Financing Microfinance

Exploring the Funding Side of Microfinance Institutions

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Foreword

The Latin American microfinance industry is undergoing rapid change. The appearance of an increasing number of specialized formal microfinance institutions, created through the re-constitution, or "transformation", of nonprofit foundations, is driving new developments in the industry. These institutions are growing fast and need significant funds to support their growth. As regulated entities they have many different options as to how they fund themselves; they are also under greater pressure to correctly manage currencies and term-structures in their balance sheets.

Traditionally, the support of the Inter-American Development Bank and other donor agencies has focused on developing and strengthening the asset side of microfinance institutions: their products, delivery mechanisms, information systems and human resources. Now more attention is being paid to the funding side of these institutions; given the rapid growth of the industry, both in terms of portfolio and number of institutions, it is an issue that cannot be ignored.

So far, relatively little has been written on what is going on in the microfinance industry in terms of its funding. Few trends have been documented and many issues remain to be resolved; however, some controversies are already surfacing. For example, some observers have voiced concern and disappointment about the seeming inability of transformed microfinance institutions to ramp up savings services for low-income populations. Is this true and, if so, why?

This paper aims to reveal some basic trends in the financing of microfinance institutions—where it comes from and how it changes over time. The paper does not claim to be a comprehensive review of this topic, but it offers some new information and points to some previously unexplored patterns. The paper also identifies and examines key emerging issues that face the increasing number of transformed microfinance institutions, including access to capital markets, greater reliance on foreign currency liabilities and the search for additional equity.

Essentially, this paper represents an effort on the part of the Inter-American Development Bank to understand the direction and future funding needs of the microfinance industry. Considerable thought and effort will undoubtedly be required to properly situate donor agencies within the general trend of increasing commercial involvement in the financing of microfinance. However, our goal remains the same: to encourage the long-term sustainability and expansion of the industry.

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Exploring the Funding Side of Microfinance Institutions

SIZING UP THE SECTOR

During the past ten years, the Latin American microfinance industry has established itself as a dynamic and fast-growing segment of the region's financial markets. As a result, what once was a relatively obscure grassroots movement has become a topic of major importance in many national development strategies.

In the region, there are today several hundred institutions that specialize in microfinance, plus more than a dozen commercial banks that seriously target this sector ("downscaling"). Most of the specialized institutions operate as nonprofit organizations, though an increasing number of them are "transforming" into licensed and supervised financial institutions.[1] Overall, the Latin American microfinance industry today sports a combined microenterprise portfolio of about $1.5 billion and serves approximately 1.5 to 2 million clients. In addition, there are also many credit unions, numbering approximately 5,800 in the region, that serve microenterprises.

Of the institutions serving the microenterprise sector, 97 operate as fully specialized financial institutions (subject to bank supervision). Most of these specialized and supervised institutions have been created through the transformation of nonprofit foundations, though there are some exceptions to the rule.[2] They operate as shareholder-based companies (banks, finance companies or other) and tend to be dynamic, fast growing and profitable. In most cases, they easily outpace the performance of commercial banks in their respective countries, in terms of growth, loan delinquency and finan-

Specialized and Licensed Microfinance Institutions (US$)

Country	No. Reg. MFI	Portfolio 2001	Portfolio 2000
Bolivia	5	188,503,474	177,804,875
Brazil	37	2,000,000 [a]	1,800,000 [a]
Colombia	3	18,000,164	16,575,104
Dominican Rep.	3	51,722,816	53,692,590
Ecuador	2	70,318,860	41,572,157
El Salvador	1	31,863,140	29,518,000
Guatemala	1	13,843,000	11,154,234
Honduras	1	6,645,000	6,303,991
Mexico	2	28,741,042	14,083,217
Nicaragua	2	20,872,375	16,643,908
Panama	1	1,465,310	552,642
Paraguay	1	18,741,000	20,952,000
Peru	37[b]	453,424,854	340,010,124
Venezuela	1	7,376,000	3,353,000
Total	**97**	**913,517,035**	**734,015,841**

Source: Web-sites of Bank Superintendencies; Web-site of Accion (www.accion.com).

(a) Estimated combined portfolio, according to the Central Bank of Brazil.

(b) 12 Cajas Rurales de Ahorro y Crédito included in the numbers for Peru (combined portfolio of $59 million in 2001).

