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Financing Microfinance Institutions: The Context for Transitions to Private Capital

Accelerated Microenterprise Advancement Project

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Accelerated Microenterprise Advancement Project (AMAP) is a 4-year contracting facility that USAID/Washington and Missions can use to acquire technical services to design, implement, or evaluate microenterprise development, which is an important tool for economic growth and poverty alleviation.

For more information on AMAP and related publications, please visit www.microLINKS.org.

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Abbreviations

AMAP	Accelerated Microenterprise Advancement Project
CAF	Corporación Andina de Fomento
CDFIs	Community development finance institutions
CGAP	Consultative Group to Assist the Poor
DCA	Development Credit Authority of USAID
EBRD	European Bank for Reconstruction and Development
HNWI	High net high worth individuals
IFC	International Finance Corporation of the World Bank Group
IMI	Intenationale Micro Investitionen Aktiengesellschaft
MBB	MicroBanking Bulletin
MIF	Multilateral Investment Fund
NGOs	Non-governmental organizations
OPIC	Overseas Private Investment Corporation
PKSF	Palle Karma Sahayak Foundation
ROE	Return on equity
SRI	Socially responsible investing
S&P	Standard and Poor's
WWB	Women's World Banking
USAID	United States Agency for International Development

Definitions

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

Some terms are highly specific to this paper and require definition. Readers are urged to read the following definitions in advance of the report.

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

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

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

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

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

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

Executive Summary

“Until now microfinance has been driven fundamentally by development concerns, most importantly higher incomes for the poor. Increasingly, microfinance will be driven by the twin concerns of the competitive market place: market share and profits.”

Robert Peck Christen and Elizabeth Rhyne,
Microfinance Enters the Marketplace, 2000, p. iv.

Microfinance is in the process of transforming from a sector dominated by a mission-driven ethos to one responding to the needs and interests of private capital. The sector must do this if it has any hope of reaching a significant number of poor people with permanent financial services. The transformation must be made with confidence that the low-income financial service market niche of developing countries (estimated at more than \$300 billion), which microfinance professionals have proven viable, will be better served by a transformed, highly competitive industry.

The transition to private capital has, in fact, already begun, and a few microfinance institutions (MFIs) are entirely funded by private money. But the transition has been uneven, slower and more difficult than most imagined. Many claim this is so because MFIs lack the capacity to attract and absorb private capital. Capacity remains a challenge, to be sure. The sector still has trouble attracting experienced managers and directors, it continues to struggle with new product development, and business systems are often inadequate. At the same time, however, advances in and access to best practice knowledge, improved regulatory regimes and stronger sector associations, among other things, have had a cumulative and positive effect on the sector’s capacity. So while it may be a stretch to claim (as some have) that there are no human resource limitations in microfinance, it is clear that many MFIs can profitably employ commercial capital to invest in the capacity required to grow.¹

From a commercial investor’s perspective, it is also clear that the sector’s limited ability to attract private capital is at least partly *symptomatic* of its having been midwived by non-commercial capital, whose \$5 billion to \$10 billion investment over the last five to ten years has left an indelible imprint on the sector. This influence has fashioned an industry that is mostly driven by a social mission, but also driven in various and often conflicting ways by conventional business practices. For this reason, the transition to private capital is as much about managing the residual non-profit influences and non-commercial capital interventions as anything else.

¹ It is important to point out that the focus here is not on the many thousands of tiny programs scattered around the world, but rather the 200 to 300 smaller MFIs. These are MFIs that typically have 1,000 to 3,000 clients, a good deal of operating experience and a basis for strong potential growth.

To understand the current and somewhat complex relationship between microfinance and its ability to attract private capital, this paper first turns to the lifecycle theory as an analytical framework to describe the ideal and actual capital needs of MFIs as they mature. The lifecycle theory is a simple, yet powerful, concept that describes the typical evolution of businesses as they grow and mature. It argues that industries and companies pass through stages of development that are similar to the phases of human life. Both are born, grow, mature and eventually die. At each stage of life, companies live or die in part based on their ability to attract appropriate forms of capital. The value of the lifecycle theory is that it provides a framework to describe the cycles through which MFIs pass and helps one understand deviations from normal business development.

The theory predicts that as MFIs mature, they progress from employing high-risk equity to a variety of risk-tolerant funding sources. This research found that this theory has generally applied to MFIs. But as with all things microfinance, some characteristics of the transition from one set of capital needs to another are unique to the sector. Four observations stand out.

First, the majority of sector risk capital has and continues to come from non-commercial sources whose allocation is based on development aims as opposed to profit maximization. As pioneers of the sector, non-profit institutions were favored by non-commercial capital as well. This created the unique situation where early risk takers were not-for-profit organizations and non-commercial capitalists; as a result, and unlike other business sectors, early risk capital was seldom owned by a profit maximizing investor or institution.

Second, in a bid to “pick the winners,” a great deal of the sector’s risk capital has been invested in MFIs across their lifecycles, rather than just at start-up. Much has been invested, for example, to fund institutional and product development for mature MFIs. This influential strategy has led non-commercial capital to invest in many MFIs that should be sourcing capital from the private sector. By channeling these limited non-commercial financial resources into mature MFIs that could access commercial capital, higher risk ventures were denied scarce resources and non-profit maximizing behavior was reinforced.

Third and not surprisingly, most MFIs continue to rely on non-commercial sources for funding. A recent survey of the Consultative Group to Assist the Poor (CGAP) of 144 MFIs from around the world found that that over 90 percent feel donor funding is the most “appropriate” form of financing. This included not only immature MFIs but also profitable MFIs and profitable, mature deposit-taking institutions.

Fourth, at the sector level, microfinance has not seen the rapid merger, failure or acquisition activity typical of fast growing industries. Perhaps the sector is too young for this, but there are several identifiable barriers that may be slowing these rationalization processes, many of which relate to limitations of the non-profit business model and operating mentality that emphasize social mission oftentimes over commercial goals. Hence, the preference for the term “sustainability” over “profitability.”

The profit maximizing calculations made by the private sector, in contrast, allocate capital based on the dictum that any investment opportunity meeting an investor’s risk and reward

expectations will be considered. Needs vary by investor type, but there are generally predictable decision-making and asset allocation patterns. A typology of investors suggests that high net worth individuals and some institutional investors, mostly those who are self-identified as social investors, are most likely to invest in MFIs. To invest, institutional investors will, however, need guarantee support to satisfy the fiduciary and regulatory requirements that apply to all investors, social or otherwise. And while international investor interest is more apparent, domestic investors are a better bet for long-term, responsive access to low-cost capital. Unfortunately, very little is known about the attractiveness of MFI investing as compared to other opportunities for local investors. Understanding the constraints and opportunities among local lenders and equity investors will provide a key to increasing access to local investment funds.

In the absence of commercial funders, non-commercial funders have played a pivotal role in the development and commercialization of microfinance. Where their investment allocation once favored smaller, higher risk ventures, non-commercial sources of investment funds now tend to focus on larger and regulated institutions. Investments from publicly owned international funds, such as the IADB's Multilateral Investment Fund (MIF) or funding from the European Bank for Reconstruction and Development (EBRD), for example, are 88% concentrated in regulated MFIs, which are the institutions most able to attract private debt or equity capital. Private international social investment funds that target MFIs seem less concentrated and have only about 40% of all debt funding in larger, regulated microfinance institutions. This figure is, however, due largely to Oiko Credit and Rabobank Foundation, which have invested a combined total of about \$60 million in 160 and 90 MFIs respectively, but primarily in smaller MFIs. Neither of these funds manage public institutional (i.e. donor) funds, which is the primary source of funds for most other MFI funds which, again, tend to invest in mature institutions. The geographic concentration is also skewed toward more successful markets or initiatives. Latin American MFIs, for example, receive over 40% of all investment, with almost 20% of all funds going to MFIs in Peru alone. Eastern Europe has attracted over 40%, though most of it concentrated in ProCredit banks, which together receive approximately 34% of all MFI fund capital.

The search for any kind of capital will ultimately have to satisfy the interests of investors, as well as meet the needs of MFIs. This will involve more complex and calculated funding considerations as MFIs work to secure the lowest cost and most appropriate form of capital possible. Each of the main types of capital available requires strategic cost and management decisions.

To take on *savings*, normally the least costly capital, is a major decision that demands exceptionally strong product costing capacity, as well as a keen sense of market. This is particularly true, as many MFIs are finding, if the cost of managing the many small deposits from low-income credit clientele must be offset by attracting a few larger deposits from wealthy clients. Not all MFIs will be able to take on savings, simply because they cannot comply with deposit regulations, or because such regulations do not exist in appropriate forms. For those that do, they will face significant business culture and management challenges in the transformation to become regulated entities. Best practice liability management to control liquidity, rate and concentration risk, as well as to maximize profitability, also becomes a priority.

Even though the majority of microcredit loans are or will be intermediated savings, *debt* from banks, investors or non-commercial funders will remain vitally important to the sector. Debt will remain important for both deposit and non-deposit-taking MFIs for both funding and balance sheet management.

International social investment funds are a growing debt option and are viewed by MFIs as an attractive alternative to purely private sector capital. Such social funds are attractive because they almost always provide funding at well below market costs and have keen knowledge of MFIs. These advantages, however, may be offset by the fact that over 85 percent of lending and investments are in hard currency, exposing MFIs to foreign exchange risk they are seldom able to manage or absorb. With annual fund disbursements expected to reach an estimated \$100 million in the coming year or two, only around 2 percent of total estimated demand for debt will be funded by the funds. This limits the role of the MFI funds to a demonstration role or, if given more support, an important *tactical* role explicitly leveraging private domestic capital.

MFIs are looking to commercial banks for capital as well. Reserve requirements and a lack of sector information hamper commercial bankers' interest in MFIs. To overcome these obstacles, guarantee programs that avoid negative past experiences will be required. Other domestic and international debt providers who are bound by fiduciary laws will similarly require guarantees if MFIs are to tap bond and other sources of non-bank commercial capital markets.

In the absence of readily accessible local capital, however, international initiatives with the explicit goal of leveraging local capital represents an important bridge to commercial capital. Initiatives such as the UNITUS' supported equity fund and the recent ICICI, Share and Grameen Foundation securitizations in India are examples that merit greater donor support and replication. So does the Emergency Investment Fund for Latin America proposed by Omtrix, which may be an appropriate measure to ensure MFIs have rapid access to funding in the event of social, economic or environmental crises that plague developing countries and can place MFIs under severe liquidity stress.

MFI *equity* is a special problem. Equity investment is important to MFIs because it is a much more flexible form of financing than other available options. It is necessary for regulatory purposes that a bank (MFI or otherwise) meets and maintains certain capitalization requirements to collect client savings. It is also important – critically so – because the owners of equity control and guide an institution: hence, what drives owners drives the institution. In the case of MFIs, owners have been driven largely by mission to alleviate poverty, where sustainability, rather than profit, has been the motivating factor. This, combined with being a poorly understood sector, has worked to limit the amount of private sector participation in MFIs, despite return on equity yields that are demonstrably higher than many other competing investments. Attracting equity has many barriers, including valuation problems (MFIs over price and the market under prices MFIs), limited means for investors to extract income from investments (for example, poor share liquidity, few dividends and majority shareholders unwilling to maximize profits), and the frequent incompatibility of non-profit and for-profit ownership. The fear that for-profit owners will abandon the poverty mission is a key, though still unsubstantiated, source of distrust among non-commercial shareholders. Conversely, for-profit owners fear that unless they are in the majority, non-profit owners will forever plow retained earnings into expanding

services to the poor without rewarding the risks their capital is taking. Building sound relationships between incoming for-profit and existing mission-driven owners is critical.

Poor reporting transparency and standards that are not entirely consistent with private sector needs exacerbate the challenges facing all types of capital access for MFIs. Many regulatory issues inhibit both the microfinance banking and investor environment in ways that prohibit or limit transition to private capital.

Summary Conclusions

This report argues that the microfinance sector is at a crossroads between financing dominated by non-commercial sources and one increasingly and necessarily responding to private sector financing needs and interests. It concludes that if the sector is to meet its goal of serving a large portion of the world's poor with permanent financial services, it must continue to prove the viability of its core low income market and develop significantly deeper access to domestic commercial capital.

The microfinance sector in most countries has proven its commercial viability and that MFIs can serve the market profitably when applying best practice asset management. What it has not yet shown is whether it can become an integrated part of the formal financial sector. Funding will play a significant part of its integration, especially in helping the next generation of “winning” MFIs to emerge. These MFIs, mostly smaller, existing microfinance institutions or unconventional entrants, such as consumer finance companies and bank subsidiaries, are the most likely to spur the growth, competition and innovation that will attract the interest of commercial investors.

The implications of successfully pursuing private capital will change the very nature of microfinance. At the broadest level, this change implies a shift in focus from foreign to local investors. It implies adopting a private sector culture, language and governance style, including a greater focus on profitability and greater openness to mergers, acquisitions, and other forms of entrepreneurial dynamics characteristic of young and growing sector.

To attract a significant amount of private investment, the microfinance sector must work to explicitly break down the multiple information and regulatory barriers that separate private capital from MFIs, which will require that MFIs submit themselves to the most credible and widely accepted audits, ratings and supervision available.

Despite representing only a small fraction of current supply, non-commercial capital will continue to play a critical and catalytic role in the search for private capital. Current allocation patterns that concentrate the majority of the sector's risk capital in a small number of MFIs that are largely capable of sourcing commercial capital, however, will not encourage the growth of private capital.

In the transition toward private capital, non-commercial investors need to focus resources at the early high risk-return stage of microfinance institutional development. This means the next generation of “winners” and countries with no or shallow microfinance market coverage. Because so much is known about microcredit best practice, investment in the next generation

should focus less on asset development and more on serving the needs of private capital. This will require non-commercial capital mimicking as closely as possible the methods, disciplines and objectives of private capital. Examples, such as ACLEDA in Cambodia and XAC Bank in Mongolia, demonstrate how small, relatively new institutions can choose strategies that help them access private capital rapidly and profitably. A primary and obsessive focus should be to lever domestic capital as quickly as possible, as MFIs prove they can grow the value of their business in their core, low income market.

Non-commercially funded international MFI investment funds have the opportunity to play a significant role in this development if they invest in the next generation of MFIs and have the *explicit goal* of leveraging domestic capital. This will create scarcity of inexpensive capital resources for mature MFIs forcing them to seek out commercial capital. Non-commercial capital should also continue and increase investment in public goods, such as in credit bureaus, microfinance associations and regulatory improvements.

Observations & Recommendations

For donors and other non-commercial capital suppliers, the report offers a few concluding observations and recommendations.

General Observations

Non-commercial capital should not favor supporting non-profit MFIs over commercial entities, unless the former clearly promises a more efficient and effective route to rapid market penetration and profitability.

Domestic capital is almost always a preferable source for MFIs than international capital, over the long run. This is true for deposits, local debt and equity, even if the short-term financial cost of international capital is less than domestic capital. Some exceptions may include post-conflict markets or countries where capital markets and banking systems are extremely shallow. As a means to improve competition among MFIs, public and private MFI funds should invest in the next generation of MFIs, whether small existing MFIs with potential, subsidiaries of commercial banks or unconventional players, such as pawnshops or consumer financiers.

Specific Recommendations

Savings

Ensure that MFIs are keen to dramatically advance deposits and the capacity to price, collect and administer them, particularly if they operate in both the low- and high-income savings markets.

Debt

Nurture local commercial debt networks by supporting the generation of sector information and dissemination, improved collateral arrangements, guarantee programs and strategic regulatory changes and tax advantages. In larger markets, local private sector loan funds should be considered, as should local bonds and securitizations for mature institutions.

Equity

Court potential profit-driven, private sector investors as potential owners of MFIs. Support non-commercial capital investors seeking to sell shares. Seek to create a more liquid market for MFI shares by encouraging dividend payments and access to formal capital markets (such as business buyer/seller networks, over-the-counter securities markets, stock exchanges, etc.).

International Social Investment Funds

Provide support to international social funds to *explicitly* leverage domestic capital for MFIs as opposed to relying on them to do so on their own limited budgets.

Other Non-Commercial Funders

Limit non-commercial funds to early-stage MFI development or to reach new MFI markets. Ensure that leveraging private capital is an explicit goal of any non-commercial funding intervention. Continue funding regulatory change, facilitating investment as well as other public good initiatives, such as strengthening credit bureaus or sector associations and drafting investment laws affecting access to private capital.

Future Research

This paper suggests three lines of research to improve private capital, particularly at the domestic level.

Supply of capital: To increase access to *local* capital, researchers will investigate the opportunities and barriers to MFI investment among domestic lenders and investors. Research will provide USAID missions with templates for assessing and accessing private capital in domestic markets.

Demand for capital: Through a closer examination of mature and promising MFIs, develop a diagnostic template to understand MFI capital needs, possible capital development strategies and management capacity requirements. Research will help MFIs and USAID missions develop customized plans to gain access to private capital.

Regulatory developments: Analyze regulatory environments highlighting and detailing policy facilitating investment in MFIs. Two to three case studies will be featured. The research will familiarize USAID missions with common and critical regulatory considerations and changes that could improve MFIs' access to private capital.

Introduction

According to the Consultative Group to Assist the Poorest (CGAP), the current combined portfolio of microfinance institutions (MFIs) worldwide is approximately \$15 billion. Microfinance is believed to be growing annually between 15 and 30 percent, translating into a demand of between \$2.5 billion to \$5.0 billion for portfolio capital and requiring \$300 million to \$400 million in additional equity each year. Non-commercial investors, including donors, bilateral and multilateral financial institutions, disburse approximately \$400 million annually to the sector. They simply cannot provide the level of funding necessary to support the microfinance industry's demand for capital funds, particularly since much of their support goes toward regulatory change, information services, sector associations and other sector development initiatives. Hence, it comes as no surprise that a CGAP survey of over 144 MFIs found funding to be the number one constraint to growth (CGAP 2004).

Estimates vary, but the bulk of the worldwide microfinance portfolio is currently funded by deposits (25 to 30 percent), debt (35 to 40 percent) and equity (30 to 40 percent).² Debt suppliers include non-commercial investors, commercial banks and private social investors. Equity is primarily owned by national and international non-profit organizations and non-commercial investors, particularly multilateral development banks. Donors have invested an estimated \$5 billion to \$10 billion over the last ten years, much of it going toward the equity base of MFIs, either as capital or technical services grants. It is not known how much pure commercial equity is owned by the private sector, though some banks either own some or all of an MFI and a small number of private investors also own shares, though they are the minority.

Scope of this Report

This report provides a comprehensive global overview on financing of the microfinance sector in developing countries. Its primary goal is to define the MFI financing context as a means to understand the sector's potential for accessing greater amounts of commercial capital. The assessment involved a literature review, interviews with 15 leading MFIs and over 20 leading MFI financing stakeholders and investment decision-makers, and consultation with a roundtable of MFI financing experts.

Commissioned by the United States Agency for International Development (USAID) under the Accelerated Microfinance Advancement Program (AMAP) Knowledge Generation contract, the report is intended primarily for microfinance development professionals, but may also be of interest to private sector investors.³ It is the first of a series of investigations that have the shared objective of providing insights into how MFIs can access more private capital.⁴

² Regional liability structures vary tremendously, and many MFIs are not legally able to collect savings. Also, the percentage of each type of liability varies greatly depending on what data set is being used. Estimates used here are taken from the MIX Market. The data is not exact, but the order of magnitude is correct.

³ This paper uses conventional finance terms common to both microfinance professionals and private sector investors. In the case of terms specific to microfinance, we use the closest conventional finance equivalent. For example, the distinction used in microfinance to describe

This report recommends steps to test and refine its own findings in future research. Future research has the explicit goal of identifying or helping to develop tools or interventions for increasing MFI access to private capital.

This paper has two companion documents. The first is *Financing MFIs: A Regulatory Context*. This document overviews the investment regulatory environments and the ways and extent to which they encourage the supply of commercial MFI financing. The second document is *Financing MFIs MicroNote*, which provides an overview of this paper for USAID Mission Project Development Officers active or interested in microfinance.

Structure of the Report

Part One overviews business lifecycle theory. Using data from the MIX Market, the MicroBanking Bulletin and interviews with 15 mostly mature MFIs, it compares the business lifecycle to MFI financing patterns. This comparison helps describe specific challenges facing the microfinance sector’s access to private capital.

Part Two establishes the potential “universe” of MFI investors by describing the asset classes of microfinance investments with those of other established asset classes. It next places the MFI asset classes within the investment or asset allocation strategies of the most common types of commercial investor, defining both the most likely and able investors and the relative share of portfolios available.

Part Three assesses investment decision-making patterns of the major non-commercial capital investors in microfinance, identifying several notable impacts that condition access to private capital.

Part Four critically overviews the impacts and influences that the not-for-profit business model and non-commercial capital have had on shaping the current microfinance context.

Part Five examines barriers MFIs encounter when trying to access the three main sources of MFI funding: deposits, debt and equity.

Part Six provides conclusions drawn from the paper’s findings and outlines next steps for *Transitions to Private Capital* research.

“operationally self-sufficient” and “financially self-sufficient” have no conventional finance equivalent. We use “profitability” and degrees thereof in place of these terms.

