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MICRO-FINANCE INVESTMENT FUNDS: LOOKING AHEAD

A paper for the 2004 KfW Financial Sector Development Symposium

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1 Introduction: Thesis and the Core Questions

There is no doubt that micro-finance in many developing countries is or is becoming a success story: growth rate of MFIs has been steadily high; market volumes are becoming sizeable; and professionalism and governance are making visible progress.

What are the future trends: What is the future of micro-finance? Will it remain stuck to the conditions of an informal market? Will it continue to be dependent on development finance? Will it be further characterized by isolated, rather small institutions, atomized but linked by a common philosophy of promoting socially responsible capitalism from the bottom?

Our main thesis is:

Due to the demand-pressure in the huge informal markets of developing countries, the micro-finance industry will grow rapidly and steadily and will soon become an interesting market for mainstream capital market institutions and investors. Additional products, technical and commercial innovations and assurance-mechanisms will specially attract big institutional investors. In this context, Micro-finance Investment Funds (MFIFs) in their different forms and structures will play a crucial strategic and operational (commercial) role in making this market efficient and effective. Even more important, however, will be the fundamental changes in framework conditions i.e. in the field of local savings, commercial law and property rights. Development institutions should, also, focus on these legal and institutional conditions while pulling back from soft financing of sustainable MFIs. They may still have a specific role to play in promoting new innovations and the risk mitigation linked to them.

The core questions that we would like to discuss in this paper are:

- *Which trends will influence the development of MFIFs?*
- *How will MFIFs be able to shape the future of micro-finance?*

2 MFIFs: The Critical Demand-Supply Link

Since its beginnings, micro-finance has struggled to raise resources to meet the demands from the millions of economically active poor households across the world. The size of this demand[1] and its perpetuity is such that only the commercial mainstream will be able to meet it. Over the years, the industry has made significant progress towards linking with the mainstream with its stress on commercial viability of Micro-finance Institutions (MFIs), awareness generation and even advocacy creating an interest among potential investors. The emergence of the MFIFs is perhaps the answer to the quests of the micro-finance industry.

[1] It is estimated that there are nearly 500 million households (source BlueOrchard, CGAP) that require access to micro-financial services. Even if we are to assume a conservative loan requirement of US$ 200 per such household, we arrive at a worldwide demand of US$ 100 billion as micro-credit.

In this paper, MFIFs are viewed as the essential missing piece in the micro-finance jigsaw – positioned appropriately between the supply (the investors and the capital markets) and the demand (the MFIs) with the requisite skills and distribution capabilities, they can act as the critical link between the sophisticated and resource-rich capital markets and the often remote and simple MFIs. Probably, the realisation of this inherent value has led to the mushrooming of many MFIFs working across the world. As of October 2004 there were 38 MFIFs[2] in operation with 5 more to be launched soon. In addition, there are 16 development agencies and foundations acting as active investors in microfinance.

MFIFs gain further significance in the context of the UN Year of Microcredit 2005 with a stated intention of building 'inclusive financial systems'. An important focus of these inclusive financial systems must be the participation of the international capital markets in micro-finance and if possible, the vice-versa as well. Of course, MFIFs, as the critical link between supply and demand, will be essential in achieving this end: it is partially through the enabling work of the MFIFs that the aims of the UN under the International Year of Microcredit and moreover the Millennium Development Goals of halving poverty and empowering women can be achieved.

In this role as the critical link, MFIFs link the capital markets with the small micro-entrepreneurs across the world. In effect, they may be seen to be linking *the informal economy with the formal economy and spell a formula for the sustained growth of the millions of low-income households trapped in the informal economy.*

In the subsequent sections, we attempt to answer the 2 core questions driving the paper and outline the complementary developments essential for micro-finance to realize its true potential and meet its demand.

3 Which Trends will Influence the Development of MFIFs?

In this section, we examine the trends—both emerging and desirable—that will significantly influence the development of MFIFs. The growth of the MFIFs is intrinsically linked to the development of the micro-finance marketplace i.e. the demand-side. Hence, these trends would need to be viewed from both the supply and demand perspectives.

3.1 Supply-side Trends: Entry of Mainstream Players

The supply-side is marked by a number of positive developments especially the entry of mainstream commercial players chiefly large commercial banks and institutional investors. Goodman (2004) provides an account of the growing involvement of the traditional financial sector players in micro-finance including commercial banks, pension funds and traditional investment funds. Building further on his account, we would like to emphasise the potential of the two most players whose involvement is the most critical for the future of MFIFs and micro-finance: the large or the ‘big’ financial players and institutional investors. We also attempt to assess the associated trends on the horizon.

[2] Goodman (2004)

a. **The big financial players:** The big players in the financial sector, probably, hold the key for unleashing the true potential of micro-finance. These big players consist of local and international commercial banks and financial institutions. These players can provide micro-finance:

- Access to capital: The big banks and leading financial institutions can provide essential capital to micro-finance. Banks with access to capital from the common public as depositors in addition to institutional investors are amongst the largest reservoirs of financial resources. Effective linkages with banks can provide the micro-finance industry the much needed capital to meet its demands. The case of Indian banks, which have taken a keen interest in financing MFIs, is noteworthy here. The National Bank for Agriculture and Rural Development (NABARD) in India, an arm of the central bank which encourages Indian banks to invest in micro-finance, reports that during the year 2003-04 Indian banks lent an equivalent of US$ 412 million to micro-finance Self Help Groups of poor women in rural areas.

- Access to capital markets: In addition to capital per se, banks can provide the micro-finance industry access to the capital markets by acting as intermediaries. For instance, banks can offer their investors opportunities to invest in micro-finance as part of a basket of investment opportunities thus indirectly providing MFIs access to capital. The Dexia Bank, which has floated the Dexia Microcredit Fund as an investment opportunity for its investors, is a suitable example in this context. The Dexia fund, aided by professional fund management, has leveraged investments to provide loans of US$ 75 million (cumulatively) to 50 MFIs in over 20 countries since its inception in 1998.