[1] This process usually implies that a new financial institution is created and that the original nonprofit foundation takes controlling equity stake in it, while ceasing to provide financial services itself.

[2] Including (a) 14 Cajas Municipales de Ahorro y Crédito in Peru, which are owned by municipalities and supervised by the Bank Superintendency, and (b) 12 Cajas Rurales de Ahorro y Crédito, also in Peru, that are supervised and shareholder-based organizations, but did not originate in nonprofit foundations.

cial returns.[3] These 97 institutions, which do not include nonprofit foundations or downscaling banks, had a combined portfolio of about $914 million as of December 2001. In that same year, they registered an impressive overall portfolio growth of 24 percent.[4]

Until recently, much of microfinance development has been focused on developing and strengthening the asset side of microfinance institutions: the products, delivery mechanisms, information systems and human resources. Relatively little attention has been paid to the funding side of these institutions; how they obtain financing, its terms, and who they get it from. Very little is known, or at least written, about the challenges they face and their strategies for the future.

However, given the rapid growth rate and the increasing formalization of the industry, these issues merit more attention, particularly in the case of nonprofit foundations that are about or have transformed into formal financial intermediaries. They go from an environment dominated by donors, with all that it entails, to a market-based competitive environment that offers variety of funding sources. They also have to cope with the fact that they are unique institutions with distinct risk profiles due to their informal clients, different credit methodology and atypical owners (i.e., the original nonprofit foundation, donor agencies and specialized microfinance funds).

BEYOND THE ASSETS SIDE

The issue of funding is crucial to financial institutions, regardless of whether they operate as commercial banks, finance companies, credit unions or nonprofit foundations. They all need to refinance their loan portfolio in one way or another, either through debt, deposits or equity. However, as far as microfinance is concerned, the issue of funding is likely to be of little concern to downscaling commercial banks, since they already have established savings programs and long-standing access to financial and capital markets. For them, the addition of a microenterprise portfolio will be of minimal importance in relation to their overall funding needs and decisions.

In contrast, the issue of funding is of central importance to microfinance institutions that operate as nonprofit foundations and those that have transformed into regulated financial institutions.

Microfinance institutions that operate as nonprofit foundations generally obtain their funds from donors, retained earnings and, in some cases, from public second-tier financial institutions. Some of the more successful nonprofits have managed to obtain funding from commercial banks, but rarely in amounts exceeding their own equity. At some point, therefore, growth oriented nonprofits typically find themselves constrained by lack of funding. Consequently, it is an important topic for them; unfortunately, the possibilities to resolve the constraints are limited. More donor funds can be sought, but over the long term, the main solution is to transform into a licensed and supervised financial institution, which can more easily access funding through savings accounts as well as from financial and capital markets. This is a fundamental reason behind the appearance of an increasing number of specialized and supervised microfinance institutions in Latin America.

As for microfinance institutions that have taken the leap and subjected themselves to bank supervisory authorities, they tend to aggressively pursue a range of funding sources to support their continued growth. As mentioned before, they currently seem to grow at rate of 24 percent per year and are therefore set to require an additional $278

[3] See Jansson (2001) for a discussion on the performance of microfinance institutions compared to commercial banks.

[4] Based on numbers provided by Bank Superintendencies and network organizations. Smaller samples of 20-30 microfinance institutions over the period 1997-2001 have shown annual growth rates varying between 20 and 35 percent.

million in funding in 2003.[5] To meet this demand, they seek funds in the form of bank loans, savings accounts, term deposit and, increasingly, directly through capital markets in the form of bond issues. Since these institutions are fully specialized in microfinance, their ability to fund themselves in mainstream markets is essentially a litmust test of the underlying value of microfinance: is it becoming a generally recognized financial activity, or is it still seen mainly as a fringe grassroots activity?

Microfinance is most mature and accepted in Bolivia and Peru, where a significant number of MFIs operate since several years back. In Bolivia there are five specialized microfinance institutions licensed and supervised by the banks superintendency, one bank and four private financial funds (a sort of finance company); in Peru there are 37: one bank, one finance company and 35 smaller institutions of three different kinds.[6] In Bolivia, the institutions transformed between 1992 and 1998; in Peru, the institutions have in some cases existed since the early 1980s, though a large number of transformations took place between 1995 and 1998.