⁴ This paper does not seek to estimate total supply and demand for MFI capital. Such a task would require far more resources than available and would, in any event, offer questionable overall value. Instead, the paper relies on estimates made primarily by CGAP.

Business Lifecycle, MFIs, and Finance

1.1 The Business Lifecycle

Microfinance institutions and the microfinance sector are unique in many ways, but as with all industries and businesses, they pass through commonly defined stages, or points in a lifecycle. The so-called lifecycle theory is a simple yet powerful concept that observes how businesses and industries are born, grow, mature and eventually die. At each stage, they share a set of common market development, management capacity and financing structure characteristics.

A number of authors have applied the lifecycle theory to greater or lesser degrees as a means to explore a range of research questions related to microfinance growth and development.⁵ It is used in this study as a tool for comparing financing patterns at different stages of an MFI's life to that of the "typical" business, as predicted by the lifecycle model.⁶

There are many variations used to describe the basic stages of the business lifecycle. Four are normally included: youth, growth, maturity and decline or exit. Appendix One provides a detailed explanation of each lifecycle stage as it relates to MFIs. It is important to note here that while the theory is explicit about the characteristics of each stage of growth, it does not predict when, or how fast, a company or sector will evolve. Some sectors, such as telecommunications, have gone through the lifecycle phase at least three times in the last thirty years, the most recent iteration being the fast-moving mobile technology phase. Likewise, the steel industry has been through at least two evolutions, but over some 50 years, each has taken several decades to complete. As businesses can go through multiple lifecycles, the theory does not specify age in terms of years, but identifiable stages with common characteristics. It is also noteworthy that the lifecycle does not predict the causes of change. In the case of steel, for example, tariffs and protectionism slowed development; conversely, in telecommunications, technology drives current developments, whereas deregulation drove change during the 1980s and early 1990s.

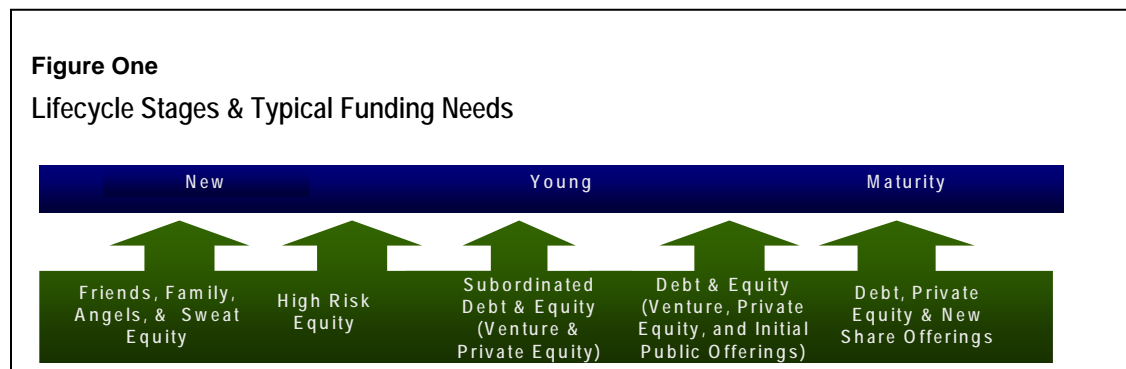
The lifecycle theory also characterizes the capital needs of businesses at each stage of life. Again, while the theory generalizes needs, it provides a means to compare typical financing patterns against that of microfinance.

⁵ It is important to recall that the lifecycle theory is not used here to identify the causes of MFI financing challenges or sector change. Many view an MFI legal status as an important determinant of access to private capital. Various institutional types come with distinct challenges, but the basic progression of capital needs remains strikingly similar. For applications of lifecycle theory in microfinance see Kooi, Peter, *Raising Capital through Equity Investments in MFIs: Lesson from ACLEDA, Cambodia, UNCDF/SUM and UNDP Africa*, New York, NY, 2001; Meehan, Jennifer *Tapping the Financial Markets for Microfinance: Grammeen Foundation USA's Promotion of the Emerging Trend and Next Steps*, Grameen Foundation USA, October 2004; and Schneider, Louise, *Strategies for Financial Integration: Access to Commercial Debt*, Women's World Banking, Financial Products and Services Occasional Paper, Women's World Banking, New York, New York, July 2004.

⁶ The focus of our discussion is on financing businesses through the various lifecycles. For a fuller explanation of the lifecycle model see Appendix One.

A traditional company's finance needs at **youth** are usually relatively modest (depending on the type of business), but business risk is high at this point of development and funds can be difficult to secure. This is why most businesses at this stage fund themselves through friends and family, savings and sweat equity. Other potential sources include suppliers, customers and government grants. As there is rarely any formal assessment of business potential, financing decisions are based on the attractiveness of the business idea and faith in the individual(s) involved.

In the **growth phase**, businesses need expansion capital normally in excess of that which personal connections can supply. Possible sources include banks, profits, partnerships, grants, suppliers and leasing. "Angel" investors, venture capitalists, or other equity providers willing to take greater risk in exchange for greater potential return are often sought at this stage. Use of supplier and commercial bank debt is common, though it usually requires collateral businesses seldom have. Towards the end of the growth phase, businesses often require mezzanine financing as a means to prepare for public share offerings and/or to increase growth. Financing at this stage is more complex and requires increased management and more formalized systems.



In the **mature phase**, business growth tends to flatten and companies concentrate on reducing costs and maintaining market share. As a result, business planning, strategy and efficiency become critical. The firm becomes more sophisticated about financing and financing decisions, and about managing cash flows and tax liabilities. As profits mount, debt generally becomes increasingly desirable for tax shelter properties and for leveraging shareholder gains. Sources of capital include profits, commercial banks, capital markets (bonds, money markets, etc.) and equity investors.

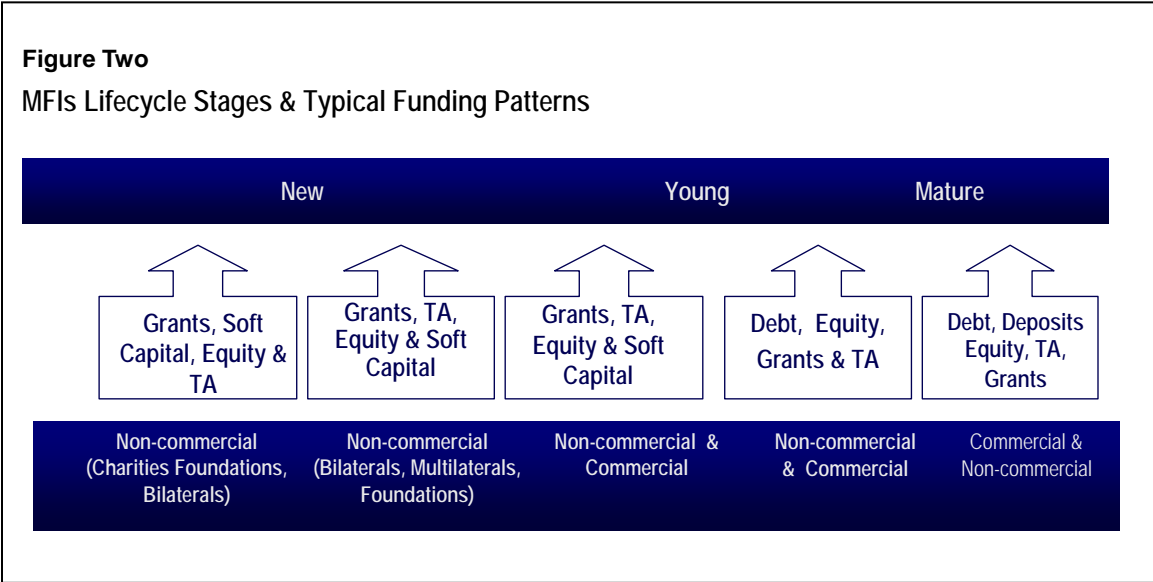
The progression of capital needs and related business developments may seem obvious, but it is ignored at the peril of businesses and investors. The now infamous U.S. "dot.com" businesses offer a classic case study. By securing massive infusions of initial public offering capital, many dot.coms skipped over management lessons normally learned in the start-up and early growth phases. Immature management, combined with underdeveloped markets and often non-existent

asset bases led many dot.coms to squander millions of dollars. This wild expansion and derailment of Internet-based businesses will have long-term impacts on the sector’s ability to raise capital in an organized fashion. By contrast, a steady progression through lifecycle stages would have moderated sector expansion and “market-tested” management, resulting in a stronger base for future investment and growth.

Financing through the MFI Lifecycle

As with any other youthful venture, MFIs in the **youth phase** need highly risk tolerant capital. This has come primarily in the form of non-commercial equity such as grants and subsidized loans from charitable organizations and development agencies. A good deal of sweat equity has also been invested by non-profit organizations sponsors/owners and founding managers.

In the **youth phase**, MFIs need capital to gain market share and to achieve economies of operational scale. Capital sources are retained earnings, non-commercial equity in the form of technical assistance, free, low- or no-cost loans for portfolio use. This stage often finds MFIs making the transition from non-profit organizations to regulated institutions. This normally requires equity infusions similar to mezzanine finance. Large sums of long-term debt for portfolio capital are also common at this stage. Investors are typically large multilateral financial institutions, founding non-profit organizations, and occasionally other investors including banks, employees (primarily through employee stock option programs or ESOPs), private investment funds and wealthy individuals. Commercial bank debt can be important, as are deposits, for those MFIs legally able to collect them.



At **maturity**, MFIs increasingly resemble other formal financial institutions. Their financing needs not only focus on volume, but the cost and flexibility of funds as well. Financing for regulated MFIs mostly comes in the form of deposits, medium-term debt and retained earnings. Non-regulated institutions rely on commercial bank loans, national and international development agencies, governments, supporting non-profit organizations, and retained earnings. Larger MFIs may also issue new stocks (that is, equity) or bonds.

Where MFIs Diverge from the Typical Business Lifecycle

As predicted by the lifecycle model, the progression from high-risk equity to a variety of risk tolerant funding sources largely applies to the experience of MFIs. As with all things microfinance, however, some evolutionary characteristics are unique to the sector.

Non-commercial Capital is the Risk Capital for the Sector

While subsidies can play an important role in the start-up of a new sector, non-commercial capital, technical assistance and low- or no-cost portfolio financing has played a disproportionate role in microfinance compared to other industries, since it comprises the bulk of the sector's risk capital. According to CGAP, donors have pumped between \$5 billion and \$10 billion into the sector over the last five to ten years. Of course, not all of this was direct investments in MFIs. Even if only half the funds were direct investments, however, this would represent 17 percent to 33 percent of outstanding MFI assets. Since much of this capital was used for "technical assistance and to cover operating deficits" it *de facto* represent a large share of the sector's early risk capital.⁷

The Use of and Continued Reliance on Non-Commercial Capital Across the MFI Lifecycle

Lifecycle theory predicts that the use of risk capital decreases as a business matures. The available data for MFIs supports this lifecycle progression.⁸ Mature, profitable MFIs listed on

⁷ CGAP, "Foreign Investment in Microfinance: Debt and Equity from Quasi-Commercial Investors", Focus Note No. 25, January 2004, http://www.cgap.org/docs/FN25_ForeignInvestment_Final.pdf

⁸ The MIX Market and MicroBanking Bulletin data are used throughout this report since they are comprehensive sources of publicly available information on MFIs. The two data sets are *reasonably* representative of the universe of MFIs, even though many MFIs (primarily small) are not included. Though they suffer from common statistical limitations inherent to small sample sizes and uneven reporting, both data sets offer enough longitudinal data to provide a sense of trends within the industry. Trend analysis should be considered indicative rather than definitive, however.

Table One Commercial Funding Liability by MFI Age 2001 & 2003 *				
Lifecycle Stage	2001		2003	
	All MFIs	Profitable MFIs	All MFIs	Profitable MFIs
Youth	57.3	57.3	31.1	58.4
Growth	49.3	49.3	24.0	36.8
Mature	86.8	86.8	79.1	94.3

Data from 2002 displayed similar trends between age categories. It was not included here since it was strongly skewed, due either to outlying or incorrect data.
Sources: MicroBanking Bulletin, Issue 8, November 2002 and MicroBanking Bulletin, Issue 9, July 2003.

Table Two Capital Asset & Commercial Funding Liabilities by Region			
Region	Capital/ Asset Ratio (%)	Commercial Funding Liabilities Ratio (%)	Debt to Equity Ratio (%)
All MFIs (n = 124)	42.7	44.1	1.9
FSS MFIs (n = 66)	40.4	76*	2.5
Africa	44.4	42.6	2.0
Asia	37.6	65.8	1.6
East and Central Asia	60.1	9.0	1.1
LA	35.3	71.8	2.7
Middle East and North Africa	71.4	23.9	0.4

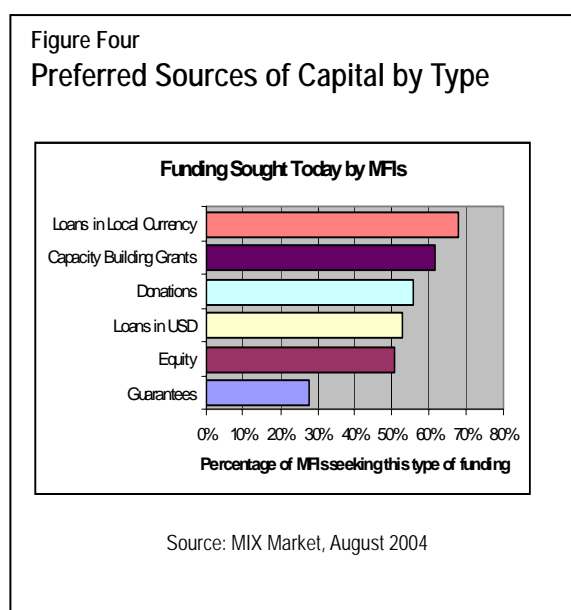
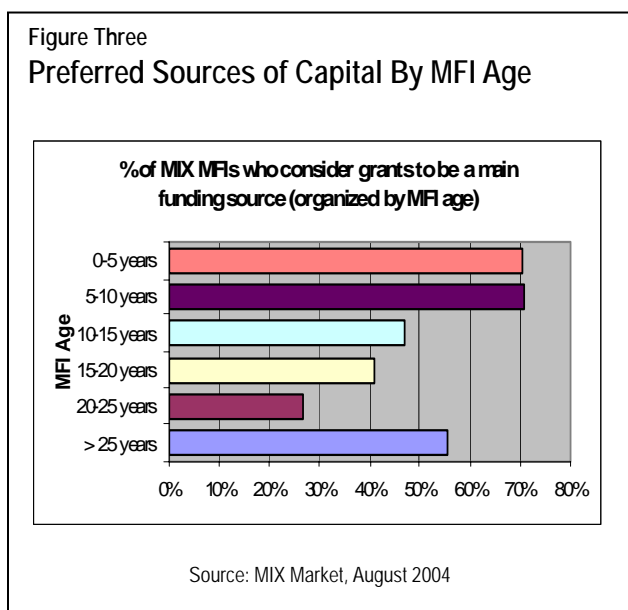
Source: MicroBanking Bulletin, Issue 9, July 2003

the MicroBanking Bulletin (MBB), for example, consistently have more commercial funding than younger institutions.⁹ (See Table One.) Findings are similar regionally, albeit at levels corresponding to the relative maturity of the sector in each region. (See Table Two.) In Eastern

⁹ Commercial funding is defined as all funding sourced at market rates. The commercial funding liability ratio presented in Table 1 is a function of commercial rate funding/total liabilities. It is important to note that the standard deviations for this ratio are quite high, indicating substantial variations from the average. A closer assessment of the data suggests that if MFIs deviate from the norm, it is towards less, rather than more, commercial funding.

Europe, for example, the sector is still quite young, and average commercial liabilities are much lower than other regions. In the more mature markets of Latin America and Asia, commercial liabilities are higher, averaging 71.8 percent and 65.8 percent respectively, with a combined average of over 100 percent for mature institutions. In Africa, the average commercial funding ratio is 42.6 percent, though it varies a great deal by age and size.

These observations make sense *vis-à-vis* the lifecycle model. Two other observations do not. First, contrary to lifecycle predictions, start-up MFIs are expected to have less commercial funding than growth MFIs, but the available data illustrate similar, if not higher levels for start-ups.¹⁰ (See Table One.) Second, profitable, non-deposit taking MFIs are not, on average, fully commercially funded. In fact, the average commercial liability level is less than 60 percent. The lifecycle model expects businesses to have full access to commercial capital at this stage. This finding is symptomatic of anemic leveraging, or debt to equity ratios, which are far below the 8:1 many MFI professionals believe is ideal.¹¹ Counter-intuitively, but consistent with commercial liability findings, profitable start-ups have higher average leveraging than growth-stage MFIs.



The presence of between \$300 million and \$500 million in loan guarantees suggests the problem of inadequate leverage is more profound than the average commercial liability ratios imply.¹² Indeed, many of the best performing MFIs still need guarantee support to access commercial debt. A recent evaluation of mature, highly profitable Latin American MFIs, for example, found

¹⁰ Please note that this observation is based on a small sample size and is therefore subject to bias. That the same trend is noted in 2001 through 2003 suggests some statistical rigor, however.

¹¹ The Basle Convention standard suggests an institution's equity be no less than 8 percent of its risk-weighted assets. As such, the limit on how much an institution could borrow will ultimately depend on the institution's mix of assets.

¹² Sources: CGAP (2004); Enterprising Solutions (2002); Goodman (2003).

that third party guarantees were often required to secure debt in adequate volumes.¹³ Even world-class MFIs such as Women's World Banking (WWB) Cali and other Colombian WWB affiliates require guarantees despite consistently high levels of performance.

The lack of commercial capital available to MFIs is disconcerting. More worrisome, however, is the stated *preference* by most MFIs for non-commercial capital. A recent CGAP survey, for example, found that almost all types of MFIs, in all markets, believe non-commercial funding is the most appropriate form of capital. MIX Market data confirms that non-commercial capital continues to figure significantly in the capital searches of MFIs of all ages. (See Figures Three and Four.) While it may seem prudent to seek out the lowest cost capital available (in this case, non-commercial capital) for the reasons elaborated in Part Five, such behavior may, in fact, contribute to barriers to private capital, and may ultimately cost more than some non-commercial capital, slowing the development of the sector.

Sectoral Lifecycle Developments

Just as individual businesses go through lifecycles, so too do industries or sectors. An important and constant part of sector development is rationalization, or the processes by which strong businesses grow to dominate a sector and weaker ones are acquired, merge or fail. This process is certainly evident in the finance sector in countries with reasonably liberal financial laws. The number of small US banks, for example, has declined from 15,000 to 8,000 over the last ten years. The number of Canadian credit unions has dropped from over 3,000 to under 800 in the same period. In Mexico, the number of large banks has decline from 15 in 1990 to 6 today. A similar process is taking place in most developing countries where financial liberalization has taken place.¹⁴

The microfinance sector has yet to experience significant rationalization even in the most competitive markets. Neither Bolivia nor Peru, for example, both relatively mature markets, have seen a single high-profile merger. There have been relatively few failures as well.

Perhaps the sector is still too young. But even if it was not, there are several potential barriers that may be slowing the rationalization processes. Many charity supported MFIs and small cooperatives, for example, resist change and growth because they are satisfied serving a small niche clientele others have yet to discover. Some charity-minded funders keep non-commercial

¹³ See Jansson, Tor, "Financing Microfinance", Inter-American Development Bank, Sustainable Development Department Technical Paper Series, Washington, D.C., 2003, http://www.iadb.org/sds/publication/publication_3252_e.htm.

¹⁴ See Hanson, James A. (2003) Banking in Developing Countries in the 1990s, World Bank Policy Research Working Paper 3168, World Bank, Washington D.C. Rationalization processes, such as mergers, failures and acquisitions, are a key part of a healthy market dynamic. Mobile phone markets offer the most obvious and dramatic example of this process. Competition in these markets is fierce and has pushed ownership of cellular phones to near saturation levels in just a few years. The industry is also among the most innovative as well. The result: more clients are served with better, lower-cost services. But even older industries, such as steel, textiles and agriculture, experience periodic rationalizations that benefit the consumer through greater product diversity and lower costs.

operations alive that for-profit investors would not. Many non-profit MFIs do not have commercial shareholders constantly pressuring for growth and profitability, which can lead to mergers, acquisitions or closures. Private shareholders are much faster than non-profits at “pulling the plug” on failing institutions.

Summary

The evolution of capital needs as predicted by the lifecycle model compared to that of microfinance financing yields several important observations. They include:

- Non-commercial capital has been the main form of early risk capital;
- Non-commercial risk capital remains an important source of funds, even as MFIs mature;
- Some mature and profitable MFIs that should have full access to commercial capital do not make it a priority, or simply choose not to access it; and
- The microfinance sector has not experienced and may face barriers to mergers, acquisitions and failures typical of fast-growth industries.

The comparison also suggests that:

- Scarce risk capital is being diverted from youthful and growth-oriented institutions to mature MFIs that could likely access private capital;
- Start-up MFIs may be more commercially driven than growth MFIs;
- Non-commercial capital influence or reinforce non-profit maximizing behavior among MFIs; and
- Non-profit and non-commercial capital origins of the sector may inhibit sector rationalization.