A number of large leading international banks have been engaged in micro-finance in various capacities including commercial and promotional with soft funding. Dexia Bank, Deutsche Bank, Citibank and ABN AMRO Bank are notable examples. With increasing awareness and the realisation of the market opportunity of micro-finance, it is likely that such banks would venture further with far larger commercial investments being made in micro-finance. Banks may envisage launching of commercial micro-finance funds possibly in consortiums with other banks with suitable structuring and guarantees—perhaps in partnership with development finance institutions—to attract a large number of investors.

b. **Institutional Investors:** Another set of potentially very large investors in micro-finance is the category of institutional investors. This category of investors consists of pension funds, traditional mutual and investment funds[3] and insurance and re-insurance companies. Pension funds in particular provide a suitable proposition for micro-finance investments. They are distinguished by their access to long-term 'patient' capital. Micro-finance provides suitable opportunities for such investments with low-defaults and stability in terms of returns. In addition, institutional investors have access to a substantial pool of

[3] See Goodman (2004) for examples of traditional investment funds acting as investors in micro-finance.

capital. Pension funds in the US, for instance, reached a formidable size of $ 4.8 trillion in 1995[4]. Estimates for the size of the same pension funds in 1999 were reported to be $ 7 trillion[5]. Even if 2-3% of the investments of these funds could be diverted to micro-finance as investments, the industry would more than meet its demands! Pension funds in Peru invested in Mibanco's bonds – buying 82% of a $6 million issue[6]. A Swiss Pension fund has also invested in the Dexia Microcredit Fund.

3.2 Demand-side Trends: Factors Influencing Market Development

The Micro-finance Institutions (MFIs) embody the demand for micro-finance and are the clients of MFIFs. Growth of the MFIs will directly influence the market opportunities of the MFIFs. We attempt to analyse the factors (or desirable trends) that will create larger markets for MFIFs:

- **Making local currency finance available to MFIs**

  While financial services may be made available from international sources including commercial investors, the MFIs would face issues of currency risks, as they do through current MFIF investments. Given this reality, it is important to promote the availability of local currency finance as a solution. Local currency finance could be mobilised through linkages with local commercial banks or via the route of deposit mobilisation from clients. This will, of course, require awareness building in the local markets and regulatory reforms to allow for deposit mobilisation. Developments in this regard are already noticeable with linkages being made between banks and MFIs for accessing commercial funding and a number of developing country governments engaging in formulating micro-finance policies[7]. Suggestions for fostering further such developments are detailed in section 5 on the critical importance of enabling framework conditions.

- **Long-term finance for MFIs**

  MFIs, like any financial institution, must have a minimum amount of their own capital or equity. This capital is required for leveraging more capital and for reducing the risk of its lenders and depositors. International standards on banking (for example those set by the Basel Accord) have specified a minimum risk weighted capital adequacy for banks. Similar standards must be applicable to MFIs also. It is likely that commercial investors would demand these standards when entering the micro-finance market[8]. The demand for

[4] Source: Joint Economic Committee, Congress of the United States, "Economically Targeted Investments", Issue June 1995. (http://www.house.gov/jec/cost-gov/regs/eti/solution.htm)
[5] Source: The International Herald Tribune, October 18, 1999. (http://www.iht.com/IHT/DIPLO/99/jf101899a.html)
[6] Source: Conger, Lucy, "To Market, To Market", Microenterprise Americas, Inter-American Development Bank, 2003
[7] Dr. Syed Hashemi of the CGAP reported 62 MFI-bank linkages in 36 countries and 50 countries working on micro-finance policies in his presentation at the ADB's Regional Workshop on Commercialisation of Micro-finance in May 2004 at Bali, Indonesia.
[8] ICICI Bank required a minimum capital adequacy of 20% when it agreed to invest in the equity of Bhartiya Samruddhi Finance Limited (BASIX) in India.

equity investments in this context is significant. For instance, Souza-Shields[9] estimates the capital requirements for equity investments in MFIs in Latin America to be over US$ 3.5 billion (based on the Basel recommendation of 8% equity of the total assets).

- **Meeting the complete credit needs of the clients along their growth track**

  MFIs must adapt their systems to meet the complete credit needs of their clients. This would imply being able to provide loans compatible with the needs of the clients. Most MFIs need to make intensive investments in promoting new and poor clients. Typically, these new clients—with low-levels of economic activity—start with very small loans, which in-turn implies high transaction costs for the MFI. With the growth of the economic activities of the clients, their loan requirements also increase. Most MFIs, however, do not cater to higher loan requirements and restrict their product range with a maximum permissible loan size. As a result, clients who have successfully graduated to a higher economic level would either be restricted to taking smaller than optimum loans or would look for alternative sources for the required loan. In the case of the latter, the MFI ends up loosing a valuable and less expensive client.

  MFIs should attempt to develop strategies to meet the credit requirements of their clients along the growth track of the clients to continue to benefit from their initial investments made in building the clients' capacities. Such a strategy may be implemented by the MFI itself with different internal divisions catering to different categories of clients or in partnership with other local banks on a fee sharing arrangement.

- **Promotion of more commercially viable MFIs**

  Despite our claims of a strong MFI sector with a vast outreach, the fact remains that only 250-500[10] commercially viable MFIs exist, perhaps, catering to 25 million micro-entrepreneurs[11]. To reach an estimated target market of 500 million micro-entrepreneurs[12], a large number of such commericially viable MFIs with the ability to interact with the mainstream commercial markets would need to be promoted. This process of promotion would include promoting new MFIs in regions which are yet unreached by micro-finance interventions and building capacities and training of existing MFIs for them to be able to transact effectively with the commercial markets.

