations, among other interventions, are having positive effects on the sector's capacity. While improvements vary by country and institution, many MFIs now have or can develop the capacity to profitably employ commercial capital.

To make the transition to private capital, MFIs will have to play by a new set of rules -- those of the private sector. These rules are numerous, but all revolve around profit making, an objective that has not entirely entered the poverty focused lexicon of microfinance. Achieving funding goals also require *structured, professional funding strategies*. Some MFIs have such strategies, unfortunately most rely on rather informal and *ad hoc* approaches to funding. As MFIs grow, adopting professional strategies becomes all the more important, because growth is heavily contingent upon access to funding, which is increasingly only available from the private sector. In the absence of a clearly defined funding strategy, MFIs typically drift toward the sources they know best, which are often non-commercial in nature. This tendency is amplified by the existence of a good deal of donor and donor-driven funding (e.g., via MFI specialty investment funds and development banks), which offer terms and prices not always in line with what the market would provide. These factors combine to make the transition to private capital all the more difficult.

2-Scope and Structure of the Paper

This microNOTE is an extract of *MFI Financing Strategies and the Transition to Private Capital* one of three papers produced from the second stage of "Transitions to Private Capital" research, funded by USAID under Chemonics International's Accelerated Microfinance Advancement Program (AMAP) Financial Services Consortium's Knowledge Generation task order.[1] The objective of this research is to describe, compare and contrast MFI funding strategies, identifying those that contribute to the transition to private capital and those that do not.

A variety of secondary and primary data sources are used in this paper, including interviews with over fifty microfinance sector experts and MFI executives in Uganda, Peru and the Philippines.[2] These countries were selected as a representative cross-section of developed microfinance markets from around the world. This paper does not, however, detail three case studies. Rather, it draws on examples from the three countries to illuminate trends and examples found in other countries as well.[3]

3-Portfolio Funding Strategies – Demand Strategies

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

But deposit strategies are rarely well planned. Logically, the most often cited reason for mobilizing deposits was that they are generally considered to be the lowest cost and most stable funding available. Unfortunately, very few MFIs seem to know the true cost of deposit taking; while financial costs can be calculated, operational cost are difficult to determine. Some transforming MFIs in Uganda, for example, can only guess at the costs. In markets where commercial banks are entering the lower income deposit market as in Uganda, or in some intensely competitive urban markets, such as in Peru, not knowing costs can cause great strategic funding errors. As an executive in Stanbic Bank in Uganda pointed out "The low-

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

[2] Field work missions and other interviews were conducted between April and June 2005.

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[3] The author would like to thank Joanna Ledgerwood and Terri Kristalsky of SPEED Uganda, John Owens of MABS in the Philippines, and COPEME in Peru for their support of this research.

hanging fruit has already been picked" and future growth in the low income deposit market will be more difficult and costly than many transforming MFIs expect. Still, as the same manager points out, there are other reasons for entering the market besides low cost funding, such as the opportunity to cross sell other fee-based services – something MFIs with their limited capacities may struggle to do well.

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

4-Debt Strategies

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

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

Small Unregulated MFIs

Small, unregulated MFIs typically have the least ability to raise debt financing. Their challenges, as with most small businesses, revolve around lack of experience, untested or poor capacity, lack of credit history and poor collateral. Also, smaller MFIs are the least likely to develop formal funding plans and seldom have the sophistication to forge commercial ties with private lenders. Debt funding strategies of small, and to a lesser extent, medium sized unregulated MFIs thus tend to focus on grants, retained earnings, development bank funding, some international finance development agency funding, and, for the more savvy among them, commercial bank loans.[4]

Large Unregulated MFIs

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

Some of these MFIs have successfully used development finance funding to lever commercial finance. Some MFIs use loans and grants from development agencies to guarantee commercial bank loans; similarly, some use foreign denominated loans to do "back to backs" to avoid currency exchange risk.[5] Most subsidized funding is, however, not used to leverage private capital as the perceived cost is too high,

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

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

despite the fact that several MFIs have demonstrated that establishing a banking relationship leads to better and more flexible funding options in the future.

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

Newly Regulated MFIs

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

Figure One

MFI Debt Sourcing Challenges

Though it is difficult to generalize across national boundaries, MFI debt challenges exhibit some commonalities. They include:

- Larger MFIs often have fairly well developed funding strategies and growing capacity to mange them, while smaller institutions typically have *ad hoc* portfolio funding strategies;
- Transformation to deposit taking institutions is a highly desirable strategy for most MFIs;
- MFIs are seldom fully aware of deposit funding costs, and as a result, may not strategically maximize the development and pricing of savings products and services;
- MFIs with large, term deposit funding strategies operate in two fundamentally different markets: low income asset and high income liabilities. These markets react differently to economic events which must be accounted for strategically;
- Debt funding remains important to all MFIs even those intermediating savings;
- Development agency, particularly national development bank, funding remains important to many MFIs and critical to many non-regulated MFIs ;
- National development banks often provide important sources of capital, but do not always encourage the transition to private capital;
- International MFI investment funds often replaces subsidized funding in MFIs and may be an important bridge to local private capital markets;
- Foreign exchange risk, while minimal in larger institutions with some capacity to hedge, is a problem for smaller institutions;
- Commercial rating agencies provide excellent market credibility;
- Despite probable higher costs, MFIs of all sizes, regulated or not, can access private capital to their immediate and long term advantage, this is particularly true of smaller institutions with the desire to grow;
- More sophisticated capital market instruments such as bonds and securitizations are helpful to large, regulated MFIs.

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

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

Despite a keener focus on private funding among newly regulated institutions, they still typically rely somewhat on development banks and international funders. In the case of the latter, quasi commercial debt financiers (e.g., specialty MFI funds) become more strategically

desirable as they provide competitive terms for fairly large, longer term loans, and, as important, bring a degree of market credibility.[6]

Mature Regulated

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

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

Some larger MFIs have also accessed capital markets through bond issues and securitization. These are highly desirable strategies as they tend to offer low cost, long term financing for portfolio funding purposes and, in some cases, institutional investments. Unfortunately, few MFIs will be able to do either bonds or securitizations soon if only because transaction costs are significant and require large issues if they are to be economical. Few MFIs can put large volumes of capital to work quickly enough. Other barriers include such things as issue and institutional credit ratings, and shallow financial markets, which prohibit bond issues.

5- MFIs and Equity Strategies

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

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

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

At the same time, local entrepreneurs in many microfinance mar-

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

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

Possible strategies to overcome these equity investment challenges include:

- Demonstrate a credible commitment to returning profits to shareholders (such as through regular payment of dividends);
- Use of valuation experts to ensure fair share price;
- Offer different classes of shares with different ownership rights to keep investor confidence up and MFI mission drift anxieties down; and
- Increase openness to the governance and non-financial benefits commercial investors bring (i.e., do not limit universe of potential investors to social investors).

6- Encouraging Private Sector MFI Financing

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

Figure Two

Financing MFIs and Development Agencies

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

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

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

In terms of finance, some recommendations include:

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

7- Summary

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

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

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

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

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

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