Mainstream Eye for the MFI

2.1 The Mainstream Eye for the MFI

Commercial investors are guided by asset allocation strategies that basically define the universe of possible investments and the proportion of each asset class they can buy for a given portfolio.¹⁵ This means that even before the quality of a specific investment can be considered, the relative interest of an investor is more or less set.

For the most common types of investors, asset allocation strategies are so well defined, in fact, that they result in fairly predictable investment patterns. Generally speaking, asset allocation principles applicable to each of the most common types of investors transcend international boundaries. This means that the relative proportion of a given asset class found in a Peruvian or South African pension fund will be roughly the same as those found in a US or British fund, with obvious differences influenced by local economic conditions and regulatory regimes.¹⁶ Thus, the processes by which investors allocate funding to different asset classes is of great interest to microfinance, since they can define the type of investor and the likely amount they are able or willing to consider investing in MFIs.¹⁷

Unfortunately, the asset class or classes to which microfinance investments belong is not established. This makes it difficult to explain their potential to commercial investors. It also makes benchmarking, or comparing the performance of a given asset against a group of its peers, difficult to impossible. This is problematic because most commercial investors need to prove to regulators and clients that they are making sound investment decisions.

Establishing MFI investments as an asset class is therefore important if commercial capital is to be accessed at any scale. It is also a necessary step toward identifying where MFI investments fit within investor asset allocation strategies and toward defining the “universe” of potential investors.

¹⁵ Asset allocation, or the process of dividing a portfolio among major asset categories, such as bonds, stocks or cash, has the purpose of managing risk and maximizing profit through portfolio diversification.

¹⁶ It is important to explain that when we speak of asset allocation strategies, we do so at the broadest level. Many readers will note that asset managers have distinct views on the economy and adjust their holdings strategically. This usually involves differential weighting of higher and lower risk investments within portfolios. The most common difference is variations of the proportions of equity versus income investments. (See Figure Five and Six).

¹⁷ For the sake of brevity and unless otherwise stated, MFI investment refers to either direct investments in MFIs or indirect investment through private funds investing in MFIs.

MFI as an Asset Class

The risk and return potential of a given investment is normally understood by comparing it to an established asset class benchmark. Benchmarks are useful tools that define the relative standards by which competing investments are judged. Most equity mutual funds, for example, use the Standard & Poor's (S&P) 500 as a benchmark. When assessing an investment, it is important to compare it against the appropriate benchmark. For example, comparing a bond fund to the Russell 2000 small capital company index is not particularly meaningful because they have distinctly different risk levels. Categorizing an asset class is thus critical for understanding an investment's expected risk and return potential.

Where MFI investments fit into the rules governing commercial investor asset allocations is not well established precisely because they are not a well-defined asset class. As a result, commercial investors considering an MFI investment are forced to judge MFIs on the basis of perceived rather risk rather than established asset class expectations. Perceptions vary greatly and are not particularly helpful as a means to understand the potential for commercial investment

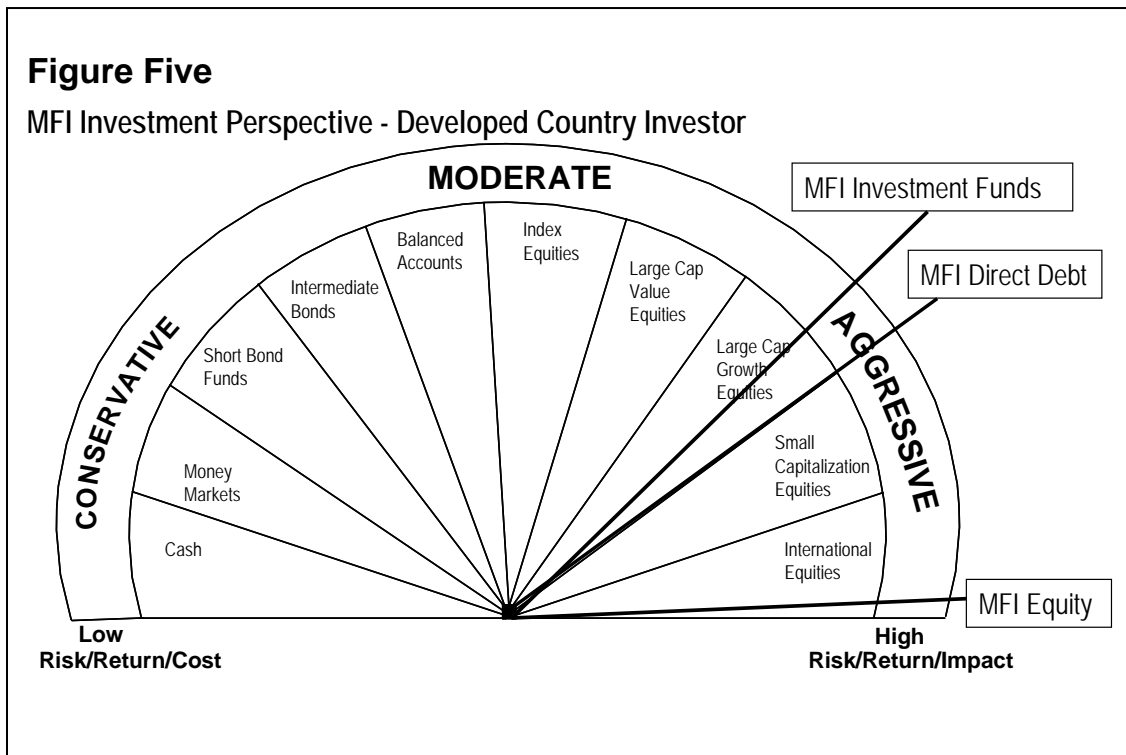
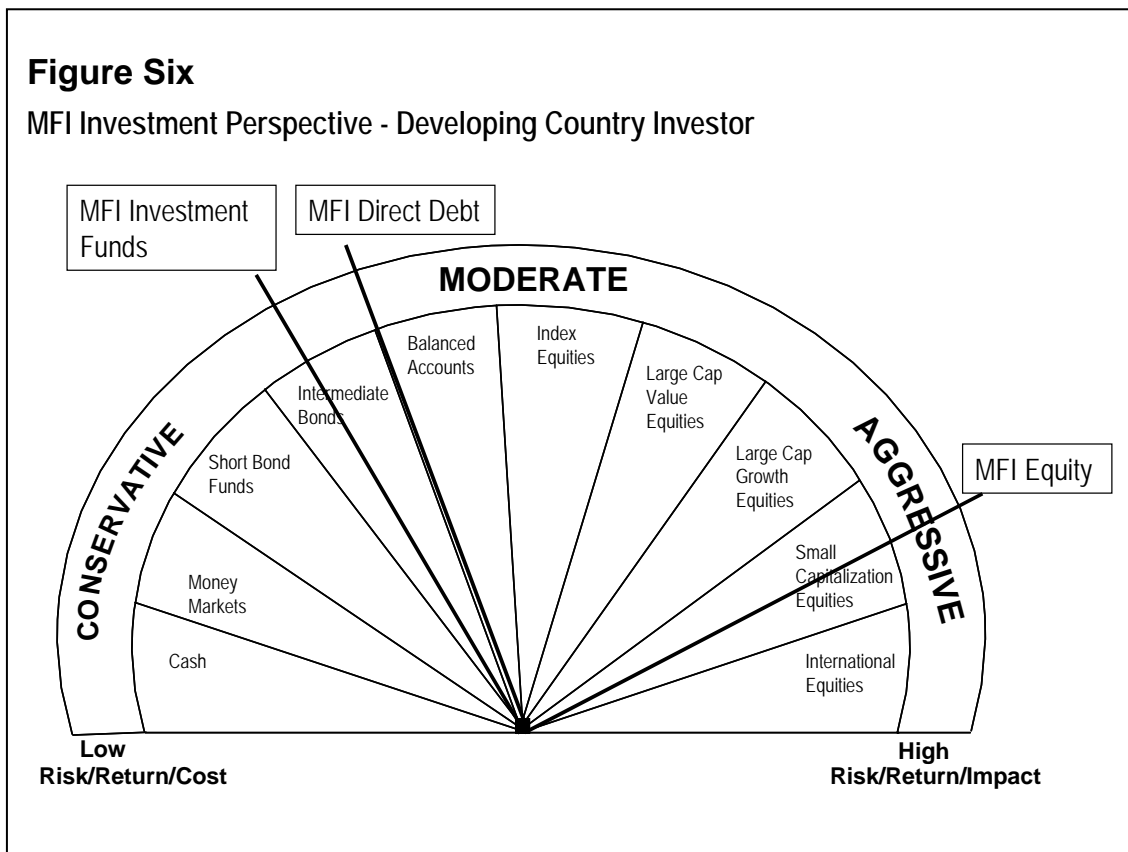


Figure Six

MFI Investment Perspective - Developing Country Investor



in microfinance. This led Francis Coleman of Christian Brothers Investment Services to attempt to place mature and profitable MFI investments on an investment risk spectrum. (See Figures Five and Six).¹⁸ As imprecise an exercise as this may be, the results are instructive.¹⁹

Coleman explains that among *developed country* investors, MFIs would be classed as an emerging market, small capital investment.²⁰ This implies that in addition to normal liquidity and business risk, microfinance involves additional country currency, transfer and settlement risks. MFI debt would be viewed as less risky than equity, but is still the equivalent of small capital company equity. MFI equity, for various reasons to be explored in Section Five, is at the extreme end of the risk spectrum.²¹ Investing in an MFI investment fund, such as MicroVest, Blue Orchard or LACIF, would be considered equivalent to intermediate bonds. A triple “A” S&P rating for a local currency MFI bond, such as those issued by Compartamos, may be considered the equivalent to an emerging market large capital equity. An un-rated bond issue, or debt in an MFI would be considered junk, and probably would not be considered by investors at all.

Given the typical range of investment options available in developing countries, MFI investments have a more attractive risk/reward profile than they do international investors. (See Figure Six.) Since domestic investors have more intimate knowledge of local economic environments and because none of the added risks of international transactions exist, MFI equity would likely be considered a risky small capital equity.²² MFI debt would vary depending on the MFI involved, but a mature institution likely represents the equivalent of an intermediate bond.²³

Asset Allocation and Commercial Investment

Commercial capital investment decision-making or asset allocation strategies follow fairly simple rules that balance return and income liquidity needs.²⁴ The relative importance of each is unique to every portfolio, but some generalizations apply.

¹⁸ Francis Coleman is Vice President of Christian Brothers Investment Services (CBIS). CBIS is a socially responsible asset management company that manages \$4 billion worth of Catholic religious institution money. The analysis was given to a workshop on Socially Responsible Investment and MFIs, held September 3, 2003 in Guatemala City. See Cheng, Julie and Marc de Sousa-Shields, “Microfinance and Social Responsible Investment in Latin America”, Workshop Report, Enterprising Solutions and the Inter-American Development Bank, Guatemala, September 2003, <http://esglobal.com/resources.htm>.

¹⁹ Note that the discussion of asset classes, the risk associated with each MFI investment instrument is compared to the *closest approximate* perceived asset class. This is technically confusing because asset classes are not normally compared to one another (e.g., saying MFI debt is comparable to the risk of a small capital equity). Comparisons are not intended to be technically correct rather they are meant to provide a general sense of how private investors may perceive asset class risk on their risk spectrum. Doing this gives us an idea of the potential of an MFI investment opportunity relative to the risk spectrum understood by conventional investors.

²⁰ The MFI asset classification is generalized and based on input from several social investment fund managers bound by regulatory and fiduciary compliance in the US and Europe.

²¹ The issue of benchmarking and equity is covered in more detail in Section Five.

²² The size of a small capital company (measured by the amount of equity) varies by country. In a developing country, a small capital company may have less than \$10 million equity capital, whereas in the US it is often defined as a company having less than \$500 million in equity.

²³ MFIs may have considerable foreign currency exposure, which adds to the risk factors that investors would need to consider.

²⁴ Liquidity is defined as the ability to convert assets (in this case, MFI shares) into cash or cash equivalents.

Most generally, investors buy more lower-risk, higher-liquidity investments than higher-risk, lower-liquidity investments. As a result, the proportion of high-grade tradable securities in most large institutional portfolios is quite large, as it is in most individual portfolios. Fortunately, for microfinance, asset allocations strategies are not about *reducing*, but *managing* risk. Each asset class has its appeal and a microfinance investment might find a place within any portfolio, large or small. Of course, asset allocations are different for each type of investor and they are also strongly affected by different economic conditions and regulatory and tax environments. Thus, the chance of microfinance being considered for investment differs by investor type.

It is important to note that, outside of regulatory and macroeconomic studies of investment patterns, very little has been written about the investment decision-making patterns of developing country investors. Fortunately, and as noted, basic asset allocation principles are not that different among countries. Thus, the chance that any of the common investor types listed below will consider or make a MFI investment is about the same in a developing country as in a developed nation. This said, developing country investors are likely to consider MFI investments as less risky than international investors, increasing their attractiveness.²⁵

What follows is a typology of commercial investors that outlines typical asset allocation strategies and barriers to investing in MFIs.²⁶

Defined liability and institutional funds include pension funds, insurance funds, trusts and other funds managed by or on behalf of a private institution. Within OECD countries there are over \$8 trillion in pension fund assets alone. Insurance funds in the US control over \$3 trillion.²⁷ These funds invest in a wide variety of instruments, though regulation and fiduciary practice portfolios tend to limit the bulk of investment to high-grade, tradable securities.

Some very large funds buy higher risk assets, such as venture funds, private equity funds or emerging market investments. These purchases are used to offset risk posed by other assets in a portfolio and are typically part of well-defined risk diversification and decorrelation strategies.²⁸

²⁵ As will be seen, however, the research clearly did not find enough information on the investment patterns and habits of developing country investors. More investigation is required to build an effective case and strategy for encouraging more domestic investment in MFIs.

²⁶ Regulation and taxation issues strongly shape investment decisions. These issues are touched on in this document, though not in detail. For a fuller treatment of regulatory considerations see *MicroNote: Financing MFIs: A Regulatory Context*.

²⁷ For full statistics: see Organization for Economic Co-operation and Development web site at: <http://www.oecd.org/dataoecd/20/41/2768608.pdf>

²⁸ Correlation is the simultaneous change in value of two numerically valued random variables: for example, the positive correlation between cigarette smoking and the incidence of lung cancer. In terms of investing and the interests of this paper, decorrelation refers to two conditions. First, many investors believe that developing country and emerging markets are decorrelated. Second, many also believe that MFI performance does not suffer, or at least not as much, by the economic environments that cause the fortunes of other financial institutions to fall. Investing in emerging markets therefore offsets risk found in developed country investments.

Normally only managers of very large portfolios include high-risk investments in any significant volume. CalPHERS, the largest US pension fund with assets of \$146 billion, for example, invests around \$1.4 billion, or 1 percent of its portfolio in emerging markets.²⁹ Of these, most are concentrated in South Korea, Taiwan, and other fairly well developed emerging markets. The combined total emerging market investment of 15 other large US pension funds, by contrast, was found to be less than \$100 million. This is because fiduciary practice encourages defined liability funds to invest primarily in the market or currency of beneficiary liabilities. Transaction costs also limit higher-risk, specialty investments, such as investments in MFIs or MFI funds.³⁰ Larger funds also need to invest several millions of dollars in any single investment to merit the costs of analysis and fiduciary compliance. MFI investments are rarely this large.

In developing country markets, defined liability funds are growing at a fast rate. They are subject to strict asset allocations regulations that often stipulate the exact quality and quantity of assets a fund may buy. Some countries restrict funds to purchasing government securities.³¹ In many Latin America countries, regulations are more liberal and most funds are able to buy a modest amount of high quality domestic tradable securities, and an even smaller amount of international securities.³² This allowed Peruvian pension funds to buy MiBanco bonds, which, with the help of guarantees from the International Finance Corporation (IFC) and the Corporación Andina de Fomento (CAF), was considered an acceptable, high-quality security. As in developed countries, however, defined liability funds will have a difficult time investing in MFIs without some form of guarantee, until such time that they become a more defined asset class with an established historical performance profile.

Publicly available funds are those funds that have passed rigorous regulatory hurdles allowing sales to the general public. Mutual funds are the most common type of publicly available funds. They currently control over \$14.5 trillion in assets worldwide of which approximately \$6.5 trillion are held in the US alone. Funds mostly intermediate individual capital, but some is institutional capital. These funds invest in a wide variety of instruments, though most are publicly traded securities. Asset allocation strategies are usually linked to a single asset class (for example, blue chip equities, bonds, small caps, etc.) geared to the market it hopes to attract. The bulk of mutual funds invest in conservative bond or blue-chip equities. A much smaller number of funds invest in higher-risk, small capital or specialty investments.

²⁹ Figures for 2003. See the CalPHERS Annual Report at: https://www.calpers.ca.gov/mss-publication/pdf/xtCTINcuOVt0n_2003%20CAFR%20with%20art.pdf

³⁰ Transaction costs include all expenses related to finding, assessing, managing and divesting or closing out an investment or loan.

³¹ See Hanson, James A. (2003). Banking in Developing Countries in the 1990s, World Bank Policy Research Working Paper 3168, Washington, DC: World Bank.

³² See Yermo, J., "Insurance and Private Pension Compendium for Emerging Economies, Book 2, Part 2:2a, Pension Funds in Latin America: Recent Trends and Regulatory Challenges." Organization for Economic Co-operation and Development, available at: http://www.oecd.org/document/28/0,2340,en_2649_201185_2742748_1_1_1_1,00.html.

Mutual funds are bound by numerous rules regulating public offerings. In the US, for example, they must value at least 85 percent of their portfolio holdings daily. In theory, they can invest 15 percent in non-liquid investments, such as MFI opportunities. In practice, however, most funds want to value 100 percent of their holdings daily. There are exceptions. A new Luxembourg registered, Swiss-based mutual fund dedicated to microfinance, responsibility, has negotiated a special agreement with regulators to value their holdings monthly or quarterly. The US-based Calvert Foundation offers a “community investment note,” which is publicly available as well. The notes are designed to pay a below-market rate of interest. Structured as promissory debt, these notes meet all federal and state registration requirements for public distribution.

The costs of launching and maintaining a publicly available MFI mutual fund is a second challenge, particularly for funds investing in businesses with limited market appeal. This is because a fund needs to amass \$50 million to \$75 million in assets within three years to be an attractive business proposition. Most fund managers do not believe they could attract this level of funding to a microfinance fund due to the risk level and difficulty of explaining what amounts to a fairly complex investment.

As with managed money, public funds are also sensitive to transaction costs. In the mutual fund market, competition is so intense that most funds do not charge a fee for purchasing them, and there are tremendous pressures for the lowest possible management fees as well. Complex MFI investments and transactions are, as a result, not affordable without great scale. Not surprisingly, responsibility will initially target larger investments in other private funds investing in MFIs and potentially very successful, large MFIs.

Public funds have a much shorter history in most developing country markets and tend to be available only where fairly large, upper-middle-class investor markets and relatively developed capital markets exist (for example, in Mexico, South Africa and Malaysia). Funds are typically conservative in nature, favoring a mix of high-quality domestic and international tradable securities. Funds are subject to similar regulatory regimes and follow similar asset allocations as those found in developed markets. There are a small but growing number of social investment mutual funds in developing country markets. These funds, such as the ABN AMRO’s Fondo Ethical in Brazil, do not typically consider microfinance investments (even though, for example, ABN AMRO supports MFI activities).³³

Private funds are those that are not cleared by regulators to be sold to the general public. Rather, they are sold privately to institutional (pension, university and trust funds) and high net worth investors. Funds invest in a broad range of investments, often in medium- to high-risk instruments, such as private equity funds for strip malls and high-technology

³³ See Bayón, R., J. Chen, and Marc de Sousa-Shields, “Towards Sustainable and Responsible Investment in Emerging Markets.”

venture capital, or in specialized investment instruments (such as hedge funds). Private funds usually correspond to a single asset class and are bought by investors as part of their overall asset allocation strategy. Private funds are not heavily regulated and need only comply with their own prospectus and general business law.³⁴ Often private funds have minimum investments of several million dollars as a way to maintain low operating costs.

Except for those formed to invest in microfinance, few private funds would consider investing in microfinance. Nonetheless, some small business emerging market venture funds and equity capital funds, including Avishkaar in India, have made MFI investments. While a potentially interesting source of capital, local funds have not yet made significant investments in the microfinance sector.

There are also a handful of private funds *dedicated* to MFI investments that operate in a manner consistent with private sector funds. They are discussed in Part Three, which focuses on non-commercial funds, since it is not yet clear how commercial their operations really are.³⁵

Individual investors can be divided into two types: i) those with *modest portfolios*; and ii) *high net worth individuals* (HNWI).³⁶ Individual investors place money in private and public funds, as well as invest directly in stocks and bonds through brokers. Asset allocation rules for both types of individual investors depend mostly on a person's age and portfolio size. Risk tolerance is generally negatively correlated with age and portfolio size. Thus, modest portfolios, or those under \$500,000, are reasonably conservative, consisting mostly of mutual funds, blue chip securities, high-yield bonds, and cash/cash equivalents. Due to the small size of most of their investments, modest portfolios owners are more risk averse and highly sensitive to transaction costs.