- **Livelihood Promotion**

[9] Souza-Shields, Marc de, "Financing Micro-finance Solutions to Poverty", Enterprise Solutions Global Consulting, 2001. Paper presented at the Inter-American Development Bank's IV Forum on Microenterprise, November 2001.
[10] Estimates of MFIFs such as BlueOrchard. Additionally, the survey by CGAP and Mix revealed a similar picture which found that 39 of the 54 funds had invested in a total of 439 MFIs only; 150 of which had received investments from 3 investors.
[11] Assuming 50,000 active clients per MFI
[12] Source BlueOrchard, CGAP

Poor clients without adequate capacities to make productive investments would require access to technical assistance services. These services may take the form of training to build specific skills like marketing and financial management and promotion of economic opportunities specifically suited for the local context. Investments may also be made in enhancing the productivity of the local resources, which would impact the income earning capacities of the clients as well as the non-clients in the region. Development of watersheds, irrigation facilities and market linkages are suitable examples. Such activities may not themselves constitute micro-finance but would effectively work to create the grounds for micro-finance to flourish.

- **New Technologies and Innovations**

  Micro-finance is intrinsically a transaction cost intensive business and MFIs must constantly strive to develop more efficient solutions and methodologies through innovations. Solutions may lie in leveraging new technologies like Smart Cards, Biometrics, Point of Sale (POS) Terminals or Automated Teller Machines (ATMs). Action-research for the development of such innovations must be supported to increase the efficiency of micro-finance operations – reducing costs and increasing profitability.

  Learning from the commercial retail finance industry may also be helpful for MFIs in improving their efficiency. Credit scoring, for instance, is a technology used by the retail banks to determine the credit worthiness of retail borrowers based on characteristics of customers determined from an analysis of the past portfolio data. Many MFIs, especially the successful ones, have developed capable and detailed information systems maintaining portfolio history of all their clients for a number of years. These information systems can now be used to develop automated credit scoring systems to determine the credit worthiness of new clients, thus, lowering the costs of credit appraisals. Of course, credit scoring systems would not replace the existing micro-finance methodologies but complement them providing a better judgement of the risks.

The last 3 factors—promotion of commercially viable MFIs, livelihood promotion and the development of innovations including the use of new technology—would require promotional investments and are ideally undertaken by the development finance sector. The role of development finance is further detailed in section 6 of the paper.

4 How will MFIFs be able to shape the future of micro-finance?

Answering the second question on how the MFIFs will be able to carry out their role as the ‘critical link’ involves understanding the important success factors affecting MFIFs.

At the same time, MFIFs must address the important risk factors affecting the industry. Thys and Barres (2004) provide a detailed analysis of the risks faced by MFIFs including credit risk, country risk, currency risk, operational risk, risk to reputation and liquidity risks. Apart from these risks, we would, like to highlight another risk: the risk associated with fast and dynamic growth. The micro-finance market is currently witnessing growth at a very high rate (20-40%) with a large diversity in structures and frameworks present across the world. Mistakes made at this stage could have severe repercussions for the future of the players and the entire industry. Such a risk makes it vital for MFIFs to properly consider and implement the success factors.

In this section, we analyse two sets of success factors: success factors at the organisational-level i.e. the MFIF per se and at the industry-level.

4.1 Success Factors for MFIFs: Organisational-level

A number of MFIFs have been started to meet the needs of the MFIs. However, being in their nascent stages, most of the MFIFs are fairly small. Building a minimum break-even size is essential for the fund to be viable and eventually successful. At the same time, being juxtaposed between MFIs and investors, there are a number of other issues as well that successful MFIFs need to bear in mind.

- **Achieving a sustainable size:** A minimum break-even level of investments would be necessarily required to make MFIFs commercially viable. Hence, MFIFs need to achieve the break-even level or a minimum sustainable size in their micro-finance investments. Goodman's pioneering study (2003) on MFIFs analysed the size of MFIFs vis-à-vis the minimum sustainable size of typical commercial funds. His findings are that the minimum sustainable size of commercial funds is typically $20-30 million. Compared to this, most of the MFIFs are found to be far below the sustainable size. An analysis of the 38 funds considered by Goodman (2004) reveals that only 9 funds (only 24%) out of the 38 have an asset base of US$ 20 million or more. Some of these funds have invested in other markets as well. A more dramatic picture is revealed when we look at the purely micro-finance investments of these funds – only 5 funds have reached a micro-finance asset base of US$ 20 million or more. MFIFs need to find strategies to overcome this issue. A possible route is of consolidations with funds of similar profiles and objectives.

  Size of the funds is also critical for attracting investors. Pouliot (2004) illustrates the importance of the size of funds in attracting investments through the case of institutional investors (perhaps the most promising for micro-finance): institutional investors would not hold more than 5% of a fund; with most funds below the $ 20 million threshold, investments in funds from institutional investors would typically not be more than $ 1 million. This low investment size would in-turn lead to inflating the Total Expense Ratios (TER) of the investment – hence serving as a disincentive for the invertors.