Asset allocations for HNWI are more sophisticated, and portfolio size allows for greater risk diversification into non-tradable investments, such as MFIs. Investments of this sort vary widely and often reflect an investor's personal interests. They can include such things as luxury real estate, yachts, art collections, racehorses, or, in the case of social investors, organic farms, alternative energy holdings, and investments in MFIs. HNWI

³⁴ A prospectus is a document disclosing specific financial information required by the ruling investment industry regulators (for example, the United States Securities and Exchange Commission). Companies issuing stocks or bonds, or selling mutual funds or other investment products to the public are required to provide a prospectus to investors prior to purchase. Regulations vary by instrument or investment (for example, what is found in a mutual fund prospectus is different from one for a bond issue or a new stock issue). What appears in a prospectus also varies by jurisdiction, though generally the same regulatory principles apply. For more information on this topic, see <http://www.investorwords.com/cgi-bin/searchTerms.cgi?term=prospectus>.

³⁵ Data on private funds are difficult to come by since they are privately held and under no obligation to divulge business information, except to shareholders. Some organizations, such as Blue Orchard, however, do provide regular information to the public.

³⁶ Accredited or sophisticated investors, including high net worth individuals, institutional investors and certain other entities, are wealthy investors who can meet certain requirements for net worth. In the US, HNWI are those with over \$1 million in assets or over \$200,000 in income for more than two consecutive years. Definitions and regulations vary by jurisdiction, but high net worth individuals are generally sufficiently knowledgeable about investments or, if not, can afford to pay for such knowledge. Given their relative sophistication, institutional investors are free to suggest a much wider range of investment products and services than non-accredited investors. This means any alternative investment, such as in MFIs or MFI funds, are acceptable investment options.

tend to be less sensitive to transaction costs, particularly when it comes to non-tradable hobby investments. However, given that HNWI represent a small portion of the investor universe, and the large and diverse choice of investments competing for their funds, it is not surprising that we don't see a large number of individual investors in the microfinance sector.

In developing countries, HNWI place much of their investment portfolios in offshore, hard currency investments, though their asset allocation decisions are similar to those noted above. But both modest portfolio holders and HNWI also invest significantly in their own countries and often in small- and medium-sized businesses. Typically, these businesses are owned within a family or among a small number of associates. There is, unfortunately, little information on the decision-making processes that result in these types of investments. As these are the investors with the greatest potential for investing in MFIs, research on how domestic investors decide which ventures merit equity investments could be of great benefit to microfinance.

Financial institution lenders, such as banks and non-bank financial institutions, provide debt financing to businesses. Their main asset allocation considerations include loan portfolio management (such as diversification, pricing, terms, etc.), transaction costs, collateral and reserve requirements, and a host of other business and banking regulations. Banks regularly lend to businesses with risk-return profiles similar to those of MFIs, but normally do so only on the basis of long-established relationships and/or with full collateral coverage. Reserve requirement expenses, which increase as collateral coverage decreases, play a large role in determining the attractiveness of a bank loan. As most MFIs cannot offer significant collateral and do not have long-standing relationships with banks, commercial bank loans are difficult to source. Even if they can offer collateral, lending can be complicated by a MFI's typical lack of cash flow projection capacity. Most lenders are uninformed about the microfinance sector as compared to the in-depth knowledge and data they may have on other sectors, such as canning or printing.³⁷ Information barriers between commercial financial lenders and MFIs are, in other words, significant. A lack of supervision and rating of MFIs by "market approved" rating agencies, such as Fitch or Standard and Poor's, further compounds the market's lack of confidence in MFIs.

Depositors make distinctly different allocation decisions than other investors. For depositors, there are five main elements in the decision of where to invest their savings: stability of the financial institution, yield, access, liquidity and the range of products offered by an institution.³⁸ The relative importance of each depends on several factors, but two are most important: type of account and size of deposit.

³⁷ For a good overview see Schneider, Louise, Strategies for Financial Integration: Access to Commercial Debt, Women's World Banking, Financial Products and Services Occasional Paper, Women's World Banking, New York, New York, July 2004, p. 6.

³⁸ Yield on a savings account is defined as net return after accounting for inflation and banking fees.

Generally speaking, there are three types of savings accounts: passbook and demand, plus time deposits. Passbook and demand account holders typically favor liquidity over all other variables. Convenience, measured in the time and money needed to access an account, is also important. These considerations are exponentially important for low-income savers who comprise the bulk of MFI savers. These factors are less important for higher-income passbook savers who want a range of complementary financial services that MFIs normally cannot provide (such as investment accounts and electronic banking). For time depositors, yield is typically the most important factor, followed by institutional stability. Liquidity, by definition, is less of a concern than convenience and ancillary services. The most important characteristic of time deposit savers is that they are highly rate sensitive and will switch institutions based on marginal interest rate differences.

Social investors are different from other investors in that they seek both financial and social returns. Social investors are not a separate class of investors. In fact, almost all (99.7 percent) of the \$2.8 trillion social investor funding worldwide is bound by the same fiduciary and securities laws that govern conventional investments.

As a result, most funds specializing in socially responsible investing (SRI) are found in tradable securities, directed by asset allocation strategies remarkably similar to conventional investors. Comparing the holdings of major SRI and non-SRI mutual fund companies, for example, could find the two sharing 80 percent of the same stocks.³⁹ This is because the great bulk of funds are held in screened portfolios that are managed to avoid only the worst companies doing what social investors consider offensive, such as selling tobacco or producing nuclear power. Shareholder activists hold the next largest share of funds. These investors buy shares in companies they do not like with the explicit purpose of changing business practices found to be offensive. This is done through meetings with managers, via proxy resolutions at annual general meetings companies, or through publicity campaigns.

These social investment strategies overarch asset allocation strategies and investment selection strategies that are same as those used by conventional investors. Together they limit involvement in MFI-like investments to a fairly tightly defined set of conditions: 1) when investor demand is great; 2) when it is legally possible; 3) when return potential is attractive and achievable; and 4) when asset allocation strategies permit.

While these conditions are fairly restrictive, social investors have something their conventional counterparts do not: a natural predisposition to consider MFI-like investments. In fact, a survey in 2002 of social investment professionals estimated a strong interest in microfinance or equivalent investments in developing countries. While

³⁹ For a full treatment on social investment, see “Sustainable and Responsible Investment in Emerging Markets” by Enterprising Solutions, published by the International Finance Corporation in 2003.

this appetite has yet to be tapped, similar impulses have led social investors to invest \$14 billion in MFI-like investments in developed countries. As much as an estimated \$120 million of social investment capital has been placed in MFIs.⁴⁰ In these cases, however, investments have received some form of tax incentive or have required investors to accept a lower than market rate of return. It is critical to note that despite interest, asset allocation strategies of social investors in both developed and developing countries have permitted very few MFIs investments. Among developed country social investors, part of the reason is that their asset allocation strategies permit very few investments in developing countries. In fact, only about 0.1 percent of total SRI assets, or \$1.5 billion, has found its way to emerging markets. This limitation alone poses significant challenges to MFI funding by SRI.

Social investors face many barriers to tapping demand for investment in MFIs. First, as noted, while demand appears to be significant, few social investment firms have the resources to develop a specialty instrument for microfinance. Second, even though there is demand, it is not clear to many social investors that they could recommend an emerging market small business investment to all but high net worth individuals. Third, few, if any of the specialty funds available to social investors offer near commercial terms, which are required by the great majority of social investors.

Summary – The Able and Willing

Asset allocation strategies and regulation combine to dramatically limit the universe of possible private sector investments in MFIs, *even before the quality of the asset is discussed*. The few investment dollars legally able to invest in MFI-like assets are further reduced by the absence of widely accepted benchmarks and/or ratings from credible rating agencies. Transaction costs and the difficulty of understanding an MFI investment also limit the availability of funding.

Any MFI investors must be highly risk tolerant, particularly patient, able to absorb high transaction costs and free of regulatory concerns. Internationally, that would be high net worth individuals who are also socially responsible investors with an interest in both emerging market and community investments. Socially responsible institutional investors may also have an interest, but as with conventional investors, they fear unknown risks, high transaction costs and concerns about remaining in compliance with their fiduciary responsibilities.

⁴⁰ Enterprising Solutions Global Consulting, “Social Investment, Microfinance & SMEs, The Potential for Social Investment in MFIs and SMEs in Developing Countries”, Enterprising Solutions Brief No. 3, www.esglobal.com. Note that community development finance institutions (CDFIs) are financial institutions dedicated to the development of local economies. They come in a variety of forms and can include credit unions, non-profit loan funds, business development institutions with financing activities, or organizations offering low-income housing investment instruments. For more information, see the National Association of Community Development Financial Institutions’ website at www.nhi.org/online/issues/79/coallaw.html.

The truth is, without a simple, convenient investment offerings, few developed country investors will have the courage to invest in MFIs. Some sort of guarantee will, however, attract institutional investors, social or otherwise, but only if transaction costs are tolerable compared to other competing investments. Otherwise, MFI investments are likely to come from social investor charitable fund allocations, from funds they can afford to lose entirely, from funding that only needs to generate low rates of return, or when guarantees or subsidies are in place to offset risk or ensure a certain level of returns.

In developing country markets, there is good immediate and long-term promise to stimulate local investments. Local investors do not face the added risks inherent in international investment and have a clearer idea of local economic risks. MFIs may also offer a relatively more attractive risk-reward profile than other competing local investment opportunities. Certainly, local high net worth investors should be interested once informed of appropriate opportunities. Some institutional investors could be attracted if guarantee programs are in place for low transaction cost and widely available instruments, such as bond issues. A number of commercial banks have lent to MFIs and could do so increasingly through incentives, such as the use of guarantee funds like those available through the USAID's Development Credit Authority (DCA), tax or regulatory changes. Key to access will be addressing information gaps about microfinance.⁴¹ Even when investors are fully informed of the risk and return potential of MFI investing, securities and banking regulations discourage domestic investors' interest.

⁴¹ It is worth noting that while still nascent, social investment exists and is growing in many developing countries. In South Africa, for example, there is over \$1.2 billion in domestic SRI assets, much of which is held in community development investments, including financial service companies. SRI movements are also growing rapidly in Asia and, to a lesser extent, in Latin America and Africa.

Non-Commercial Capital and Microfinance

3.1 Non-Commercial Capital and Microfinance

As with commercial investors, non-commercial investors are governed by fairly predictable – though quite different – investment rules. Understanding their habits and decision-making is important not only because they are significant MFI funders, but also because their funding decisions interact with and influence the appeal of microfinance for private sector investors. Decision-making points vary by investor type, but generally include:

- Meeting investor’s development objective (such as poverty alleviation);
- Return – whether funds will garner sufficient “development return” on investment;
- Reputation risk – whether investment will improve an investor’s reputation;
- Compliance with institutional or fund investment policies;
- Compliance with applicable regulations (such as charitable laws and government regulation); and
- Investment transaction costs.

Private & Public Funds Dedicated to Microfinance

There are approximately 45 private social investment funds dedicated to MFIs.⁴² These funds control an estimated \$400 million to \$550 million held mostly in debt, though some is found in the form of equity and guarantees. Of this total are five new funds set to start up in 2005 with \$125 million. This will bring the near-term undisbursed supply of foreign funding to just over \$310 million and will help place an estimated \$80 million to \$100 million annual investments. Almost 80 percent of the funds operate internationally from developed country markets.

Many funds are affiliated to various degrees with established development organizations, mostly NGOs. Of these, several are affiliated with a sponsor organization (e.g., ShoreCap is affiliated with ShoreBank and ACCION Investment Management with ACCION



⁴² This number is drawn from a recent CGAP study of foreign investment in microfinance (see Ivantury, Gautam and Julie Abrams, The Market for Microfinance Foreign Investment: Opportunities and Challenges, for the 2004 KfW Financial Sector Development Symposium, Berlin, 11th and 12th, November 2004), and defines private funds as those not controlled by public institutions (despite the fact that over 80% of funding for private funds comes from public sources). Moreover, it is difficult to estimate the number of funds because the line between an investment fund and an organization giving grants or the occasional loan can be blurry. See the MIX Market for a fairly complete listing of the funds.

International). Many funds are owned and managed as part of an MFI network support organization. They operate with varying degrees of independence and formality – from totally independent subsidiaries to a department within an organization.⁴³ A small number of funds are independently incorporated businesses (such as Blue Orchard and responsAbility).

Some funds offer capital at near market rates, but the majority are below market. In most cases, interest rates or expected returns in the case of equity, are not only below market rates but they often do not, in the case of hard currency lending, account for potential currency devaluation or foreign exchange risk. Not surprising, while there is a small trend toward attracting private capital, most funds are not, and do not seek to be profitable.⁴⁴ Many are in fact heavily subsidized either by donors or investors willing to take below market rates of return. As a result, very few funds can cover full operating and financing costs through investment income.⁴⁵ Approximately 90 percent of MFI investment funds comes from international financial institutions, bilateral donors, and individual and institutional donors.

Table Three
MFI dedicated Funding by Segment
(millions \$USD for international funds only)

	Private Funds		Public Funds		All Investors	Total Volume	Number of Institutions
	Debt	Equity	Debt	Equity	Guarantees		
Regulated MFIs	101.3	134.1	424.1	80.6	53.5	795.6	114
Unregulated MFIs & Cooperatives	33.9	0.5	5.5	0.6	7.7	48.2	110
Unclassified MFIs	141.7	23.4	52.53.50	15.4	22.2	254.7	293
Total	276.9	158	481.6	96.6	83.4	1096.5	517

Source: Ivanury, Gautam and Julie Abrams, The Market for Microfinance Foreign Investment: Opportunities and Challenges, for the 2004 KfW Financial Sector Development Symposium, Berlin, 11th and 12th, November 2004

⁴³ For detailed descriptions of funds see Goodman, Patrick, “International Investment Funds: Mobilizing Investors Towards Microfinance”, Appui au Developpement Autonome, Luxembourg, November 2003, available at: http://www.microfinance.lu/comas/media/fondsinv_endef11.pdf and Enterprising Solutions Global Consulting, “Intermediating Capital to MFIs: A Survey of Financial Intermediation to Microfinance Institutions”, Enterprising Solutions Brief No. 2, www.esglobal.com.

⁴⁴ Many funds are quasi commercial in the sense that shareholders or fund investors accept lower than market rates of return on their investments, even though funds charge at or near market rates to portfolio companies and otherwise operate as commercial investors. Such funds certainly could not operate as commercial entities if they were paying full risk adjusted rates of return to investors.

⁴⁵ Due to a lack of public disclosure among the funds, assessing their financial performance is difficult and fraught with a great deal of uncertainty. The basis for these assumptions can be found in Goodman, Patrick, “International Investment Funds: Mobilizing Investors Towards Microfinance”, Appui au Developpement Autonome, Luxembourg, November 2003, http://www.microfinance.lu/comas/media/fondsinv_endef11.pdf and Enterprising Solutions Global Consulting, “Intermediating Capital to MFIs: A Survey of Financial Intermediation to Microfinance Institutions”, Enterprising Solutions Brief No. 2, www.esglobal.com and interviews with fund managers.

Table Four
Foreign Investment in MFIs by Segment
 (% of total investments by international funds only)

	Private Funds		Public Funds		All Investors	Total Volume	Number of Institutions
	Debt	Equity	Debt	Equity	Guarantees		
Regulated	37%	85%	88%	83%	64%	72%	22%
Unregulated MFIs & Cooperatives	12%	0%	1%	1%	9%	40%	21%
Unclassified MFIs	51%	15%	11%	16%	27%	23%	57%
Total	100%	100%	100%	100%	100%	100%	100%

Source: Ivantury, Gautam and Julie Abrams, The Market for Microfinance Foreign Investment: Opportunities and Challenges, for the 2004 KfW Financial Sector Development Symposium, Berlin, 11th and 12th, November 2004

The predominant MFI investment funds (i.e. those controlling the majority of fund capital) typically require MFIs to be profitable (or close to it) as a prerequisite for investment. This requirement has led to the majority of funds to be invested in larger, regulated, urban-based MFIs. In fact, the concentration of funds is considerable. (See Tables Three and Four) Over 70 percent of all funding is invested in 114 regulated MFIs. Just less than 85 percent of private equity and 83 percent of public equity is found in the same, large MFIs. Approximately 37 percent of all private fund debt finance is invested in larger MFIs, but a startling 88 percent of public debt and 64 percent of guarantee funding is found in the same institutions. ProCredit banks, which represent 3 percent of funding recipients, receive 34 percent of all funding by volume, and 60 percent of all private and public equity combined. Smaller and unregulated institutions as a result receive a much smaller share of funding on a per institution basis. A good deal of funding for smaller, non-regulated MFIs comes from Oiko Credit and Rabo Bank Foundation, which fund 160 and 90 MFIs respectively with average loans sizes of \$422,000 and \$100,000 respectively.⁴⁶

⁴⁶ Heinen, Erik, The MFI as borrower: institutional characteristics and repayment performance The experience of Oikocredit in lending to 93 micro finance institutions (1993-2002) forthcoming for the MicroBanking Bulletin, March 2005; and Ivantury, Gautam and Julie Abrams, The Market for Microfinance Foreign Investment: Opportunities and Challenges, for the 2004 KfW Financial Sector Development Symposium, Berlin, 11th and 12th, November 2004

Table Five Average Public & Private Debt Investment in MFIs (\$USD)			
	Private	Public	Public & Private
Regulated MFIs	888,596	3,720,175	6,961,404
Unregulated MFIs, Cooperatives & Unclassified MFIs	435,732	142,680	751,613
Overall Average Debt Investment	535,590	931,528	1,467,118
* includes \$ 83 million in guarantees Source: derived from data found in: Ivantury, Gautam and Julie Abrams, The Market for Microfinance Foreign Investment: Opportunities and Challenges, for the 2004 KfW Financial Sector Development Symposium, Berlin, 11 th and 12 th , November 2004			

Table Six Geographic Distribution of MFI Fund Funding (% of Total Investments)							
	Private Funds		Public Funds		All Funds	Total	Percentage of Institutions
	Debt	Equity	Debt	Equity	Guarantee		
Eastern Europe & Central Asia	13%	47%	67%	71%	2%	46%	17%
Latin America & Caribbean	59%	43%	31%	14%	76%	42%	38%
Sub-Saharan Africa	11%	9%	0%	6%	11%	6%	22%
East Asia & Pacific	9%	1%	1%	4%	1%	3%	12%
South Asia	8%	1%	0%	5%	1%	3%	9%
Middle East & North Africa	1%	0%	0%	0%	8%	1%	2%
Total	100%	100%	99%	100%	100%	100%	100%

Many other funds that control a relatively small amount of capital likewise invest in smaller institutions. SIDI, for example, makes loans as small as \$5,000. The minimum loan size range is thus broad, extending from \$5,000 to \$2.5 million. The common range, however, is approximately \$50,000 to \$500,000, with averages of \$300,000 for non-regulated and \$900,000 for regulated institutions.

Table Five shows in more detail the concentration of debt funding. Regulated MFIs receive on average *twice* the debt from private sources and *26 times* more funding on average from public sources than non-regulated and cooperative MFIs. Smaller and non-regulated institutions receive loans 81% the size of the average private investment and 15.3% the size of average public fund investment.

The geographic distribution of funding is equally concentrated. Table Six shows that Latin American and Eastern European MFIs received over 88 percent of all investment

funding. Latin America alone receives 60% of all private and 31% of all public debt. This distribution is due to the large number of mature, regulated MFIs in Latin America, and the successful efforts of ProCredit banks in Eastern Europe. Three Eastern European ProCredit banks alone, for example, have received 4 percent of all private funding and 13 percent of all public funding. Banco Solidario (Ecuador) and Confianza (Peru) received one third of all funding.

Multilateral Development Institutions and Bilateral Agencies Grant “Investment” Funding

Though growing in importance, MFI fund capital has been dwarfed by grant funding provided by development institutions (such as multilateral financial institutions, bilateral aid agencies and national development banks), which, over the past five to ten years, have invested between \$5 billion and \$10 billion in microfinance. Investments come in various forms – from technical assistance, to no- or low-cost loans, to direct equity contributions. Most, if not all, the grant and investment capital from development institutions comes from taxpayer revenue or bonds issued on the strength of sovereign guarantees. As with non-commercial social investment funds, the cost to MFIs of capital from development institutions varies from free grants to loans at near commercial terms. Allocation patterns are a function of an MFI’s overall policy direction (as opposed to the needs of the microfinance sector or the interests of the private sector) and the need to balance social and financial returns. Most MFIs attempt to operate in as commercial a manner possible, though strategy, policy, and incentives structures can inhibit such a goal.

Foundations

Other important non-commercial investors include foundations, such as the Ford Foundation and Rockdale Foundation, and charitable non-profit organizations, such as ACCION International, Women’s World Banking, Cordaid, Novib and UNITUS. While the volume of investments from non-profit organizations is much less than that from other non-commercial investors, these non-profits have mobilized a considerable amount of private charitable funds for MFIs worldwide. In addition, they provide significant technical assistance. Their funding is distributed mostly on a grant basis, though many – as noted – have lending and equity investment programs. Some, such as the Ford Foundation and the MacArthur Foundation, have program-related investment loans which offer low- or no-cost loans for highly innovative opportunities. The Ford Foundation, for example, was an investor in ProFund, a specialized equity investment fund for Latin American MFIs. The Rockdale Foundation is supporting pioneering activities for Middle Eastern MFIs.

Apex Institutions

Another significant source of non-commercial funding comes from apex institutions.⁴⁷ Apexes take a variety of forms, though most are funded and controlled by governments. Some are run directly by government departments, others channel funds through national development banks, foundations, trust funds, or non-profits organizations. There is no global estimate of apex fund assets, though they have been a significant player in the financing of microfinance. Often driven by government priorities, capital allocation criteria vary greatly, though political influences are usually present.⁴⁸ Eligibility criteria, for example, do not always demand best practice management or commercial viability. It is also common that investment allocations are based on political jurisdictions. Rates are often heavily subsidized and the terms are generous.

Some apex institutions, such as the Palle Karma Sahayak Foundation of Bangladesh (PKSF), which has lent money at below market interest rates, have been praised for their support of the microfinance sector. Some argue that these “soft loan funds have partially replaced grants to MFIs,” indicating a positive move toward microfinance commercialization.⁴⁹ The evidence of this trend is limited, however, and, for the most part, apexes seldom contribute to best practice microfinance. As Fred Levy observes, “there are few examples... where MFIs have gained access to the financial markets as a result of the direct efforts of a national apex institution,” and, in many cases, the incentive to seek commercial funds is weakened by the availability of easier funding from the apex.⁵⁰

Non-commercial Capital Allocation Patterns

While non-commercial capital can attempt to emulate private sector capital, it has been mostly unsuccessful. This is not to say that non-commercial funders do not make good investment decisions. Many do. But because return is seldom *the* primary concern, non-commercial capital allocations are considerably different from those of commercial capital. There are eight notable implications of non-commercial capital allocation patterns.

1. Non-commercial capital can go where private financing finds it difficult or expensive to go. Non-commercial capital has, in fact, largely funded the development of microfinance. It still supplies the sector with a significant amount of risk capital and will remain a vital source, particularly if it is employed with the explicit goal of assisting in the transition to private capital. This will require a shift from the traditional focus on supporting better asset management to a broader emphasis, including more support for liability and capital management.

⁴⁷ Apex microfinance institutions are defined as institutional mechanisms operating within a single country or integrated market to channel financial resources, with or without technical assistance and other support services, to a significant number of retail microfinance institutions.

⁴⁸ Levy, Fred, “APEX Institutions in Microfinance”, CGAP Occasional Paper No. 6, January 2002, www.cgap.org.

⁴⁹ P. 31, *Commercialization of Microfinance: Bangladesh*, Stephanie Charitonenko, Asian Development Bank, 2002.

⁵⁰ Levy, Fred, “APEX Institutions in Microfinance”, CGAP Occasional Paper No. 6, January 2002, www.cgap.org, page XX

2. Non-commercial capital continues to support small MFIs, some of which are experimenting with reaching poorer clients or with new product development. A good number of non-profit organizations also establish MFIs with the intention of supporting or complementing other activities, such as business or community development, health or educational services. Few of these, however, have a plan for achieving sustainability. Others seek to serve a particular market, such as a religious community or refugee population, markets that are often too small to provide MFIs the scale to become commercially viable. Similarly, apex institutions often distribute funds based on political expediency as opposed to sound investment practice, with little regard for performance. Even less favorable, non-commercial capital also continues to support many small MFIs with little future for growth or self-sufficiency. Supporting smaller and unconventional institutions should be done with an eye to helping establish the next set of high growth MFIs.

3. Funds are highly concentrated in large and regulated institutions

Investment allocation decisions by private investors is somewhat concentrated for both debt and equity. Public investment is highly concentrated in large, regulated Latin American and Eastern European MFIs. Areas with reasonably mature microfinance markets in Sub-Saharan Africa and Asia have received very little funding.

4. Many large, profitable MFIs receive non-commercial capital, even when they could access private sector capital. There are many reasons for this, wanting to invest in a success story primary among them. Non-commercial capital stakeholders are often pressured to demonstrate strong social impact. Commonly measured in terms of numbers of clients, this goal is achieved faster by investing in larger MFIs than smaller ones. Many non-commercial investors, such as development institutions, also need to invest fairly large amounts of money that small MFIs simply cannot absorb. Similarly, some private social investment funds rule out investments in smaller MFIs simply because fixed transaction costs are too high given the modest sums that could be invested. This makes investing in the private MFI specialty funds attractive to many multilateral and bilateral investors, as they are able to disburse more money to smaller investments.

Non-commercial capital preferences for large MFIs and MFI specialty funds may be diluting the risk tolerance of their bilateral and multilateral investors. That is, non-commercial funds control and allocate what is theoretically the highest-risk capital available to MFIs. Their allocation pattern, as noted earlier, favors larger, mature MFIs. This increases the scarcity of risk capital to the 200 to 300 smaller MFIs that could potentially grow rapidly to “in-fill” markets and incite competition (that is the next generation of successful MFIs). Such allocation patterns are also thought to be discouraging MFIs from seeking commercial sources of funding, particularly deposits.

5. Non-commercial capital allocations have favored investing in non-profits more than for-profit institutions. This reinforces the social objectives of microfinance, possibly forestalling mergers, acquisitions and even failures required for healthy sectoral growth and competition. As a result, investing in MFIs where owners risk future and current income is not common, but it would likely provide greater growth and development opportunities.

6. Non-commercial fund pricing may be distorting local capital markets. Very few non-commercial investors lend under purely commercial terms, and most significantly underprice the market. In Part Four, the activities of non-commercial private funds, dedicated to MFIs in particular, are considered. The assessment includes a comparison of the price of US denominated government bonds from a selection of developing countries to the prices charged by a sample of some of the more commercially oriented funds. (See Table Nine, page 44). It finds that these funds are far from charging commercial rates. In addition to undercutting local lenders, the funds may also be encouraging MFI inefficiencies and/or discouraging local capital searches, particularly deposit mobilization. The existence of highly subsidized bilateral and multilateral funding complicates the market for lending to MFIs as many of the investment funds, subsidized or not, can not compete with the availability of very cheap capital.

7. Most non-commercial funders cannot invest in equity, a scarce form of MFI financing. Bilateral institutions, for example, are not legally able to buy the shares of private companies. Some invest indirectly via non-profit intermediaries. This drives up the cost of capital and can dilute the sense of ownership and control. As argued in Part Three, the lack of direct and vested ownership is a critical limitation of most non-commercial capital.

8. Non-commercial funders simply do not have enough capital to satisfy demand nor are there significant market incentives for changing allocation patterns. Limited operating budgets and staff with varied levels of “investment literacy” restrict non-commercial investment. Development institutions have few staff that understand MFI investments well enough to select the best investments, resulting in an inefficient allocation of the limited capital they have to offer. Also, some claim that the market for placing debt in regulated, large MFIs is peaking. The argument is that larger MFIs will replace expensive debt with lower cost savings. While this may be true on an institution by institution basis, conservative projections -- assuming efforts to replace debt with savings continue at their current pace -- show the annual demand for debt among regulated and large MFIs will grow to \$2 billion annually in 2009, up from about \$450 million today. Assuming current growth patterns, public and private debt funds together would serve less than 10% of the projected demand. (See Appendix Four) This means that rather than becoming smaller, the demand for debt among larger MFIs will actually

increase and should remain a seductively inexpensive market for international funds to serve. The unregulated MFI debt market will also increase from \$220 million to around \$1.5 billion in 2009, but again, this market will demand smaller investments, unattractively increasing transaction costs to funds.

Summary

As a result of their pioneering role and current involvement in the microfinance sector, non-commercial investors have had a significant impact and influence on MFI financing patterns. As with private investors, they have relatively common asset allocation strategies that result in identifiable distribution preferences. Clearly, the relative abundance of funding for successful and high profile MFIs has serious implications for supporting the “next generation” of successful MFIs. This funding concentration may also be affecting market dynamics dampening competition and sector vitality, and hence interest from private sector investors. While it may be understandable why private funds, with a few investors with commercial return expectations would favor larger, regulated institutions, it is surprising that public sources do so, particularly given are the primary source of industry “risk capital.” Their investment in private funds has helped move down scale somewhat, but the impact is limited if one that considers Oiko and RaboBank, which do not use public institutional money, account for a significant share of investments in smaller MFIs.

A second important conclusion is that while commercial MFIs may be on the rise, the majority of them have grown from non-profit institutions that historically received the bulk of public and private funding support. Non-commercial funding allocation may thus be reinforcing the sector’s mission-driven ethos, which is at odds with many of the preconditions to attract private capital. While arguably unavoidable in the pre- “best practice era,” concentrating non-commercial capital in the most successful MFIs may not be the best way to maximize the positive impact of the limited source of risk capital to create a strong commercial microfinance sector.

Imprints and Impulses: The Influence of Non-Commercial Capital in Microfinance

4.1 Imprints and Impulses: The Influence of Non-Commercial Capital in Microfinance

In 2002, CGAP published an influential paper entitled *Water, Water Everywhere but not a Drop to Drink*.⁵¹ This paper defined in a succinct way the financing challenges facing MFIs in the mid to late 1990s. Its central thesis was that the capacity to absorb capital and not the lack of it was the main constraint to growth faced by the microfinance sector.

Over the last several years, however, capital does not seem to be as ubiquitous as it once was, and financing has taken on a new urgency. Over 90 percent of the 120 MFIs surveyed recently by the CGAP cited lack of capital as the single most important constraint to growth. Capacity remains a challenge, to be sure. The sector still has trouble attracting experienced managers and directors, it continues to struggle with new product development, and business systems are often inadequate. At the same time, however, advances in and access to best practice knowledge, improving regulatory regimes and stronger sector associations, among other things, have had a cumulative and positive effect on the sector's capacity.

So while it may be a stretch to claim (as some have) that there are no human resource limitations in microfinance, it is clear that *many* MFIs can profitably employ commercial capital to invest in the capacity required to grow.⁵² From a commercial investor's perspective, it is also clear that the sector's limited ability to attract private capital is at least partly *symptomatic* of its having been midwived by non-commercial capital, whose \$5 billion and \$10 billion investment over the last five to ten years has left an indelible imprint on the sector. This influence has fashioned an industry that is still largely driven by social mission but is increasingly adopting (in varying degrees) conventional business practices and perspectives. For this reason, the transition to private capital is as much about managing the residual non-profit influences and non-commercial capital interventions as anything else. As Robert Peck Christen and Elisabeth Rhyne explain, the industry is in transition from one that "has been driven fundamentally by development concerns" to one increasingly led by "by the twin concerns of the competitive marketplace: market share and profits."⁵³

⁵¹ CGAP Donor Brief, No. 3, "Water, Water Everywhere but Not a Drop to Drink," CGAP Donor Brief No. 3, May 2002, [available at: http://www.cgap.org/publications/donor_briefs.html](http://www.cgap.org/publications/donor_briefs.html)

⁵² It is important to point out that the focus here is not on the many thousands of tiny programs scattered around the world, but rather the 200 to 300 "second tier" MFIs. These are MFIs that typically have more than 1,000 clients, a good deal of operating experience, and a basis for strong potential growth.

⁵³ Rhyne, Elisabeth and Robert Peck Christen, (1999) *Microfinance Enters the Marketplace*, USAID, Washington, D.C., page iv.

No Longer Not-for-Profit in the Service of the Poor?

A residual non-profit mentality is a hallmark of the sector's origins. While diminishing at the management level of mature MFIs, this sentiment is still quite strong at the ownership level. Most telling is the continued preference for the term "sustainability" over "profitability." This may be a subtle distinction, but it reflects an inherent resistance to the commercialization of microfinance and to accepting one of the most basic concepts of commercial activity: maximizing profits.

In fact, the non-profit model seldom translates into superior MFI performance despite its preferential tax treatment and lack of regulation and supervision.⁵⁴ On almost all indicators, for-profit MFIs outperform non-profit MFIs regardless of age or region of operation. (See Table Seven) In a recent study, Nimal Fernando found that for-profit institutions tend to have stronger

Year	Commercial Funding Liabilities	Adjusted Return on Assets	Adjusted Return on Equity	Administrative Expenses/ Loan Portfolio	Portfolio at Risk (30 Days)
2003					
Not-for-Profit	33.8	-0.3	0.5	20.0	6.4
For-Profit	100.3	0.4	6.3	23.3	7.0
2001					
Not-for-Profit	44.3	-6.4	-23.3	37.3	2.8
For-Profit	120.6	-1.03	-2.3	27.1	2.7

Source: MicroBanking Bulletin, Issue 9, July 2003, and MicroBanking Bulletin, Issue 7, November 2001.

governance, greater stability, better access to capital, increased equity and greater scope and scale.⁵⁵

⁵⁴ The comparison should be tempered in light of the fact that many commercial MFIs have been supported by a good deal of grant and subsidized capital.

⁵⁵ Fernando, Nimal, "Micro Success Story? Transformation of Non-government Organizations into Regulated Financial Institutions, Asian Development Bank, June 2004.

Institutional transformation from a not-for-profit to a for-profit MFI has proven an excellent laboratory for highlighting the limitations of the non-profit business model.⁵⁶ A key observation from those who have studied transformations is that creating a commercial business culture within a previous not-for-profit business is a central challenge.⁵⁷ The need for and difficulties in addressing technical challenges, such as upgrading systems, improving staff skills, and complying with increased supervision cannot be understated; but the ability to develop and then harness professional management and governance capacity, however, has proven time and again the true test of transformation.

Accepting a for-profit vision is especially difficult at the ownership level. This is particularly true if new commercial capital is involved. Sharing control of strategic priorities can cause major business “culture shock,” particularly when profit-maximizing owners collide with socially-oriented owners.⁵⁸ This shock is felt most when commercial shareholders, and this would include the majority of social investors, actively and anxiously push for growth and profit maximization. Non-commercial shareholders, whose primary mission is developmental, do not have the same concerns for protecting their equity investment as commercial shareholders do. In addition, board representatives of non-commercial capital do not have as personal a stake in the MFI as private investors do, which potentially dilutes their level of commitment to effective oversight.

This is not to say that non-commercial capital funders and their managers do not have anything at stake when investing in MFIs. They risk their reputation, careers, status, and, in some cases, livelihoods. But these risks are different from those encountered by commercial investors that employ life savings or the capital of friends or family member.⁵⁹ Obviously, too, many MFIs have thrived under a not-for-profit model, as non-commercial capital has greatly contributed to the growth of the sector. But a lack of “true private ownership” results in a very different governance mentality and growth perspective.

Imprints of a mission-driven history complicate what should be a straightforward impulse for growth. As the sector matures, the limitations of a non-commercial approach are all the more apparent. As Peter Kooi wrote of ACLEDA, “grant equity caused problems

⁵⁶ We have not taken into account external considerations, such as market environment and regulatory regimes, that normally complicate transformation, particularly when there is more than one potential corporate status to choose from or a lack of an appropriate regulatory regime.

⁵⁷ See for example: Campion, Anita and Victoria White, “Institutional Metamorphosis: Transformation of Microfinance NGOs into Regulated Financial Institutions”, Microfinance Network Occasional Paper No.4, 1999; Fernando, Nimal, “Micro Success Story? Transformation of Nongovernment Organizations into Regulated Financial Institutions, Asian Development Bank, June 2004; Castello, Carlos and Danel, Carlos, *Transformation and Expansion of Microfinance Institutions*, in “Challenges to Microfinance Commercialization”, Microfinance Network and ACCION International, 2002, Kelly Hattel and Sahra S. Halpern, editors.

⁵⁸ Financial cooperatives, which are normally already regulated institutions, confront similar challenges when adopting a growth and profit maximizing mission.

⁵⁹ To be fair, non-commercial capital allocation strategies, as we have seen, are not designed to maximize profit nor are most of the supplying institutions structured in a way that can support this aim.

around the uncertainty of ownership as it delayed bringing private investors in.”⁶⁰ On the flip side, Paul Dileo notes: “Early cultivation of local investors to establish a track record as a reliable borrower” was key to the rapid success of BASIX, an Indian MFI.⁶¹ As opposed to being hampered by the search for private capital, the growth and development of BASIX was accelerated by it. While it may not have been true in the mid to late 1990s, *given what the sector knows today*, even the most poorly structured commercial loan or private investment could impart greater market discipline than the most well conceived grant or donation.

Non-commercial capital combined with the not-for-profit business model and mentality combine to provide several sectoral-level barriers to the transition to private capital. At the simplest level, the charitable instincts of some non-commercial capital has sustained many poorly managed and ill-conceived MFIs long after they should have failed, merged or grown into something much larger. These MFIs are not “market tested” through the search for commercial capital and drain precious resources away from growth-oriented MFIs.

Characteristics of the not-for-profit business structure also complicate transitions to private capital. Non-profits do not allocate retained earnings to shareholders. Developing the taste to do so is a habit that MFIs have yet to fully embrace, even when ownership is shared with commercially oriented non-commercial capital. This is because in the absence of direct ownership, most non-commercial capital is highly patient and does not depend on returns for income. Unfortunately, most private capital is not like this, and requires income as part of the incentive to invest and seeks *verifiable* dividend histories as a means to gauge potential. More than the small handful of MFIs that have provided dividends are going to be needed to demonstrate that MFIs are serious about attracting private investors.

A more complex, far reaching challenge, is that non-profit structures do not encourage mergers, acquisitions or, more importantly, being acquired. Given the nature of most non-commercial partners’ funding sources, exiting from deals is important, but not to the same intense and consuming degree it is with their private sector counterparts, venture and equity investors. For them and many owners of firms in new, fast growing sectors, an objective is not to retain ownership but to be bought by a larger entity. Many businesses explicitly structure themselves and their financing to make themselves attractive for sale (for example, becoming highly leveraged to gain market share). The non-profit ownership model and mentality, by contrast, is one of perpetual existence. This tendency is compounded by a non-profit ownership control that is heavily vested in the notion and fears that commercial interests will cause mission drift (see below).

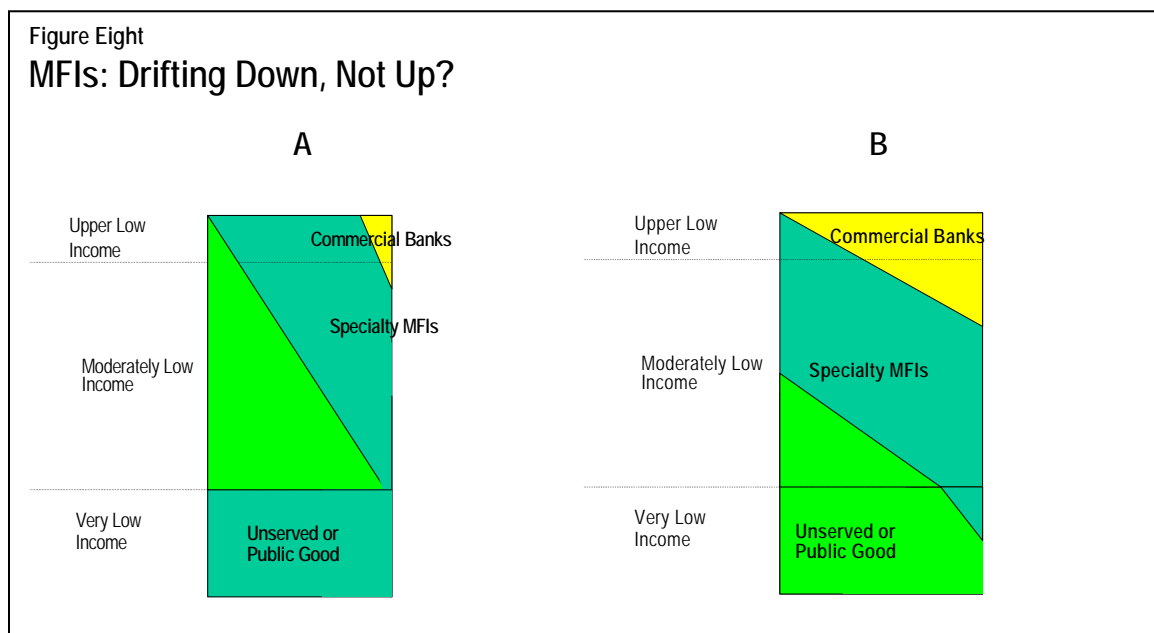
⁶⁰ Kooi, Peter, *Raising Capital through Equity Investments in MFIs: Lesson from ACLEDA, Cambodia, UNCDF/SUM and UNDP Africa*, New York, NY, 2001.

⁶¹ DiLeo, Paul, “Building a Reliable MFI Funding Base: Donor Flexibility Shows Results”, CGAP DIRECT Case Study in Good Donor Practices No. 5, April 2003, http://www.cgap.org/docs/CaseStudy_05.pdf. Data from early 2003.

The for-profit business model is quite different. It is based on making profits, the hope of which pushes businesses to become large and successful, or, if not, die trying. In some cases this openness and drive simply prepares a for profit business for acquisition or failure. Either way, the clients benefit from competition of increasingly competent institutions. Markets with just one or two relatively strong institutions and a plethora of smaller institutions with poor prospects for growth is not only bad for sector development, but for clients – both those being served and those waiting to be served.

Mission Drift without Non-Commercial Capital?

MFI growth is complicated by the fear of mission drift, or the threat that as an institution becomes more commercial, for-profit instincts will cause it to “drift” from the low margin, low-income market to a higher-margin, small business market. This worry intensifies when MFIs consider the introduction of outside commercial equity capital.