- **Development of effective distribution capabilities:** Distribution in the context of MFIFs needs to be viewed in two perspectives: the upward distribution to reach investors and enhance the size of the fund and the downward distribution to reach the MFIs.

  a. Upward distribution – to investors: The following factors would influence the success of the fund's distribution to investors:
     - The nature of the agency hosting and offering the fund to investors: The offering agency must be a credible one that will provide investors a adequate sense of safety and comfort. While there are a variety of agencies that can play this role, existing commercial banks

with established credibility and an extensive outreach to potential investors might be ideal candidates for hosting such funds.
- Incentives for the offering agency: It is also important to provide for adequate incentives to the offering agency to continue to host the fund and attract investors to it.
- Providing a clear message for its investors including providing a clear risk-return profile on the investment product

b. Downward distribution – to MFIs: Given the geographical dispersion of MFIs, achieving a cost-effective distribution is a daunting challenge for MFIFs. Keeping distribution costs low is essential, as high distribution costs would directly impact the pricing of services to the MFIs. Highly priced services for the MFIs in-turn impact the profitability of the MFI ultimately leading to poorer growth in their outreach. Solutions for lowering distribution costs may again lie in the concept of consolidating funds. Specialist agencies for the distribution of the funds may be promoted. Such agencies playing a role similar to asset managers would be able to manage the distribution of a number of funds together, hence lowering the costs per fund. Better distribution reach may also be achieved by stronger networking among funds. Such networking will also lead to reduction of costs. Use of credit ratings and consortiums of investors are common features in commercial corporate lending. It is possible to adopt similar approaches in micro-finance as well wherein MFIFs join hands on specific deals and reduce their costs of assessment and monitoring.

- **Professionalism:** The management of the MFIFs must have a clear commercial orientation for the scalability of the MFIF per se and for micro-finance as a whole. This will require a high degree of professionalism. The required professionalism entails developing a high quality of:
    - Appraisals systems developed for evaluation of potential investments (deal sourcing)
    - Monitoring and management information systems (MIS) maintained
    - Networking with MFIs and others in the industry
    - Knowledge of the local micro-finance industry's requirements accompanied by world-class asset management skills
    - Innovation in products and services to meet the industry requirements
    - Skills to raise capital from investors
    - Asset Liability Management

  Such requirements would require that MFIFs design an organisation structure that can accommodate professionals from the micro-finance industry as well as the traditional financial industry.

- **Governance:** Governance is an important issue in the management of any business. In the case of the MFIF industry, which is still in its nascent stages, governance assumes even greater importance[13]. Governance in this context would include:

[13] Please see Pouliot (2004) for a detailed analysis of the importance of strong governance systems in MFIFS and the strategies for achieving the same.

- Use of appropriate legal structures[14] and clear objectives of the MFIF for it to be able to attract and receive investments from a variety of investors and provide them returns.
- Able supervision and control of the management of the MFIF including providing performance incentives/disincentives to the management
- Influencing the governance of the investee MFIs if required to do so
- Reviewing portfolio quality and composition ('portfolio mix') on a regular basis to ensure compliance with the investment strategy.
- Maintaining high levels of transparency regarding the management and performance of the MFIF. High levels of transparency would provide current and potential investors an insight into the performance of the fund and encourage more investments.
- Ensuring accountability and reporting to the investors regarding the management of the fund. Given the nature of the industry and the social interest of many of the investors, reporting on social performance of the fund also needs to be ensured. Most MFIs do not, as yet, have standardised systems in place to report on their social performance. The governance of the investing MFIFs must work to ensure that such standardised systems are developed and implemented for the purposes of maintaining high standards of accountability of the MFIFs.

4.2 Success Factors for MFIFs: Industry-level

With the growth of MFIFs—keeping in mind important success factors and leveraging of the likely positive trends on the supply-side—it is possible that MFIFs will be able to make a substantial difference to the micro-finance market. However, MFIFs will need to work on some important areas to be successful and attract investors:

- **Creation of Suitable Products: Leveraging Securitisation and Financial Structuring**

  Mobilising resources from institutional and private investors is essential and appropriate instruments must be developed towards this end. One such instrument that has been successfully pioneered is the issue of bonds. Leading NGOs and MFIs such as Bangladesh Rural Advancement Committee (BRAC), Bangladesh; Compartamos, Mexico; Financiera América (Finamerica), Colombia; Banco Sol, Bolivia and Mibanco, Peru have issued bonds in their domestic markets. Commercial banks with increasing interest in micro-finance can also offer solutions. ICICI Bank, the largest private sector bank in India, undertook the world's first micro-finance securitisation when it bought out a portion of the portfolios of BASIX and Share Microfin Ltd in 2003. ICICI was further able to sell down this portfolio to another commercial bank.

  Such instruments have shown the way for facilitating investments and further innovations along these lines would need to be fostered. MFIFs with financial sophistication and in-depth understanding of the expectations of investors can be the ideal agents carrying out such innovations to mobilise capital – viewing it as an *alternative* to the existing route of raising direct investments from

[14] Goodman (2004 – Page 9) illustrates the need for appropriate legal structures with the example of Incofin, a co-operative company in Belgium, which after realising the restrictive nature of a cooperative is now transforming itself into a Luxembourg investment fund to be able to attract investors.

investors. Financial structuring and suitable partnerships can create a diversified range of products catering to different investor profiles. The world's first international micro-finance securities issue by BlueOrchard is a case in point. This recent (July 29, 2004) securities issue in the US markets undertaken by BlueOrchard in collaboration with the US government's Overseas Private Investment Corporation (OPIC), JP Morgan and Developing World Markets managed to raise over US$ 40 million and provide long-term debt capital to 9 MFIs in 7 countries. The issue illustrates the importance of both: strategic partnerships and financial structuring. The issue brought together a number of different actors with an appropriate mix of roles: while BlueOrchard, with domain expertise in micro-finance, launched a Special Purpose Vehicle (SPV) to issue the securities and provided the professional management and distribution capability; OPIC, a development finance institution lent credibility to the effort by providing a guarantee[15] and JP Morgan Securities joined the effort to make distribution to the institutional and private investors possible. The issue succeeded in attracting institutional, private and social investors. Financial engineering including using subordination tranches to attract commercial institutional investors to the Senior Notes[16] ensured that the investors were able to access a range of investments in the form of securities with varied risk-return profiles. This issue in many ways shows the ideal future course that micro-finance must chart if it has to fulfil the demands of the millions of unmet clients. Similar issues and financial structuring would need to be repeated in different contexts to raise capital from a wider range of investors[17].