Robert Christen suggests that the worry over mission drift may be overestimated.⁶² MicroRate data support this claim.⁶³ Mature Latin American MFIs, for example, show some upward movement of the average loan size, the standard measure of mission drift. Median loan sizes are not increasing, however, suggesting the sector is simply serving a broader range of clients than before, some of whom need larger loans. And as these MFIs grow, the number of small loans increases, resulting in more of the poor being served overall.

What is important about this finding is not that successful MFIs continue to serve the poor, but that they are doing so in a way that proves the viability of the low-income financial service market. This is the true mission of microfinance, for if a viable market exists, it will continue to be served, if not by the MFIs then by banks or other financial institutions. As Christen notes: “when shown a good business opportunity, banks take it – regardless of the client group – as long as it fits with their other core activities.”⁶⁴ The work of the sector is not necessarily about serving the poor, but proving it represents a viable market for commercial capital.

If the market is viable, commercial banks or other larger financial institutions will inevitably play a significant, if not dominant, role in the future of microfinance. This is true, not just for the commonly cited reasons, such as superior branch structure, greater access to inexpensive funding, or better technology, but because of the new market dynamic they will create as they enter the market. Undoubtedly, they will target the most viable and profitable clients, particularly from large urban markets. This will force traditional MFIs to grow, innovate or strategically market themselves to other low-income clients, most likely the poorest of the poor in urban markets and increasingly those in rural areas. (See Figure Eight)

This dynamic is likely not only because the microfinance market is viewed as increasingly viable, but because commercial financial institutions, particularly domestic commercial banks, are facing declining margins in their intensely competitive traditional higher-income markets.⁶⁵ This reality is forcing them to consider new markets. Tumbling technology costs, and improved and adapted credit technologies make downscaling initiatives increasingly attractive.

The process of commercial bank downscaling has already begun in many countries. In the late 1990s, very few banks were involved in the market.⁶⁶ Today, most countries have

⁶² See: Christen, R.P., “Commercialization and Mission Drift: The Transformation of Microfinance in Latin America”, CGAP Occasional Paper No. 5, January 2001, http://www.cgap.org/docs/OccasionalPaper_05.pdf.

⁶³ MicroRate, “The Finance of Microfinance”, October 2002, www.microrate.com.

⁶⁴ Christen, R.P., “Commercialization and Mission Drift: The Transformation of Microfinance in Latin America”, CGAP, page 35.

⁶⁵ As financial liberalization increases in developing countries, international commercial banks are gaining a greater share of local markets. A recent World Bank study by Claessens, Demirguc-Kunt and Huizinga shows that in the liberalizing context, the profit of *domestic commercial banks* across a range of developing countries is declining in the face of international bank competition.

⁶⁶ Valenzuela, L., “Getting the recipe right: the experience and challenges of commercial bank downscalers”, ACCION International, 2002.

a bank or two active or actively interested in the market. A recent Inter-American Development Bank conference on microenterprise and microfinance saw no fewer than 20 commercial banks participating. As telling, large international MFI non-governmental support organizations have begun partnering with commercial banks, and consulting practices have begun developing expertise and services to assist with commercial bank downscaling. Some banks are actually already doing microfinance without calling it that. A survey of over 900 bank products in Mexico, for example, found four very large commercial banks with over ten microcredit and savings products, that under any measure of the definition were microfinance best practice products.⁶⁷

Summary

The purpose of this section is not to disparage non-profit organizations and non-commercial capital providers or their accomplishments. Rather, it is to point out the inherent limitations of these models as they affect access to private capital. A broader objective is to discuss how commercial capital is a *key* element – not just in sustaining existing MFIs, but to elaborate how it is contributing to a new market dynamic that offers the most potential to meet the sector’s goal of serving the greatest number of the world’s poor with permanent microfinance services. Our findings and arguments include:

- Seeking profits maximizes growth;
- Non-profit business models rarely maximize profits;
- Risking one’s own capital and that of others improves financial performance;
- Non-profit ownership is a source of commercial investor concern;
- Seeking non-commercial capital reinforces impulses and instincts that make access to commercial capital more difficult, while seeking commercial capital does not;
- The entry of commercial capital to microfinance will not cause mission drift. Rather, it will create a market dynamic supportive of innovation and growth, helping to serve a greater portion of the world’s poor;
- As microfinance becomes more commercial, banks and other financial institutions will serve a greater share of MFI markets; and
- Existing MFIs need to be the innovators and pioneers, reaching new and poorer microfinance markets in the future.

⁶⁷ Research findings by Enterprising Solutions for a World Bank study on commercial bank microfinance market participation by commercial banks undertaken in 2002.

Commercial Capital Challenges

5.1 Commercial Capital Challenges

Attracting and managing private capital begins with sound liability management and decision-making. This is more than a just function of meeting funding needs. Each type of capital has its advantages and disadvantages. Cost implications are key, but so are other considerations, such as the mix of funding, the flexibility of liability structures and, of course, liquidity management. More complex yet is that every operational decision – financial and non-financial – has immediate and long-term financial management implications.

MFI liability management is further complicated by the simple fact that institutions seldom have easy access to the variety of capital resources enjoyed by other financial institutions. The barriers to each type of capital – deposits, commercial debt and equity – offer specific challenges that are addressed below.

Savings

Savings are the most prized form of funding for small financial institutions. They are an attractive pro-poor product as well as a stable, low-cost source of funds. The introduction of savings has also been credited with attracting more clients, improving customer satisfaction and loan repayment, and motivating better institutional governance. Savings MFIs are also more likely to be fully funded commercially than other MFIs, and rely less on commercial borrowing.⁶⁸ This trend is consistent with mature developed country markets where savings typically constitute up to 85 percent to 95 percent of the funding base of small savings institutions.⁶⁹

If savings are so valuable, why do many MFIs not take them? The main reason is that the microfinance industry developed primarily from non-profit organizations that were not legally allowed to mobilize savings. Nonetheless, an increasing number of MFIs are mobilizing savings. In 2000, the MIX Market listed only 25 MFIs offering savings services. By 2003, the number had grown to 90. Still, some MFIs do not take deposits because they cannot meet the regulatory requirements to do so, or because appropriate regulatory regimes do not exist. A recent CGAP survey of MFI funding issues showed almost all MFIs by type and region believed regulatory barriers were, after funding, the greatest challenge to growth. Much of this concern focused on lack of suitable deposit regulatory regimes.⁷⁰

⁶⁸ To control for forced or very new savings programs, this estimate only includes those institutions whose deposits were greater than 20 percent of total assets.

⁶⁹ See Miller, Terrance, “Learning the Ropes from U.S. Community Banking Financial Institutions: Lessons for Microfinance Institutional and Industry Development”, unpublished paper available from Enterprising Solutions infomex@esglobal.com, August 2004; and Wisniwski, Sylvia, “Microsavings Compared to Other Sources of Funds”, Eschborn, Germany: CGAP Working Group on Savings Mobilization - GTZ – BMZ, 1999.

⁷⁰ CGAP/MIX, “Study on MFI Demand for Funding: Report of Survey Results”, 2004, <http://www.microfinancegateway.org/content/article/detail/14588>.

Savings are universally understood as an inexpensive, abundant source of funding. Unfortunately, it is a source the microfinance sector still understands relatively little about. This is because deposit collection is a distinctly different business than lending. Many MFIs are basically credit management companies with both human and physical resource assets tied closely to credit management and growth. Changing focus from credit to savings has proven challenging and, in many cases, collecting significant deposits has taken longer than many MFIs would have thought necessary. The difficulty is reflected in the fact that of the 90 deposit-taking MFIs listed on the MIX Market, only 42 percent had savings equal to or greater than 50 percent or more of assets.⁷¹

Strong institutions are required to manage deposits and the sophisticated systems required for managing them. Only institutions able to fulfill a variety of regulatory and supervisory conditions are permitted to collect savings. A case in point is the ability to accurately pinpoint the cost of deposit collection. This involves complex product cost calculations, a skill seldom available to MFIs. Estimates of the direct and indirect costs of deposit mobilization vary greatly – from as low as 2 percent to as high as 30 percent of operating costs.⁷²

This range is not particularly instructive and clouds the debate as to whether or not MFIs can effectively mobilize savings from their poor clientele as a competitively priced source of funding. Opinion and evidence are mixed. Some believe that profitably managing many small savings accounts is possible, but requires economies of scale and efficiencies that few MFIs have achieved.⁷³

A sample of 67 MIX Market-listed deposit-taking MFIs with a savings collection history of more than three years showed that a relatively small *average* deposit does not necessarily correlate with a low volume of savings. (See Table Eight) This observation is true for any size, age or location of MFI. Several West African *mutuels/caisses* and the Equity Building Society in Kenya are good examples of how small savings can be an effective and significant source of portfolio funding. MFIs in the same and other markets, however, have experienced difficulty mobilizing deposits in volumes sufficient to meet portfolio needs. XAC bank in Mongolia, for example, wants to decrease dependence on large institutional deposits and collect more small, less expensive passbook and current account savers.

⁷¹ See Mix Market data at: <http://www.mixmarket.org/en/demand/demand.quick.search.asp> Demand Data from 2002.

⁷² Fiebig, Michael, Hannig, Alfred and Sylvia Wisniwski, "Savings in the Context of Microfinance – State of Knowledge, CGAP, Washington D.C., 1999; 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; and Hannig, Alfred, "Mobilizing Microsavings: The Millennium Challenge in Microfinance, 1999 available at: <http://www.microfinancegateway.org/content/article/detail/2024>.

⁷³ Chowdri, Siddhartha, H., "Downscaling Institutions and Competitive Microfinance Markets: Reflections and Case Studies from Latin America, Commissioned by Calmeadow, edited by Alex Silva, August 2004.

Some believe that funding MFIs with micro-deposits is possible if the cost of doing so is offset by a small number of large deposits. “The effective mobilization of savings from higher income individuals and institutions will enable MFIs to become true financial intermediaries and to diversify their liability structure within their local markets.”⁷⁴ An assessment of 15 Latin American credit unions by Dave Richardson supports this observation. His data demonstrated funding efficiencies with around 20 percent of depositors contributing about 80 percent of deposits (normally term deposits).⁷⁵ Richardson concludes that deposits can be an attractive source of funds if a small number of large deposits cross-subsidize the administrative costs of many small savers.

Table Eight Return on Equity & Average Savings Deposit		
	Return on Equity	Average Savings Balance
Savings Institutions	6.3%	\$126
Non-deposits	9.3%	\$81
Source: MIX Market		

The "Robin Hood" strategy of taking deposits from the wealthy to fund loans to the poor is not without its challenges. First and foremost it requires MFI to split their attention between two distinct markets: wealthier term depositors and low-income credit and savings clients. This market mismatch presents many management challenges. As noted in Part II, longer term large depositors favor rates and security above all, while smaller depositors favor liquidity, security and convenience. These differences raise difficult questions about what is the appropriate branch structure, image, business culture and management capacity. Attracting large deposits will also force competition with established commercial financial institutions for their traditional clientele, possibly putting upward pressure on savings interest rates.

The Robin Hood strategy also adds greatly to the complexity of liability management as each segment offers distinct risk and cost structures. Financial costs for larger deposits are higher because these depositors generally want medium-term contracts (six months to two years) with rates commensurate with other fixed-interest term investments. Locking in term rates presents a risk to the MFI, especially in light of the short-term nature of their loan portfolio; if rates drop significantly during the term, then profitability can suffer.⁷⁶ If the MFIs set prices incorrectly compared to the competition's, then the MFIs expose themselves to significant concentration risks, or the risk of having too great a proportion of funding concentrated in the accounts of a small number of depositors. This risk should not be underestimated, since time depositors are notoriously price sensitive, moving money even for a few basis points. Price sensitivity and the perception that MFIs are higher risk than commercial banks force many institutions to offer the best yields in their markets to attract clients, driving up the cost of funds.

⁷⁴ Otero, Maria presenting at the InterAmerican Development Bank annual Microenterprise Conference in Cartagena, Colombia, September 6, 2004.

⁷⁵ 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.

⁷⁶ Product cost accounting is important in this sense to ensure MFIs can compare the cost of long-term deposits versus other forms of long-term debt.

Despite the challenges, the Robin Hood strategy has been successfully employed by several MFIs. Caja los Andes, for example, believes it is better served by expanding the amount and extending the tenor of larger term deposits than other forms of funding, since they require less up-front effort and can be tailored to each client. Other MFIs, such as FIE and Banco Sol, have similar strategies. They should take note, however, that financial liberalization in the US and Canada created conditions that nearly wiped out trust companies in Canada and savings and loans in the US. These were institutions that offered a limited line of products and services and attracted clients primarily by offering better long-term deposit rates than commercial banks.

Commercial Debt

There are many reasons why debt capital is and will remain important for MFIs. First, it is always less expensive to lend someone else's capital than your own equity. Debt can also be less expensive than savings, particularly for MFIs new to the deposit business. Additionally, as MFIs mature they will require some level of debt to manage healthy balance sheets. The most important reason debt remains important to MFIs, however, is that the majority cannot yet access deposits, or if they can, deposits cannot be collected in volumes sufficient to cover loan demand. Of course, and for a variety of reasons, some MFIs prefer to remain non-deposit taking institutions and, as such, they rely greatly on debt finance.

Debt levels among highly successful mature deposit-taking institutions can be considerable. Deposit-taking MFIs considered for Blue Orchard's recent securitization, for example, have debt levels averaging 38 percent of liabilities compared to 47 percent for all MFIs in the portfolio. A sample of ten large deposit-taking Latin American MFIs studied by Jansson showed the continuing importance of commercial debt, which constituted 30 percent of liabilities in 2001, down from 39 percent in 1997 (or a decrease of only 2.3 percent a year).⁷⁷ Interviews with fifteen MFIs for this study suggested similar patterns, with debt comprising between 25 to 50 percent of deposit-taking institutions' liabilities.

Portfolio funding aside, debt will always play a role in the maintenance of healthy balance sheets. This is particularly true of larger institutions that require large volumes of funds for liquidity and rate risk management. Debt in larger commercial financial institutions normally ranges from 20 percent to 30 percent of liabilities. In small commercial institutions it comprises a smaller portion of liabilities, usually between 5

Figure Nine
Benefits of Commercial Debt

- Improved risk management through diversified funding sources
- Increased access to funding to assure continued growth in outreach and portfolio
- Possibility of lowering financial costs over the medium term through savings and financial investment, such as bonds
- Longer maturities in the commercially funded capital structure
- Improved profitability from increasing leverage
- Access to domestic and international debt and capital markets, on attractive terms

Source: Strategies for Financial Integration: Access

⁷⁷ Savings in this same sample represented 69 percent of funding in 2001, up from 51 percent in 1997. Interestingly, long-term debt (including long-term savings deposits) constituted almost 50 percent of funding in 2001, down from 58 percent in 1997, indicating increasing dependence on short-term savings.

percent and 20 percent.⁷⁸ Mature institutions mostly require rapidly available short-term funds and large quantities of long-term funds. Medium- and long-term debt is important when deposits cannot keep pace with loan demand, or in times of economic crisis.

Debt in Transition

The real debt transition question is not whether MFIs need commercial debt, but whether they are developing borrowing relationships that ensure appropriate risk, liquidity and profit management. Our assessment is yes they can, but not fast enough, and that the transition to more and better-priced debt is really just beginning.

Commercial debt continues to be shy and most lenders hesitate to lend to MFIs, despite their good performance. Those that do provide only short-term capital, where long-term capital is in dire need. There are number of good reasons for this, including the fact that most MFIs do not have sufficient collateral to back loans. For commercial bankers, lack of collateral increases the risk of lending. It also can affect cost, as uncollateralized loans require lenders to set aside more reserve requirements than for fully covered loans. Information barriers are also strong. Bankers and commercial capital markets rarely understand microfinance, and many lenders have the impression that microfinance is a charitable activity.⁷⁹ Even for those who don't have that perception, their understanding of microfinance as a business is limited, and so too is their ability to assess risks and their willingness to lend.

The result is limited commercial debt interest in MFIs. A recent CGAP survey on funding showed that the majority of non-deposit-taking MFIs felt they could not fund 30

Figure Ten

The Next Best Attractive Target Client Group

Facing increased competition for the 150 or so large commercial clients in their home market, two commercial banks in Honduras began investigating the potential of making more loans in the range of \$15,000 to \$250,000 to small- and medium-sized businesses.

Part of their challenge was to better understand the sectors in which the businesses operated. They knew little, for example, of trends outside those affecting large commercial enterprises and this made lenders unable to fully assess the risk attached to a given loan.

When presented with the idea of lending to MFIs, bankers expressed many doubts – doubts based on incomplete sector knowledge. Once they better understood the potential and the likely average loan size, however, their doubts converted to questions such as “how do we learn more?” and “how can we meet some MFI clients?”.

As a recent WWB publication by Louise Schneider noted, a significant part of the challenge in accessing commercial loans can be addressed with better marketing and public relations. She wrote... *As commercial banking sectors experience increased levels of competition in their traditional markets and search for new markets MFIs should proactively market their high growth industry as the next attractive client group for hungry banker to pursue.*

Schnieder, Louise, *Strategies for Financial Integration: Access to Commercial Debt*, Women's World Banking, Financial Products and Services Occasional Paper, Women's World Banking, New York, New York, July 2004.

⁷⁸ Wisniwski, Sylvia, “Microsavings Compared to Other Sources of Funds”, , Eschborn, Germany: CGAP Working Group on Savings Mobilization - GTZ – BMZ, 1999.

⁷⁹ The social investment industry suffers a similar image problem. Despite a preponderance of empirically rigorous studies documenting social investment's superior performance compared to conventional investments in almost all investment fields, the mainstream press and uninformed critics continue to claim social investors must forfeit financial yield for social return (See Bayón, Chen, and de Sousa-Shields for a full treatment of this topic).

percent portfolio growth with debt alone. This finding is significant because non-deposit-taking institutions' main source of commercial funding is debt.

Emergent sources of debt are the social investment funds detailed in Part Three. As noted, these funds represent a potential bridge to commercial capital markets. Free of regulatory reserve requirements that hamstring local lenders, these funds can make low- or no-collateral loans without breaching regulations or incurring extra reserve costs. Many also provide local market credibility (even if they do not always act entirely commercial). The funds are also plugged into the microfinance sector, as they are “fundamentally part of the donor world”.⁸⁰ As a result, they have access to knowledge and experience far beyond that which local lenders typically have. This familiarity reduces risk and transaction costs.

While there are many good things about social investment funds, there are some downsides as well. The majority of fund lending, for example, is in hard currencies (US dollars or euros). This exposes borrowing MFIs to currency exchange risk, something they are seldom equipped to manage. Sudden macroeconomic shocks affecting currency values can threaten the survival of MFIs, even those that are relatively large and stable.⁸¹ More invidious, incremental currency devaluation costs are routinely passed along to MFI clients, those definitively less able manage macroeconomic tides.⁸²

The opportunity costs of not developing local capital networks in favor of international loans should not be understated. While initial financial costs of international social investment funds may be lower initially, well-worn domestic lender relationships will ultimately outweigh the value of international sources if only for the rapid access they offer. Over the long term, international funds will be more expensive if MFIs have not properly networked an abundance of commercial sources. These considerations are exponentially more important as MFIs grow and need to manage increasingly sophisticated liquidity and rate risks.

International social investment funds are in great demand and their numbers are growing. A recent CGAP funding survey showed that all MFIs – with the exception of deposit-taking institutions – rated social investment funds as the second most appropriate source of financing. Among the ten MFIs studied by social investment funds (most of which lend below market rates and are subsidized, and hence cannot be considered commercial) grew in equal proportion to a decrease in subsidized liabilities – from 10 percent to 2

⁸⁰ Kaddaras, James and Elisabeth Rhyne, “Characteristics of Equity Investment in Microfinance”, Council of Microfinance Equity Funds, April 2004, available at www.accion.org.

⁸¹ Banco ADEMI in the Dominican Republic has recently experienced grave difficulties from overexposure to hard currency loans when the Dominican Republic peso lost one-third of its value in 2002 and then suffered a further large depreciation in 2003. For specifics on the economic crisis in the country, see the *Perspectiva Ciudadana* website at: <http://www.perspectivaciudadana.com/040117/economia05.html>

⁸² Oddly, according a CGAP study, while many MFIs still prefer local currency loans, there is a continued demand for US dollar denominated debt, perhaps reflecting strong connections to international non-commercial capital, or worse, a poor understanding of liability management.

percent between 1993 and 2002.⁸³ Fernando Nimal reports similar findings in his study of transformed NGOs.⁸⁴ The absence of access to local capital makes international debt funds important suppliers of funding for some MFIs. With annual fund disbursements expected to reach only \$75 million to \$100 million in the coming year or two, however, *the funds will only be able to fund around 2 percent of total estimated demand for debt.* For this reason alone, they should be considered as tactical fund suppliers in a broader strategy to fund MFIs.

The recent Blue Orchard \$40 million securitization of nine MFI portfolios represents another international source of debt finance. Offering a different rate of return to investors accepting various levels of risk, the securitization will provide participating MFIs much needed long-term capital (seven-year terms) at a fairly reasonable price. The issue has four tranches, the first of which is \$30 million in senior notes guaranteed by the Overseas Private Investment Corporation (OPIC). This substantially decreases the risk for the 22 individual and 3 institutional commercial investors whose combined investment totals \$27.3 million for 69 percent of the deal.⁸⁵

Even though the Blue Orchard instrument once again favors large MFIs, it is encouraging because it has significantly enlarged the potential investment universe for the microfinance sector by attracting commercial institutional investors. If the economics of the instrument work and foreign exchange risk can be well managed, then this vehicle represents a potentially unlimited source of long-term financing for large MFIs.

⁸³ Jansson, Tor, "Financing Microfinance", Inter-American Development Bank, Sustainable Development Department Technical Paper Series, Washington, D.C., 2003, http://www.iadb.org/sds/publication/publication_3252_e.htm.

⁸⁴ Fernando, Nimal, "Micro Success Story? Transformation of Non-government Organizations into Regulated Financial Institutions", Regional and Sustainable Development Department, Asian Development Bank, June 2004, <http://www.adb.org/Documents/Studies/microfinance-success/default.asp>.

⁸⁵ Interview with Dominice, Roland, Blue Orchard, June 09, 2004, personal interview.

**Table Nine
Investment Fund Developing Country Risk Premiums**

Issuer	Developing Government Dollar Bond YTM % *	Fund A Rate to MFI %	Management Fee %	Risk Premium	Fund B Rate to MFI %	Management Fee %	Risk Premium
Argentina	85.49	9	3	-79.49	7.7	3	-80.79
Brazil	5.99	9	3	0.01	7.7	3	-1.29
Colombia	4.72	9	3	1.28	7.7	3	-0.02
Dominican Republic	16.12	9	3	-10.12	7.7	3	-11.42
Guatemala	9	9	3	-3	7.7	3	-4.3
Jamaica	10.41	9	3	-4.41	7.7	3	-5.71
Kazakhstan	9.15	9	3	-3.15	7.7	3	-4.45
Mexico	3.25	9	3	2.75	7.7	3	1.45
Philippines	5.22	9	3	0.78	7.7	3	-0.52
Russia	4.9	9	3	1.1	7.7	3	-0.2
South Africa	3.46	9	3	2.54	7.7	3	1.24
Uruguay	32.03	9	3	-26.03	7.7	3	-27.33

* US dollar denominated debt of emerging market governments expiring between 09/2006 & 09/2007

Ultimately, however, MFIs' exposure to foreign exchange risk and the limitations of social investments funds, in terms of types and maturities, highlight the need to develop domestic sources of commercial capital. Foreign funding, as Elizabeth Littlefield, CEO of CGAP argues, "whether donor money, quasi-commercial or foreign commercial funds, should be seen as a second-best solution, giving way to domestic sources over time."⁸⁶

In the absence of ready access to local capital, however, international initiatives with the explicit goal of leveraging local capital into the sector represent an important bridge to commercial capital. Initiatives such as UNITUS' supported equity fund, and the recent ICICI, Share and Grameen Foundation securitizations in India, are examples that may merit greater donor support and replication. So does the Emergency Investment Fund

⁸⁶ Cited in Microfinance Matters, Issue 5, September/October 2004.

proposed by Omatrix, which may be an appropriate measure to ensure that MFIs have rapid access to funding in the event of social, economic, or environmental crises that plague developing countries and can place MFIs under severe liquidity stress.

If local debt is the cornerstone in the transition to private capital, then guarantee programs should also play a role in facilitating access to commercial capital. Guarantees are provided to lenders by a third party. They act as a form of collateral to reduce lender risk, often facilitating loans that would not otherwise be made. They also often lower the cost of debt at the same time. In addition to simply facilitating access to credit, guarantees are flexible and simple mechanisms, adaptable to many different situations. They also create a leveraging effect, generating several times their value. Most guarantee programs leverage funds at a rate of between 2:1 and 3:1.

Guarantees have three main forms: i) stand-by letters of credit, ii) collateral deposits, and iii) simple guarantee agreements. They can back different financial instruments including loans, credit lines and bonds. In the 1980s, most MFI guarantee programs consisted of collateral deposits guaranteeing individual loans. This design, however, is expensive since each individual loan had to be guaranteed. It also left MFIs open to a moral hazard in that clients might choose not to repay a loan because they know it is guaranteed. Today, intermediary models and stand-by letters of credit are the most used forms of guarantee, which means that an MFI's portfolio is guaranteed, rather than the individual loans.

The key to successful guarantee programs is that they are properly designed, which has not always been the case. Experience to date has been mixed. This is the case for a variety of reasons, including perceived difficulty of collecting from a third party, poorly structured agreements, and unattractive loan pricing. Additionally, guarantees can be costly to establish and the specter of moral hazard is always present, as is the problem of adverse client selection. These challenges are not inevitable, however, and good guarantee programs do exist.

Good guarantee programs not only provide access to commercial capital, they help establish long-term lending relationships with the banking sector. Moreover, benefits can be had for young and mature, regulated and unregulated MFIs alike. Even mature, highly successful MFIs use guarantees. WWB Cali, working with support from the Women's World Banking international finance team, for example, has used a number of intermediary guarantees to diversify debt sources, lower the price of loans and improve terms. Other major actors such as ACCION, LACIF, and the Deutsche Bank have guarantee programs as well. (See Table Ten.)

A few MFIs have also used guarantees to tap local commercial bond markets. Compartamos in Mexico was able to sell its first bond issue to high net worth individuals on the strength of a Standard and Poor's mxA+ credit rating. It is now using this experience and employing development institution guarantees in new issues to penetrate

the much larger Mexican institutional investor market.⁸⁷ Others MFIs are employing similar strategies. As noted, guarantors helped MiBanco bonds attract Peruvian pension funds and the Grameen Foundation used its own funds to partially guarantee the ICICI-Share securitization in India.

Local bonds and securitizations have good long-term potential for the sector, but they are certainly not appropriate for younger MFIs. Moreover, many local capital markets are not sophisticated or deep enough to support such instruments, so their appeal as a transitional tool is limited to a certain number of countries and larger MFIs.

Table Ten Guarantee Models					
	Model	Mechanism	Coverage	Duration	Fees
Development Credit Authority (USAID)	Intermediary	n/a	Up to 50%	n/a	n/a
Women's World Banking	Intermediary	SBLC	Theoretically 50% of the credit line; can go up to 90%	One year, renewable	1% of the SBLC amount in US\$
ACCION	Intermediary	SBLC	Around 50% on average; can go up to 90%*	One year renewable	3% per year of credit guaranteed
LA-CIF	Intermediary	SBLC	n/a	n/a	Market rates
International Guarantee Fund	Intermediary and portfolio	SBLC	n/a	Length of credit guaranteed	3% to 5% per year of the credit guaranteed
Deutsche Bank Microcredit Development Fund	Intermediary	Loan to the MFI	n/a	3 to 8 years	1-3%

Management Implications of Debt

As MFIs take on more sophisticated debt instruments, increasingly sophisticated and informed treasury financing skills are required to determine the cost and liquidity advantages of different tenors and types of debt, including savings. Efficient liability management and planning is key, as growing institutions need to ensure sufficient liquidity while maintaining a minimum of non-performing assets. Striking this balance demands strong liability information and analytical tools. Unfortunately, aside from a very limited number of “best practice” liability management resources, there is little

⁸⁷ Other bond issues include three owned by Internationale Micro Investitionien Aktiengesellschaft (IMI) for the following MFIs: FinAmerica, BancoSol and MiBanco.

sector-specific microfinance guidance available to MFIs as they manage a larger number and greater volume of liabilities.⁸⁸

Equity

“It is not reasonable to expect a quantum leap in private investment in an industry that most private investors find difficult to evaluate for lack of benchmarks and transparent data”

Nimal A. Fernando,
Micro Success Story? Transformation of Nongovernmental Organizations into Regulated Financial Institutions, page 11.

Although equity usually makes up a relatively small portion of the total financing of larger MFIs, it is their most important source of commercial funds for several reasons. Equity is a much more flexible form of financing than other available options. It is necessary for regulatory purposes that a bank has enough equity investment to meet minimum capitalization requirements. Most importantly, though, the shareholders of any firm are its owners and, as such, control the ultimate purpose and direction of the firm.

It has been a source of some frustration that though many transitioned and transitioning MFIs demonstrate high return on equity, there still is very little commercial equity interest and/or investment in the sector.⁸⁹ Indeed, aside from a small number of international funds, such as ShoreCap and Profund, there is no organized pooling of MFI equity capital.⁹⁰ Most equity remains in the hands of non-profit organizations, either local or international, or is held by international financial institutions. Aside from cooperative member ownership, a few employee stock ownership plans and a few share purchases by private institutions or individuals, there is little significant private sector, local ownership of MFIs.

So why don't commercial investors take advantage of what is surely favorable performance and buy shares of MFIs? The answer is that relative profitability is not the only relevant issue. Both low return-on-equity and high return-on-equity firms attract investment well enough in other sectors throughout the world. Generally speaking, if a firm is unable to attract investment, there is either a problem with the pricing of the

⁸⁸ See, for example, the Bankacademie Treasury Management Toolkit prepared by Joachim Bald; see also Schnieder, Louise, *Strategies for Financial Integration: Access to Commercial Debt*, Women's World Banking, Financial Products and Services Occasional Paper, Women's World Banking, New York, New York, July 2004.

⁸⁹ According to the MBB, the large, regulated Asian and Latin American MFI peer groups averaged a return on equities in 2002 of 31.6 percent and 27.7 percent, respectively (the last period for which we have data). This would seem to compare favorably to US regional banks, which were averaging 16.9 percent, or US savings and loan/savings banks, which were averaging 14.1 percent at the time of this writing and that have no trouble raising equity investment.

⁹⁰ The Council of Microfinance Equity Funds, led by ACCION International, is an organization comprised of 19 funds. The majority of member assets, however, are held in debt.

investment opportunity or with the investment mechanisms themselves. Equity pricing issues arise whenever there is poor valuation and/or the firm deviates from the behavior of a normal, profit-seeking business. Investment mechanisms can be hampered by a firm's governance, government regulations and high transaction costs, among other things. These barriers and other barriers to investment are discussed below.

Valuation

A precondition to the sale of anything, including shares in a bank, is that it has a price. The higher the price a firm gets for its shares, the easier and "cheaper" it is for it to raise money. For the sake of argument, let us say that there are four notional valuations that an MFI might receive:

1. The price range currently being paid by development banks and specialty funds that invest in MFI equity. This would appear to correspond to the MFI's "book value" plus or minus 20 percent to 30 percent;
2. The theoretical correct price that would be reached in a "perfect" market;
3. The market clearing price that reasonable, profit-seeking investors would pay; and
4. The (heavily discounted) uninformed price that investors unfamiliar with MFIs would pay upon first hearing about the opportunity.

While the "correct price" is always unknown prior to sale, and the "uninformed price" is obviously going to be the lowest, the relationship of the remaining two prices is of interest. Evidence that the market clearing price is lower than the prices paid by development-oriented investors exists in the simple observation that development banks find selling their shares in the private market challenging, to say the least. Information asymmetries exist in the marketplace, but ultimately if MFI shareowners are searching for investors properly and pricing correctly, buyers should be available. If this is not true, then there must be a good reason why the private sector is not investing in microfinance on a more significant scale.

An examination of the stock price of BancoSol of Bolivia – one of only two known stock exchange-listed MFIs – provides some clue about how at least one open market values a large, regulated and successful MFI. In 2001, the last date for which the Bolivian stock exchange has trade information on BancoSol, the Bolivian market seemed to value BancoSol at 82.5 percent of its book value, a fairly large discount to book. In August 2004, Banco de Credito de Bolivia was offering its 7.3 percent stake in BancoSol at a price indicating a valuation of 92.7 percent of its book value.

The fact that it has not yet been sold implies that the market-clearing price for BancoSol shares is some unknown amount less than 92.7 percent of its book value since no one has purchased the shares since listing. Most mainstream Bolivian banks are trading at factors closer to 100 percent to 110 percent of book value. The data are too slim to conclude that markets will value large, regulated MFIs around 20 percent less than mainstream banks, but it certainly merits more study.

Forecasting Ability

As with debt financing, the ability of an MFI to accurately forecast its future financial performance is both an important and largely underdeveloped skill in many MFIs. Investors will certainly not err on the side of generosity where uncertainty about these future earnings prospects exists. Anecdotal evidence suggests that MFIs especially tend to be “optimistic” in their assessments of their own future prospects. Hence, there is a need to develop good financial planning and forecasting capacity so that MFIs are better equipped to demonstrate sound forecasting, which would in turn improve their ability to raise money via equity sales *and could also increase the value of current investors’ stockholdings.*

Profit Distribution

Since the price of shares is largely determined by expected future profits, any business decision or policy that seems likely to limit those future profits will also result in a decrease in the share price. If investors have doubts about an MFI’s commitment to growth and eventual distribution of earnings, they will further discount the value of the firm’s shares. This cannot be overstated. If the governance of an MFI does not commit itself to a specific plan for someday distributing profits to its investors, demand for their equity will be low. Tellingly, while investigating their investments, the members of the Council of Microfinance Equity Funds found that “in interviews with general managers of leading MFIs in all four developing regions, few offered a clear indication of how (or when) their current investors would exit their companies....”⁹¹ Any lack of governance preoccupation with the financial fate of current and future investors is strong negative signal to the marketplace.

The regular payment of dividends to investors is very good way for a company to build credibility for this commitment in the marketplace. It shows the market that the firm has profits and is willing to pay investors for the risk that they are taking. Some MFIs, including SHARE, ACLEDA, XAC, Card Bank, have offered dividends to investors with positive results, since investors tend to respect a reliable stream of cash much more than vague promises of future wealth. The use of preferred shares that pay a regular promised dividend and have a higher priority at liquidation is a particularly good way to attract investment that might qualify as equity for regulatory capitalization purposes in a suspicious marketplace.⁹² However, smaller MFIs infrequently (if ever) distribute dividends because they reinvest all of their profits in expanding their operations. Fast growing firms very rarely pay significant dividends in any industry.

⁹¹ “Characteristics of Equity Investment in Microfinance,” Council of Microfinance Equity Funds, 2004, p. 6.

⁹² Or better yet, convertible preferred shares that can become common shares in the event of a buyout opportunity.

Liquidity

Liquidity is another element that investors seek. A lack of liquidity will naturally result in further discounting of share value. Things that are hard to sell are simply worth less than things that are easily convertible to cash. Ideally, a firm seeking equity investment would be listed on a stock exchange where they could quickly, easily and anonymously buy and sell shares. The problem that small, growing institutions face in becoming listed on stock exchanges is that many countries in which microfinance is flourishing do not have active stock exchanges. Even when they do, they are mostly designed with very large institutions and conservative investors in mind. It is therefore normal that small- and medium-sized MFIs are unlisted, and that, lacking a good distribution mechanism, are held in relatively few hands. This said, larger MFIs that can economically overcome the barriers involved would benefit from being listed on their national exchanges. There may also be a role for offshore specialty stock exchanges that might have lower barriers to entry and cater to this market. In any case, as with the BancoSol example, stock markets make stock much easier to sell, dictate prices and provide validation of firm valuations.

Other options are also being explored to increase share liquidity. For example, an increasing number of strategic buyouts of early investors are occurring. Profund, the Latin American MFI venture fund, is at the fore of these transactions and will soon exit from the Venezuelan MFI BanGente through a purchase of shares by Banco del Caribe. As Elizabeth Littlefield of CGAP recently noted, “the growing interest of commercial banks in microfinance may be a portent for more such buyouts, especially in Latin America, where many of the first equity investments in microfinance were made. Investment funds are also taking the initiative to find creative solutions to illiquidity, such as through ‘roll-ups’ that allow investors to trade shares in a single institution for shares in a basket of investments.”

Suitable Investors?

Another factor somewhat specific to MFIs is the fact that many founding NGOs and social investors fear outside ownership and its potential to diminish the sense of a social mission. The Council of Microfinance Equity Funds eloquently describes its struggles with this problem in its 2004 report, “Characteristics of Equity Investment in Microfinance.” The report repeatedly cites fears that the unrestricted sale of its interests in MFIs to the general public might result in “the acquisition of shares by unsuitable investors” and a desire for “...capital that respects the nature of the microfinance business.”⁹³ While it is anyone’s right to sell to whom they choose, vetting of prospective buyers is a definitional limitation to the liquidity of the shares. If shares are sold with such restrictions attached, the price they can be expected to fetch will certainly be lower than would otherwise be the case. Perhaps more importantly though, it is also a

⁹³ Kaddaras, James and Elisabeth Rhyne, “Characteristics of Equity Investment in Microfinance”, Council of Microfinance Equity Funds, April 2004, p. 6. Available at www.accion.org.

strong signal to the marketplace that entrusting money to these managers (of funds and like-minded MFIs) may involve a sacrifice of profit to other priorities. If this is the case, it will surely – and rightly– result in a further discount to share price. Whether profit maximizers or profit sacrificers, MFIs are handicapped by the image or brand among conventional investors that they undertake charitable activities. As many MFIs have found, raising equity capital is difficult in any circumstance; imposing a “suitable investor” policy further limits the potential universe of investors, making a successful equity search that much more difficult.

Transparency and Supervision

Another area of special concern to MFIs is that they be viewed as solid, professional organizations. Investors fear corruption and mismanagement in MFIs more than in most businesses. Operating low-end, cash-intensive business in emerging markets known for poor rule of law seems to present such risks.

The use of outside auditors is a widespread method of ensuring transparency and reassuring investors. Outside auditors are valued for their ability to provide objective insight into and verification of a firm’s financial statements and claims and act as an honest broker to the outside world. International investors may also prefer the use of first-tier international auditing firms (such as Deloitte Touche Tohmatsu, among others) that they know and trust. Voluntary use of these firms generally lends credibility to an MFI and is obligatory for any institution looking to establish itself as a serious investment opportunity.

Being under supervision by a government regulator is another significant plus as it provides investors the confidence of a transparent and consistent reporting regime. Similarly, being rated by a credible rating agency improves an investor’s sense of security.

Benefits of For-Profit Ownership

As alluded to at the beginning of this section, the most important aspect of equity is that the shareholders (not the debt holders, outside patrons, or the clients) ultimately own and control the MFI. There is no better way to motivate the managers of a firm to improve their operations and eliminate waste than to provide them with the proper incentives to do so. The private sector has proven this time and again. The ability to tie managers’ compensation and job security to financial results or any other performance measure is in the hands of the owners alone. Fears sometimes voiced among MFI supporters that such profit-incentive arrangements will orient MFI managers to the short term at the expense of the long term are only valid if incentives are unwisely tied to short-term performance. A smart board will reward executives for doing the right thing for the long-term health of

the firm. The best way to ensure that all of this happens is to have an intensely for-profit ownership contingent.

Transitions for Equity

Of course, the transition from NGO to commercial entity need never be made. If an NGO MFI is financially healthy or securely subsidized, its not-for-profit owners and board may choose to keep close control of the organization and limit outside, for-profit investment in order to assure faithfulness to its mission or to serve market segments that are not profitable. While this is a valid choice for an MFI, it is likely to be very limiting in terms of financing, competitiveness and growth options. Moreover, if this is the choice that is made then the institution is really a charity, not a company, and its financing strategy will follow very different dynamics than those listed above.

Thus, NGO-transitioning MFIs have a special need to convince investors that they intend to operate in the interest of investors and then actually do so. After years of refining the art of selling their social mission to donors and “social investors,” this may be the difficult part of the transition. The irony (not being pointed out here for the first time) is that by effectively orienting the firm to a profit-motive footing, the MFI can reduce its financing expenses and improve its services, operating costs and market penetration to its target population. Where a conflict may arise is if the MFI is determined to serve non-viable market segments. Investors would view this as throwing their money away and would not tolerate it, or they would demand the market be proven viable before they invest. In any case, the increased costs associated with supporting such financially non-viable activities are necessarily passed on to other micro-borrowers and depositors in the form of increased loan interest, decreased deposit interest and increased service fees. The lower performance caused by such policies will also result in the MFI being viewed as a higher risk by bankers, subjecting it to higher interest rates. In addition, the MFI will fetch yet lower prices for its shares, all of which incur costs that will also be assumed by the clients or the MFI owners.

Summary

Attracting commercial capital is fraught with an array of barriers – from those that are internal to MFIs to those that are external, such as information asymmetries among investors and lenders to regulatory considerations.

At the most general level, MFIs must have a keen understanding of the supply market for distinct types of capital. This requires not only facts and figures, but also the ability to speak the language of investors, understanding the performance measures and rating systems they employ, and providing information in a format they understand. These considerations alone represent impressive challenges given the relative insularity of the microfinance community in most countries.

There are also abundant challenges specific to gaining access to each of the main types of capital. Domestic deposits and domestic debt are ultimately the most desirable from a cost and liquidity management perspective. Regulatory issues are clearly critical for deposits, but so too is clearly understanding the marketplace and managing resulting liquidity implications. Debt presents a series of specific considerations. Even though it is generally more expensive than deposits, it will remain, at least at the sectoral level, a cornerstone to MFI funding in the transition to private capital. Thus, a critical development will be the creation of networks of local debt sources for MFIs. This will help supply short term portfolio growth capital and longer term balance sheet maintenance. Guarantee programs will play an important role in developing access.