MFIFs should also consider securitization of the existing portfolios of MFIs. An SPV launched exclusively for this purpose could issue notes backed by loan portfolios of a number of MFIs that are selected keeping in mind the need for diversification across countries, regions and currencies. Here again, credit enhancements provided by development finance institutions would work to enhance the appeal of such issues. In addition to capital, such securitisation deals would provide capital relief to the MFIs, which will be able to continue to increase their outreach without negatively affecting their capital adequacy ratios.

A related possibility that can be explored is of securitisation of existing portfolios of MFIFs and banks. Many domestic banks—in India for instance—that have been active in micro-finance can consider securitising their micro-finance portfolios. Packaging of these portfolios with credit enhancements would provide for ease of distribution to institutional investors internationally – thus bringing in additional investments in micro-finance.

Going ahead, securitization and further innovations in financial structuring will play a critical role in expanding the opportunities for MFIFs. Additionally, partnerships with a range of institutions such as guarantors, credit insurers and credit rating agencies will help MFIFs significantly expand their marketability.

[15] The OPIC, actually, issued fully guaranteed Certificates of Participation (COPs) to institutional and private investors and invested the inflows from the COPs in the issue. In effect, providing a guarantee to these new investors for their investments in micro-finance.
[16] Goodman (2004)
[17] BlueOrchard is planning a second closing of the issue by end of 2004.

The importance of the roles of such institutions in providing suitable mechanisms for creating conducive conditions for investors is discussed below.

- **Creating Suitable Conditions: Enhancing Investor Confidence**

Conditions making for a conducive investment environment would need to be created. Such conditions entail providing risk mitigation to investors, enhancing credibility of the MFIFs and their products and development of transparent reporting systems. Possible mechanisms of creating such conditions include:

i. Risk mitigation through guarantees: Provision of guarantees from large and credible institutions including governments and development finance institutions can serve to mitigate the risk of investors and can help attract new investors to the micro-finance marketplace.

ii. Credit Insurance: Credit insurance is common in the commercial financial sector. Application of similar instruments in micro-finance can be used to create investor confidence. Credit insurance may be undertaken at the level of an entire portfolio where, for instance, all losses beyond the first 15-20% may be insured. Insurance and re-insurance firms such as Swiss Re could provide such forms of insurance. The insurance from such a firm would serve as a 'quality seal' of the investment product increasing its attractiveness to large institutional investors who might not yet be familiar with the micro-finance industry or the MFIF managing the investment product but may be willing to consider investments based on this quality seal serving as a recommendation.

    Such credit insurance can also be used in combination with securitisation issues as a credit enhancement wherein the credit portfolio being securitised can be insured to increase the investors' comfort.

iii. Credit Ratings: Commercial investors, especially banks and institutional investors, have standard practices for credit appraisal, which includes rating of potential investments. Providing credit ratings from international rating agencies such as Standard & Poor (S&P), Fitch or Moodys to these investors would enhance the compatibility with their appraisal systems and increase their confidence. MFIFs—and perhaps MFIs too—must aim to get themselves and their portfolios rated by credible and recognised rating agencies. Compartamos in Mexico, for instance, chose to get its bond issue rated by S&P, which gave the issue a high rating in the Mexican markets[18]. The high rating, perhaps, enabled Compartamos to issue its bonds worth $ 15 million in the domestic markets reaching both private and institutional investors.

Another important condition for enhancing investor confidence is making the investor community aware of the lower risks of micro-finance investments including the low-default risk and the low-correlation with volatility in the larger financial markets. Creation of this condition will require investor education and

[18] Conger (2003)

has been also discussed below under effective marketing and communication for promoting micro-finance investments.

- **Creating Fund of Funds Structures: Increasing diversification**

  Higher levels of diversification of the portfolio may be provided to the investors through the creation of a fund of funds. This would entail creating a fund that assesses and invests in selected MFIFs and diversifies its risks over distributors and geographies. The responsAbility Global Micro-finance Fund and the Positive Investment Fund are the first initiatives in this direction. Of course, the concept of fund of funds in micro-finance—including these two funds—is still in a trial-and-error stage of development and the fruition of the concept may still be years away. The development of this innovative concept, however, can have significant implications for the development of the micro-finance marketplace.

  Going ahead, a number of such funds could be promoted by banks themselves. Such a fund of funds would be able to attract a large number of commercial investors leveraging the credibility and reputation of the bank accompanied by a high level of diversification of the portfolio. In-effect, a number of MFIFs would be able to obtain access to capital.

  It is also possible to develop similar structures of funds investing across industries. This way the existing market credibility of an established industry may be leveraged to attract investments in micro-finance. For instance, a fund of funds focussing on sustainable investments may include an MFIF in its portfolio as well. As a result, the MFIF would be able to mobilise investments from investors who may not as yet be interested in making a direct micro-finance investment only.

- **Creating Networks through Equity Participation**

  Creating networks of MFIs through equity participation is a potential strategy for building successful MFIFs while creating a strong demand-base of MFIs as well. Pursuing such a strategy would entail making equity investments in selected MFIs to acquire a significant stake and subsequently playing an active role in the governance of the invested MFIs – driving them towards sustainable growth and profitability. Such an approach implies a long-term commitment to the invested MFIs.

  MFIFs with deep knowledge and experience of promoting sustainable MFIs are well suited to adopt such a strategy. With the experiences and learning with its initial investments, the MFIF can go on to build a network of strong MFIs that are able to reach a large clientele by accessing commercial investments on a sustainable basis.

  Internationale Micro Investitionen Aktiengesellschaft (IMI) AG and the ACCIÓN Gateway Fund are notable examples of MFIFs adopting such an approach. IMI has been able to build an asset base of Euro 46 million with investments in 18 MFIs[19]. The average return on equity (RoE) of the invested MFIs is projected to

[19] As of June 2004. Source: IMI Website (http://www.imi-ag.com).

be 14% by December 2004. The network of these 18 MFIs (mostly registered as local banks) was able to reach a combined portfolio of Euro 813.4 million or US$ 1 billion[20]. IMI plans to have a common name (ProCredit Bank) and corporate identity for all its invested MFIs so that they may benefit from the combined brand equity.

At the same time, the control and participation in the governance of the MFI gained through equity investments may be a temptation for existing fixed-income investment funds to venture into equity investments. Perhaps, it is this temptation that has led 26 of the MFIFs surveyed by CGAP to invest in both debt and equity. However, as Pouliot (2004 page 8) illustrates, this "twin capital approach" of providing debt and equity is a 'potential minefield of conflicts of interests' and can have 'dangerous' consequences. Such a tendency must be avoided by MFIFs.

- **Creating Effective and Standardised Systems of Reporting including Social Reporting**

  Due emphasis has been laid previously by Pouliot (2004) on the importance of high-levels of transparency and accountability as a product of good governance. Reporting to investors becomes an essential task for attaining high standards of transparency which in-turn provides comfort to investors. The industry, still in a nascent stage, needs to develop standardised systems of reporting with common definitions of key performance ratios that will provide commercial investors greater comfort with their micro-finance investments[21].

  Additionally, stress must be laid on a special aspect of reporting in micro-finance: reporting on social returns.

  - Micro-finance is promised as an investment with a double bottom line including economic and social returns. A large number of investors, especially private investors, who enter the micro-finance market, do so with social objectives. However, no universally acceptable standards exist for reporting on the social performance of micro-finance investments. Research to develop appropriate cost-effective and universally acceptable systems for tracking meaningful and significant social impact or 'social returns' needs to be supported. The research results need to be then taken forward to create a consensus among the varied categories of investors and promoters of micro-finance. Further, reporting on social returns must be integrated with the rating of the MFIFs to present a complete picture of the likely performance of the MFIF.

- **Effective Marketing and Communication**

  Like other businesses, effective marketing would play a vital role in the growth of MFIFs as well. Being in its nascent stages, the MFIF industry requires an even greater emphasis on marketing and communication to attract investments. A key role of communication at this stage is building greater awareness about

[20] As of June 2004.
[21] See Goodman (2004) for the need to develop standardised industry-wide definitions of key performance ratios for MFIFs.

micro-finance as an investment opportunity and the actual (low) risks associated with it.

An important issue that MFIFs need to address is the high perceived-risk of micro-finance investments. The perceived risk of micro-finance investments is high due to the unconventional form of this business and the local country risks that often are superimposed on the industry. At the same time, the returns are only moderate (200-300 basis points over the LIBOR) creating a risk-return mismatch in the minds of potential investors. Marketing and communication campaigns must focus on generating awareness and addressing the concerns of the high perceived-risk in micro-finance. Specifically, the low-default risk, the low-correlation with volatility in the financial markets and a certain level of independence from the commonly perceived local country risks need to be highlighted to increase the attractiveness of micro-finance investments.

Focussed efforts should be made on specific types of investors. Institutional investors that represent, perhaps, the most promising group of investors may be the first priority of such efforts.

5 Critical Importance of Enabling Framework Conditions

Apart from successful MFIFs that keep in mind important success factors, risks and important issues (such as those discussed above), success of MFIFs and in fact of entire economies will necessarily require enabling framework conditions that govern the actors in the market. Framework conditions at the local level directly influence the growth of MFIs and the local population, which in-turn leads to the growth in the potential market available to MFIFs. In this section we look at important areas requiring reforms for progressing ahead.

5.1 Reforms in the Local Financial Sector and Banking Law

Reforms in the local financial sector and the banking law can have direct implications for the development of the micro-finance market. The removal of interest rate restrictions, elimination of subsidised and directed lending and the creation of specially designed legal structures to recognise and include micro-finance in the financial sector are notable examples of such reforms. Countries with progressive and liberal frameworks for micro-finance will be able to develop stronger and larger micro-finance markets meeting the essential needs of millions of low-income households. Of course, such vital regulatory reforms will need to be carefully conceived and properly implemented. A recent study by Loubière et al. (2004) that compares financial sector liberalisation and reforms in different countries shows that Bolivia with progressive reforms and liberalization was able to create a larger micro-finance market than Colombia whose regulatory framework maintained features of a non-liberalized financial system including interest rate controls and directed lending. This contrast with Bolivia is striking especially when one considers that Colombia's population being 5 times that of Bolivia.

Reforms in the banking law can also work to enable MFIs to access domestic capital including through deposit mobilization and linkages with local banks and financial institutions as discussed below.

5.2 Accessing Domestic Capital

Access to domestic capital is an important factor influencing the growth of MFIs. Domestic capital has the inherent advantage of having its sources in the immediate vicinity of the MFIs (hence implying lower operational/monitoring costs for the suppliers) and, importantly, no currency risk. Despite these advantages most MFIs are unable to access domestic capital. We look at the reforms needed to progress on this front:

5.2.1 Enabling Deposit Mobilisation

In our attempts of making MFIs viable financial institutions playing a role akin to local banks we tend to overlook the need to have sufficient provisions for the MFIs to mobilise deposits from the local community like local banks are able to. MFIs using deposits to finance the micro-loans will also be able to reduce their cost of funds and increase their profitability. In addition, savings are a very valuable financial service for clients — arguably even more important than credit in the case of the poorest clients. Providing access to saving services would thus be a boon for the clients and the MFI alike.