Finally, there is the special case of equity. The reason there is a lack of private capital equity available for microfinance is partly the result of pickiness among current MFI owners and partly the result of factors beyond the control of the sector. Key to improving the attractiveness of MFI shares is to first create or improve conditions that will provide investors some means, or at the least the promise of withdrawing income from their investments. This involves changing the prevailing non-profit mentality of MFIs that has not favored dividend distribution. More important and related, the sector must become more comfortable with the fact that the low-income market is a proven market and as such offers commercial investors a solid, long-term, profitable alternative to other financial services niches.

Summary Conclusions

This report argues that the microfinance sector is at a crossroads between financing dominated by non-commercial sources and one increasingly and necessarily responding to private sector financing needs and interests. It concludes that if the sector is to meet its goal of serving a large portion of the world's poor with permanent financial services, it must continue to prove the viability of its core low income market and develop significantly deeper access to domestic commercial capital.

The microfinance sector in most countries has proven its commercially viability and that MFIs can serve the market profitably when applying best practice asset management. What it has not yet shown is whether it can become an integrated part of the formal financial sector. Funding will play a significant part of its integration, especially in helping the next generation of "winning" MFIs to emerge. These MFIs, mostly smaller, existing microfinance institutions or unconventional entrants, such as consumer finance companies and bank subsidiaries, are the most likely to spur the growth, competition and innovation that will attract the interest of commercial investors.

The implications of successfully pursuing private capital will change the very nature of microfinance. At the broadest level, this change implies a shift in focus from foreign to local investors. It implies adopting a private sector culture, language and governance

style, including a greater focus on profitability and greater openness to mergers, acquisitions, and other forms of entrepreneurial dynamics, characteristic of young and growing sector.

To attract a significant amount of private investment, the microfinance sector must work to explicitly break down the multiple information and regulatory barriers that separate private capital from MFIs, which will require that MFIs submit themselves to the most credible and widely accepted audits, ratings and supervision available.

Despite representing only a small fraction of current supply, non-commercial capital will continue to play a critical and catalytic role in the search for private capital. Current allocation patterns that concentrate the majority of the sector's risk capital in a small number of MFIs that are largely capable of sourcing commercial capital, however, will not encourage the growth of private capital.

In the transition toward private capital, non-commercial investors need to focus resources at the early high risk-return stage of microfinance institutional development. This means the next generation of "winners" and countries with no or shallow microfinance market coverage. Because so much is known about microcredit best practice, investment in the next generation should focus less on asset development and more on serving the needs of private capital. This will require non-commercial capital mimicking as closely as possible the methods, disciplines and objectives of private capital. Examples, such as ACLEDA in Cambodia and XAC Bank in Mongolia, demonstrate how small, relatively new institutions can choose strategies that help them access private capital rapidly and profitably. A primary and obsessive focus should be to lever domestic capital as quickly as possible, as MFIs prove they can grow the value of their business in their core, low income market.

Non-commercially funded international MFI investment funds have the opportunity to play a significant role in this development if they invest in the next generation of MFIs and have the *explicit goal* of leveraging domestic capital. This will create scarcity of inexpensive capital resources for mature MFIs forcing them to seek out commercial capital. Non-commercial capital should also continue and increase investment in public goods, such as in credit bureaus, microfinance associations and regulatory improvements.

Observations & Recommendations

For donors and other non-commercial capital suppliers, the report offers a few concluding observations and recommendations.

General Observations

Non-commercial capital should not favor supporting non-profit MFIs over commercial entities, unless the former clearly promises a more efficient and effective route to rapid market penetration and profitability.

Domestic capital is almost always a preferable source for MFIs than international capital, over the long run. This is true for deposits, local debt and equity, even if the short-term

financial cost of international capital is less than domestic capital. Some exceptions may include post-conflict markets or countries where capital markets and banking systems are extremely shallow.

As a means to improve competition among MFIs, public and private MFI funds should invest in the next generation of MFIs, whether small existing MFIs with potential, subsidiaries of commercial banks or unconventional players, such as pawnshops or consumer financiers.

Specific Recommendations

Savings

Ensure that MFIs are keen to dramatically advance deposits and the capacity to price, collect and administer them, particularly if they operate in both the low- and high-income savings markets.

Debt

Nurture local commercial debt networks by supporting the generation of sector information and dissemination, improved collateral arrangements, guarantee programs and strategic regulatory changes and tax advantages. In larger markets, local private sector loan funds should be considered, as should local bonds and securitizations for mature institutions.

Equity

Court potential profit-driven, private sector investors as potential owners of MFIs. Support non-commercial capital investors seeking to sell shares. Seek to create a more liquid market for MFI shares by encouraging dividend payments and access to formal capital markets (such as business buyer/seller networks, over-the-counter securities markets, stock exchanges, etc.).

International Social Investment Funds

Provide support to international social funds to *explicitly* leverage domestic capital for MFIs as opposed to relying on them to do so on their own limited budgets.

Other Non-Commercial Funders

Limit non-commercial funds to early-stage MFI development or to reach new MFI markets. Ensure that leveraging private capital is an explicit goal of any non-commercial funding intervention. Continue funding regulatory change, facilitating investment as well as other public good initiatives, such as strengthening credit bureaus or sector associations and drafting investment laws affecting access to private capital.

Future Research

This paper suggests three lines of research to improve private capital, particularly at the domestic level.

Supply of capital

To increase access to *local* capital, researchers will investigate the opportunities and barriers to MFI investment among domestic lenders and investors. Research will provide USAID missions with templates for assessing and accessing private capital in domestic markets.

Demand for capital

Through a closer examination of mature and promising MFIs, develop a diagnostic template to understand MFI capital needs, possible capital development strategies and management capacity requirements. Research will help MFIs and USAID missions develop customized plans to gain access to private capital.

Regulatory developments

Analyze regulatory environments highlighting and detailing policy facilitating investment in MFIs. Two to three case studies will be featured. The research will familiarize USAID missions with common and critical regulatory considerations and changes that could improve MFIs' access to private capital.

Appendix One MFI Lifecycle

The Microfinance Lifecycle

(Not including capital needs)

	Youth	Growth	Maturity
<i>Focus</i>	Vision.	Outreach and professionalization.	Strategy.
Target Market	Microcredit.	Micro and small credit, other products, including savings, can be important.	Micro and small credit focus but open to all, expanding range of products and service.
R&D and Marketing	Informal, but operating close to local market, no brand.	Deepening market knowledge, opening new markets, building brand, competitive intelligence.	Sophisticated market knowledge, segmentation analysis, branding, customer loyalty is critical.
Institutional orientation	Getting basic systems in place, sustainability.	Growth, marketing, competition, profitability, productivity, investment rather than costs.	Cost-cutting rather than investment, competition, efficiency, strategy.
Institutional Architecture	Decentralized, flat structure, informal and entrepreneurial culture and organization.	More hierarchical, more formal, more likely to be regulated, innovative but organized culture that is pursuing professionalism.	Formal, professional, layered structure, innovation may be institutionalized but vibrant culture is rare.
Leadership/ Governance	Management-led and informal.	Increasingly competent and active governance at management level as well as strategic oversight.	Competent leadership at management and board level, various committees function effectively, governance focus is on oversight and strategy.
Owners	Mostly members or proxy owners, some private sector.	Development banks and specialized investment funds, still many members, some private equity, decreasing NGO ownership.	Development banks, specialized investment funds, increasing private sector, still many members, some NGO or proxy ownership remains.
Systems	Informal, manual, basic management information systems; developing from basic to solid internal controls, sometimes audit.	Formalized, effective manual systems, established processes and procedures, management information systems sophisticated enough for growth, improved internal controls.	Sophisticated management information systems, new delivery systems that take advantage of information technology, well-developed internal controls, audit.
Profitability	Operating sustainability near or greater than 100%, not typically financially self-sufficient or profitable.	Operating sustainability greater than 100%; near or better than financial sustainability or profitability.	Usually profitable.
Competition	Little competition.	Competition varies from slight to fairly intense depending on the market.	Intense competition in many markets.

Transparency	Little.	Learning how, driven by need for capital.	Core transparency unquestionable.
Resources	Typically a shoestring budget.	Never enough, but much larger quantities available. Investment decision-making difficult and very important as a result.	Investment funds are available, key is strategic and efficient management of resources.
Characteristics of Capital Needed	Highly risk tolerant, value added technical support, speculative, big or no return expected.	Less risk tolerant, more established risk/return expectations, more complex covenants, more sophisticated ownership, and value added.	Risk averse, complex covenants but more standardized, lower transaction costs, low value added, low price.

Appendix Two – MFI Peer Group Capital/Asset & Commercial Funding Liability Ratios

MFIs BY PEER GROUP		Capital/ Asset Ratio	Commercial Funding Liabilities Ratio
All MFIs (n = 124)		42.7	44.1
FSS MFIs (n = 66)		40.4	76*
1. Africa Large	n	6	6*
	avg	25	114.8*
	std	16.1	105.1*
2. Africa Medium	n	8	8
	avg	47.6	41.4
	std	20.1	36.4
3. Africa Small	n	7	7
	avg	57.4	39.2
	std	25.6	36.8
4. Asia Large	n	4	4*
	avg	36.5	131.4*
	std	21.3	174.5*
5. Asia Medium	n	7	7
	avg	34.6	70.3
	std	20.7	42.3
6. Asia Small Broad	n	5	5*
	avg	36.6	95.7*
	std	17.3	55.7*
7. Asia Small Low-end	n	5	3
	avg	44.2	26.4
	std	38.5	23.8
8. Eastern and Central Asia Large	n	5	3
	avg	42	1.2
	std	32.3	2.1
9. Eastern and Central Asia Medium	n	9	7
	avg	60.9	16.7
	std	34.5	18.3
10. Eastern and Central Asia Small	n	6	4
	avg	70.9	4.1
	std	24.8	8.2
11. Latin America Credit Unions	n	11	11*
	avg	23.6	134.9*
	std	8.8	51.2*
12. Latin America Large	n	12*	12*

	avg	17.4*	95.5*
	std	9.6*	25.9*
13. Latin America Medium	n	8	8
	avg	43.8	71.8
		Capital/ Asset Ratio	Commercial Funding Liabilities Ratio
	std	17.4	42.7
14. Latin America Small Broad	n	8	6
	avg	42.4	18.3
	std	18.5	24
15. Latin America Small Low end	n	10	8
	avg	54.9	9.8
	std	25.4	20.2
16. Middle East & North Africa	n	9*	7
	avg	71.4*	23.9
	std	19.4*	28.1
17. World Wide Small Business	n	4	4
	avg	58.4	36.5
	std	29.1	41.2
<p>n = number of institutions in category. avg = average score. std = standard deviation from the average score.</p>			

Source: MicroBanking Bulletin, Issue 9, November 2003.

Appendix Three – Investor Typology

MFI Investor Typology

	Investors - Owners of Capital	Risk Tolerance	Return Expectations and Needs	Time Horizon	Objective	Instruments	Transaction Cost Sensitivity	Potential Interest	Experience	Examples*
Commercial Investors										
Depositors										
Passbook and Demand	Individuals, institutions, businesses.	Low.	Low.	Short.	Safe, convenient place to save.	Savings and disposable income.	High.	Good if regulated.	Poor to good: few MFIs have reached 80% deposit funding levels or more. Cost and competition are key factors.	MIBanco, Centenary Bank.
Time Deposits	Individuals, institutions, businesses.	Low.	Low.	Medium.	Competitive rates of return, safe place to save, complementary products and services.	Savings and disposable income.	High.	Good if regulated.	Poor to good, few MFIs have reached 80% deposit funding levels or more. Cost and competition are key factors.	MIBanco, Centenary Bank.

Commercial Bank Loans	Commercial banks.	Low to medium.	Low to Medium.	Short to medium.	Timely repayment at competitive interest rates, retaining client repeat and other financial business.	Short and medium term loans.	High.	Good if regulated.	Poor to good. Guarantees often required even for blue chip MFIs such as Women's World Banking Cali. Increased access in Latin America and Eastern Europe, less in other regions.	Colombia
Defined Liability Funds	Pensioners, insurance companies, insurance policyholders, trusts, etc.	Low to moderate.	Low through to high, though mostly medium.	Short to long.	Meet asset class average return on all investments.	Publicly traded securities, some private equity and debt.	Medium.	Poor internationally, poor to good domestically (e.g., MiBanco bonds were bought primarily by Peruvian pension funds).	Poor internationally though some institutional investors have purchased Blue Orchard securitization package. Poor to good domestically (e.g., MiBanco bonds were bought primarily by Peruvian pension funds). Guarantees normally Required.	Blue Orchard, private social investors.
Publicly Available Investment Funds	Individual investors, pension funds, insurance funds etc.	Asset allocations include all types of investments, degree of interest defined by the focus of the fund and the need to diversify.	Low to high.	Short to long.	Meet or beat asset class average for competing funds.	Publicly traded securities, some private equity and debt.	High.	Poor – regulatory and fiduciary concerns make non-tradable securities difficult for funds to invest in.	Very few funds that invest in MFIs are widely available to non-accredited investors. Others have prospectus that allows for public distribution but seldom have minimum investment levels allowing for broad market appeal. All publicly available funds currently available require investors accept below commercial rates of return. Relatively little investment on the part of private investors as a result.	Calvert Foundation, responsAbility.
Private Funds										
Private funds for institutional investors.	Institutional and high net worth individual investors.	Moderate to high.	Moderate to high.	Medium to long.	Maximize profits compared to fund investing with similar asset strategy.	Tradable securities to private equity and real estate.	High to moderate.	Poor – to good depending on the nature of fund. Fiduciary concerns make it difficult to invest in asset classes not fully benchmarked.		
Venture capital funds, private equity funds.	Institutional and high net worth individual investors.	Moderate to high.	High.	Medium to Long.	Maximize profits through value added investment (i.e., provision of capital and strategic advice at the strategic and governance level).	Private equity.	High.	Moderate – most have defined investment targets (e.g., high-tech companies). Some small business fund have invested in MFIs.	Very few funds have invested in MFIs. Some private equity and venture funds in developing countries have made MFI investments.	Aavishkaar (India), UNITUS (India Fund).

Private Investors

High Net Worth Individuals	Individuals and families.	Low to high risk tolerance correlated to size of portfolio first, then age. Few have interest in both developing country markets and MFIs. Interest among social investors is higher if investment is commercially priced but would constitute an only a small portion of any given portfolio. Many social investors have invested in below market rate funds.	Moderate to High.	Medium to Long.	Maximize profits. Invest in interesting things (e.g., racehorses, luxury homes, and microfinance institutions.	Publicly traded securities, private equity and debt, real estate, private equity, interest investments (e.g., luxury cars and homes, art collections, MFIs).	Medium to High.	Poor to high – conventional investors likely not interested; social investors would be very interested.	Several private investors (domestic and international) have made investments in MFIs. They are high-net worth individuals and some are professional investors. Prime targets for bonds, securitizations, and certificates of deposits. Some may make investment in MFI equity funds or directly into MFIs.	Grey Ghost Fund is aimed at coordinating HNWI social investors investments in MFIs. Several social investment professional have made investments on behalf of HNWI.
Moderate Net Worth Individuals	Individuals and families.	Low to medium – risk tolerance correlated to size of portfolio first, then age. Little interest both in developing country and MFIs. Interest among social investors is higher if investment is commercially priced, but would constitute only a small portion of any given portfolio. Many social investors have invested in below market rate funds.	Moderate.	Medium to long.	Maximize profits.	Publicly traded securities, certificates of deposit.	Low to medium.	Poor to high – conventional investors likely not interested; many social investors would be interested. Likely modest investments are hampered by lack of publicly available instruments and high transaction costs.	Several private investors (domestic and international) have made modest investments in MFIs via below market investment funds. Investments of this sort are more charitable giving than investing.	Oiko Credit and Calvert Foundation have many modest portfolio owners in their funds. Some private social investment professionals have also placed investors with modest sized portfolios in MFI funds.

Non-Commercial Investors	Investors - Owners of Capital	Risk Tolerance	Return Expectations/Needs	Time Horizon	Objective	Instruments	Transaction Cost Sensitivity	Potential Interest	Experience	Examples*
Specialized investment funds for MFIs.	Institutional, individual investors, charitable institutions, bilateral and multilateral development institutions.	High.	Medium.	Medium to Long.	Support the development of MFIs. Some provide debt and are passive investors. Others, though fewer, provide value added equity investments (i.e., capital and strategic advice at the governance level).	Private equity and debt.	Medium.	High - dedicated to MFI Investments, though some also invest in small businesses or financial institution serving small business as well. Tend to invest in established MFIs.	Several funds have over 10 years operating experience, many more over 5 years. A handful are new. Few operate commercially, most require subsidized rates. Almost all capital is invested below market rates.	MicroVest, ShoreCap, ProFund, LACIF funds, AfriCap, Oiko, Triodos.
Charitable Investors	Foundations, institutions, network organizations (e.g., ACCION, WWB etc.) .	High.	Low.	Medium to Long.	Poverty alleviation through the development of microfinance.	Grants, some low interest loans (e.g., program-related investments from foundations), and some equity.	Low.	High to low.	Poor to excellent. Charitable institutions have been key early investors in MFIs and MFI specialty funds and many continue to make good investment today. Many donors, however, continue to grant money to MFIs that do not necessarily need it or reinforce the image that microfinance is a charitable activity.	Ford Foundation, Mercy Corps, Freedom From Hunger, ACCION International, Opportunity International, <i>Allianza Noruega</i> .
Bilateral Aid Agencies	Taxpayers.	Moderate to high.	Low to moderate.	Medium to long.	Poverty alleviation through the development of microfinance.	Grants, private equity, debt and guarantees. Majority investments provided are grants (i.e., equity) for institutional development. Some guarantees and equity (normally via intermediary not-for-profit organizations or special investment funds or MFI support organization).	Low.	Moderate – many conflicting budget priorities make it difficult for microfinance professionals to access funds.	Poor to excellent. Donors have pioneered MFI investments. They have contributed the bulk of technical assistance that drove the development of the sector. Some donors continue to lend or invest outside of best practice and compete with commercial funders. Many donors also continue to grant money to MFIs that do not necessarily need it or to MFIs that would otherwise not exist (and take up valuable other resources). Donor involvement can also create image that microfinance is a charitable activity.	USAID, Sida, CIDA, DIFID
Multilateral Development Banks	Taxpayers via national government commitments.	Moderate to high.	Low to moderate.	Medium to long.	Support the development Of microfinance for poverty alleviation and national economic development.	Private equity, debt and guarantees, grants.	Low.	Moderate – many conflicting budget priorities make it difficult for microfinance professionals to access funds.	Poor to excellent. Currently the most commercially oriented investors in microfinance. Have invested in many MFIs and most MFI specialty funds. Can provide private sector with strong demonstration effect, (though few private sector investors have been attracted). Institutional limitations limit multilateral commercial effectiveness.	IADB, Asian Development Bank, IFC, World Bank, <i>Corporación Adino de Fomentometc</i> , UNCDF.
Apex Organizations	Tax payers via National governments and international development banks (e.g., IFC, IADB etc.).	Moderate to high.	Low to moderate.	Medium to long.	Support the development microfinance for poverty alleviation and national economic development.	Private equity, debt and guarantees, grants.	Low.	High – normally established with the explicit purpose of investing in MFIs.	Poor to excellent. Many development banks operate Apex funds that lend below market rates and terms and compete with commercial funders. Many also continue to fund MFIs that do not necessarily need it or that are not commercially viable or serving a social good that would merit subsidies. Apex involvement can signal that microfinance is not a commercial enterprise.	

Appendix Four – MFI Global Debt Market Projections

MFI Global Demand for Debt 2004 - 2009 Projected

	2004	2005	2005	2006	2007	2008
Regulated	436	850	1,047	1,290	1,589	1,957
Unregulated	228	489	606	751	930	1,152
Total	663	1,339	1,653	2,041	2,520	3,110

Growth of Microfinance Investment Funds - Annual Disbursements Projected

	2004	2005	2005	2006	2007	2008
Growth of Funds	125	138	151	166	183	201
Percentage to Debt	85	93	103	113	124	137
Percentage to Segment I	40	44	48	53	58	64
Percentage to Segment II	10	11	12	13	14	16
MFI Fund Debt Capital as a % of Regulated MFI Debt Demand	13%	7%	6%	6%	5%	4%

Assumptions
Regulated - MFIs with average portfolio of \$10m
Non-commercially funded portfolio is 20% of portfolio assets, of which 80% is funded by debt
Commercially funded portfolio is 80% of portfolio assets, of which 25% is funded by debt
Unregulated - MFIs with average portfolio of \$5m
Non-commercially funded portfolio is 30% of portfolio assets, of which 50% is funded by debt
Commercially funded portfolio is 70% of portfolio assets, of which 50% is funded by debt
Portfolio growth rate of 25% annually
Commercial capital share of portfolio 2004 70% (average)
20% of commercial capital is debt (i.e. not deposits)
Non commercial capital share of 2004 portfolio 30% (average)

50% non-commercial capital is debt
Growth Scenarios
30% non-commercial declines 5% annually
Commercial capital increases 5% annually
Total Fund Assets \$500 m
Annual disbursement 25% of assets
Total disbursements to debt 68%
Total disbursements to debt to Regulated 46.7%

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