However, most banking regulators do not permit MFIs to mobilise deposits from their clients. As a result most of the MFIs are reduced to being purely micro-credit providers dependent fully on debt from other external institutions for financing their operations. Of course, the grounds for not allowing any non-bank finance company to collect deposits are not unfounded, but its important to look specifically at the case of MFIs and make suitable exceptions. Allowing deposit taking in itself is a subject of much research[22] and debate and we believe that this research in this important issue must be given utmost importance. However, in the meanwhile, simple solutions may be experimented to allow MFIs in specific contexts to start mobilising deposits, albeit in a limited way:

- Deposit taking may be permitted to institutions which have a limited and closely knit clientele, that would otherwise — being remote — have no other access to saving services or in fact may be forced to make deposits in high risk and non-productive forms.

- Deposit taking may be allowed to a limited extent (maximum deposit mobilised being only a fraction of the loan given to the depositor) to MFIs that have established a track record of high recovery rates with no defaults to their lenders. In addition, high level of minimum capital requirements may be set to provide for greater security of the depositors.

- More lenient standards may be set for issuing banking (deposit taking) licenses to well established MFIs with a history of maintaining a high quality portfolio along with demonstrated excellence in governance and management. Such concessions would allow successful MFIs to expand their outreach, lower costs

[22] Robert Peck Christen, Timothy R. Lyman and Richard Rosenberg in their paper, “Guiding Principles on Regulation and Supervision of Micro-finance”, CGAP, July 2003 provide a detailed analysis of regulation and supervision issues in micro-finance with possible alternatives and policy recommendations.

and thus benefit many more clients. In effect, MFIs would be provided an incentive to maintain high-levels of performance and governance.

5.2.2 Linkages with Local Banks and Financial Institutions

Though savings from clients would contribute to the growth of the MFIs, an even greater contribution can come through linkages with the local commercial markets – consisting of banks and financial institutions. Over and above reforms in the financial sector (mentioned earlier), local governments and central banks also have a vital role to play in this context by creating enabling framework conditions to encourage the local banks and financial institutions to invest in the micro-finance market. This encouragement may take the form of incentives for micro-finance investments and sometimes even 'disincentives' for low-levels of investments in micro-finance. Incentives may be in the form of tax-breaks, special rewards, recognition and concessions if possible. On the other hand disincentives may also serve the purpose well. The Reserve Bank of India, for instance, has set a strict requirement of 40% of all net bank credit to be invested in the 'priority sector'. The priority sector includes agriculture and micro-finance apart from other important areas like infrastructure investments. This requirement has forced local banks to consider the micro-finance markets seriously. As a result of this many Indian banks have realised the potential of micro-finance and are now, in fact, driving micro-finance ahead — a trend that would perhaps continue even without the central bank's directive.

However, in order to invest in micro-finance, the local banks themselves must themselves be able to attract deposits to enhance their own resources. This will require boosting the confidence of the common public in the local banking system. Stronger central banks with demonstrated measures for safeguarding the interest of the depositors would need to be established in economies with low levels of savings, and hence low confidence of the common public in the banking systems.

5.3 Progress in Property Rights and Commercial Laws to Facilitate Transactions

The task of building a sound and ‘inclusive’ banking system would be incomplete if we are to only stress on reforms affecting the banks per se. The overall policy and regulatory environment may need to be reviewed carefully for its ability to facilitate commercial transactions. People must be able to transact effectively with the banking system and with each other for undertaking financial and business transactions for the economy to grow. To do so people must be able to leverage their assets as security for obtaining loans and for guaranteeing their obligations under contracts. In many countries, however, this is not the condition as property rights do not facilitate commercial contracts to be underwritten. Reforms in this area are a first priority in such countries.

The work of the *Instituto Libertad Y Democracia* (ILD), Peru is noteworthy in this context. ILD works to build inclusive property systems wherein the businesses and assets of the poor may be recognised under the law and their records adequately standardised for them to be able to transact with the formal economic systems. ILD's work has revealed eye-opening facts. For example, ILD's diagnosis in Egypt found that 90% of the population held their assets outside the law and thus were not part of the formal economy. Suitable reforms were suggested by ILD the implementation of which will make for an inclusive economy with the potential to offer growth for all. ILD also aims to make the processes of legalisation more pragmatic and effective.

6 Complimentary Role of Development Finance Sector

In the wake of the evolution of micro-finance and the need to mainstream it by aligning it with the mainstream financial markets, there is a need to review the role that should be played by the development finance sector (hence forth referred to as 'development finance') consisting of donor agencies and other development finance institutions. Development finance has—undeniably—played a pivotal role in developing and promoting micro-finance and bringing it to this stage. The role of development finance will continue to be critical for micro-finance but its nature may need to be adapted to enable the growth of MFIFs.

6.1 Suggestions for the Role of Development Finance

The following are specific suggestions for the role of development finance in the mainstreaming of micro-finance:

a. Supporting the building of enabling framework conditions

As has been stressed upon before, creation of enabling framework conditions is critical for development. Development finance can influence the development of enabling legal and regulatory frameworks by:

- Undertaking policy advocacy and lobbying with local governments and central banks
- Working together with central banks and local governments and supporting research to find solutions for MFIs' demands for mobilising deposits
- Supporting reforms in the area of property rights and commercial laws in specific countries.

b. Creating a conducive investment environment: Provoking its own substitution

The creation of a conducive investment environment has been identified as an important success factor for the MFIFs at the industry-level. Development finance can play an important role in the creation of a conducive environment by:

- **Itself exiting from the financing of sustainable MFIs:** Development finance must withdraw from the financing of commercially viable and sustainable MFIs creating room for commercial players to enter. It is of course 'tempting' for both donors and MFIs to use soft money and meet their respective targets. However, this temptation must be controlled for the for the following reasons:
  - Soft money may 'spoil' the MFIs with easier conditions and hence weakening the ability of the MFIs to effectively transact on commercial terms. Sousa-Sheilds (2001) provides an insight into the ill effects of using soft money: "…subsidies impose long-term structural limitations on the growth and development of the micro-finance sector. In particular, the relative availability of inexpensive money discourages

institutions from even bothering to tap private capital markets. "

- Despite the progress made thus far, the number of MFIs with proven track records and established commercial viability is still small. Financing of sustainable MFIs with soft money may work to crowd out the serious—and potentially large—commercial players from this niche market and in turn discourage them[23].

- **Risk mitigation by providing guarantees to encourage new investors** to venture into micro-finance: In the emerging scenario marked by securitisation and structured investment funds, development finance could serve as guarantors by co-investing as junior note holders and investors in subordinated tranches. The role of OPIC in the case of the BlueOrchard securities issue is illustrative of the role that development finance can play.
  - Development finance agencies individually or perhaps in consortiums may promote specialised guarantee funds providing guarantees in securitisation deals, thus encouraging this important trend.
  - Development finance can also explore public-private partnerships in carrying out this role wherein partnerships may be forged with private sector institutions such as insurance companies to launch guarantee funds for micro-finance.

- **Promoting higher standards of governance and management:** Development finance can provide technical assistance to MFIFs to promote higher standards of governance and management in this nascent industry. This may be done through training programmes designed to raise managerial capacity and improve fiduciary practice.

- **Promoting rating of MFIFs and MFIs by recognised rating agencies:** Such ratings would provide comfort to commercial investors regarding the portfolio quality, governance and management of their investments. A continuous system of ratings will eventually lead to the promotion of transparency enabling potential and existing investors to better understand the micro-finance market. At the same time, the need for obtaining high ratings to attract investors would promote greater standards of management and governance among the MFIFs and MFIs.

  Given the unconventional nature of the micro-finance market, it is likely that rating agencies will need a special orientation to better understand and develop systems for rating the micro-finance players. This is clearly a role that development finance must undertake.

- **Promoting systems of tracking and reporting on social returns** to provide social investors a better sense of their returns. Efforts must also be made to integrate reporting on social returns with the rating of MFIFs and MFIs thus ensuring that MFIFs and MFIs retain their focus on their social objectives while pursuing necessary commercial ends. An integrated rating

[23] See CGAP Donor Brief No. 3, May 2002 which quotes the experience of a social investor who lost a deal with a promising MFI explaining "…we were offering them a loan at 24-months maturity for a rate of Libor + 4.5%… We were driven out by an international donor which was offering the same amount, at 15 years horizon, 5 years grace period, a nominal interest of 5%, and an additional 100,000 USD gift for technical assistance."

accounting for financial and social performance may be an ideal mechanism for checking mission drift of MFIs.

- **Marketing and communications to promote commercial investments:** In its efforts of mainstreaming micro-finance, development finance needs to focus on building awareness about micro-finance as a new market opportunity among commercial players including commercial banks, institutional and private investors. Focussed international events and special forums targeting investors may be organised as part of this awareness generation campaign.

c. Continuing its promotional role for creating a stronger MFI demand-base

With the large unmet demand for micro-financial services across the world and only a few strong sustainable MFIs existing a lot of efforts will need to be devoted to developing the capacities of the marketplace – the MFIs and their clients. In section 3.2 we noted the many factors that would contribute to the creation of a stronger micro-finance demand-base. Many of these factors involve capacity building and undertaking promotional roles, which must be undertaken by development finance/donor agencies. The suitable strategies for development finance in promoting a stronger demand-base are summarised below (based on the factors detailed earlier in section 3.2):

- **Promotion of more commercially viable MFIs** including promoting new MFIs in yet unreached markets and training and building capacities of existing MFIs to become sustainable.

- **Promoting livelihoods** of the poor by building the productive capacities of people and their resources.

- **Promoting the use of new technologies** like Smart Cards, Biometrics, POS terminals and ATMs aimed at the poor and remote clients.

- **Encouraging innovations in methodologies** including the promotion of efficiency-enhancing measures like credit scoring.

6.2 The Need for Clear Delineation of Roles

Development finance must focus on developmental including capacity building roles. These may include support for innovations, risk coverage, promotion of sustainable MFIs, livelihood promotion for the poor and advocacy to support creation of suitable frameworks. However, it must clearly vacate the field of direct financing of sustainable MFIs for commercial actors and at the same time create conducive conditions for commercial actors to come into play. Development finance institutions—working in concert through consortiums and forums—must engage in a dialogue with MFIFs and investors to arrive at standard guidelines for their respective complimentary roles.

At the same time, there are arguments raised about the potential role for development finance even in a commercialised micro-finance sector. These issues are open for debate but our views are presented below:

- Checking for mission drift: With increasing commercialisation and stress on profitability, its is possible that MFIFs and in-turn MFIs may choose to focus on bigger customers and go up-market deserting the smallest and poorest borrowers. It is argued that development finance institutions can play a role to check such mission drift by continuing to be stakeholders in MFIFs and ensuring that investee MFIs adhere to their target markets. On the contrary, as we have recommended earlier, development finance should focus on promoting the development of rating systems for MFIFs and MFIs that lay due stress on social performance including the poverty level of the clients reached. This is important since, eventually, the commercial investors must themselves drive the industry ahead. Investor awareness (pertaining to social performance) in this regard will be critical. This is, of course, another role for development finance that has been stressed earlier.

- Providing stability: Another argument for development finance institutions to invest in MFIFs is for providing long-term and patient capital to protect the micro-finance industry from market volatility and panic exits of private investors.

  We believe that since the eventual idea is that the markets must get involved and drive micro-finance ahead, positioning development finance agencies, as stakeholders of the funds may not be the best solution. In fact, investments from development finance are likely to lead to the dilution of the commercial motivation of MFIFs. However, panic exits of purely commercial investors cannot be written off. Perhaps development finance institutions in a role akin to central banks in the case of the commercial banking sector can maintain reserves to bail out the MFIFs/MFIs when such flight of capital happens.

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