It is easy to think that the transformation from nonprofit foundation to financial institution is over once the bank supervisor grants the operating license. After all, the microfinance institutions in question have usually spent years preparing, tightening up operating procedures, improving information systems and adjusting accounting practices. However, as this paper will show, the vestiges of their origin remain present in their capital structure[7] long after becoming licensed and supervised financial institutions.

There is no doubt that transformed microfinance institutions increasingly resemble mainstream financial institutions in some fundamental aspects (shareholder-based ownership, regulatory compliance, professional asset-liability management, etc.) but a look at the nature and composition of their funding shows that some important differences persist, even among those microfinance institutions that have operated as licensed financial institutions for quite a while.

The Changing Composition of Liabilities in MFIs

Transformed microfinance institutions start out with relatively small amounts of liabilities. As indicated earlier, a debt-equity ratio of 1:1 is fairly typical for nonprofit foundations that provide microcredit. Banks and other financial institutions, however, operate with leverage ratios of about 10 to 1.[8] Consequently, once a transforming microfinance institution has attracted the necessary investors to become licensed as a financial institution, all attention (as far as funding is concerned) is turned to liabilities.

The case of Compartamos in Mexico, which became a licensed and supervised financial institution in 2001 shows how drastic the change can be.[9] Within one year, its debt-

[5] (\$914 million x 1.24 x 1.24) – (\$914 million x 1.24) = \$278 million. Again, these numbers do not include the funding demands of nonprofit foundations or multipurpose commercial banks targeting the microenterprise sector. A reasonable, though casual, estimate is that these institutions will require an additional \$150-200 million in funding during 2003.

[6] 12 Cajas Rurales de Ahorro y Crédito (CRACs); 14 Cajas Municipales de Ahorro y Crédito (CRACs) and 9 Entidades de Desarrollo para la Pequeña y Micrempresa (EDPYMEs).

[7] Capital is a vague term that depends on the context for a specific definition. In general, it refers to long-term financial resources available for use. In this paper, “capital structure” refers to the composition of an institution’s equity and liabilities.

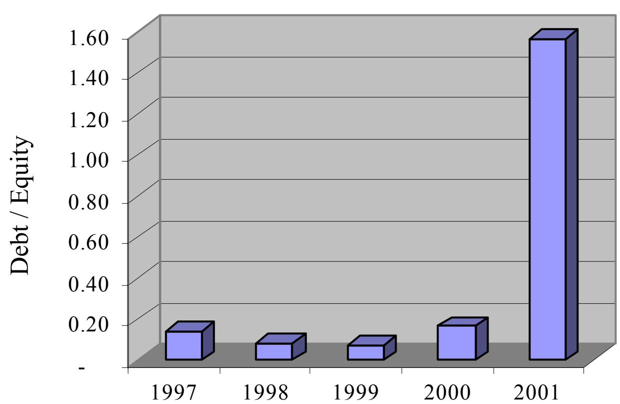
[8] Leverage ratio is defined as liabilities (incl. savings, term deposits, debt, etc.) divided by equity.

[9] Compartamos transformed from nonprofit foundation to a so-called SOFOL (Sociedad Financiera de Objeto Limitado), which is not permitted to capture deposits. In 2003, Compartamos plans to seek a license as Sociedad Financiera de Ahorro y Crédito Popular, a recently created type of finan-

equity ratio had gone from 0.14 to 1.5, still low in comparison to mainstream banks and finance companies, but more than a 10-fold increase from the year before. Compartamos' debt-equity ratio will undoubtedly continue to increase in the years ahead as more financing is needed to sustain its rapid portfolio growth (146 percent in 2001). The issue of debt funding, in terms of amounts, conditions and characteristics, will therefore become a central concern to the institution.

Compartamos is only one among many recently transformed microfinance institutions throughout the region that presently face the same issues. What kind of funding sources will be available to them, and what kind of capital structure should they aim for? Though the balance sheets of more veteran microfinance institutions do not necessarily indicate an ideal state, their capital structure nevertheless holds a clue of how the broader industry will look like in the future.

Compartamos: How Transformation Changes Capital Structure



Source: Farrington and Abrams (2002)

The Case Of Bolivia

Bolivia is the obvious case to study to understand where the broader industry is heading.

cial institution that resembles a deposit taking finance company.

In the Bolivian market, there are five transformed microfinance institutions operating: one commercial bank (BancoSol) and four so-called Private Financial Funds (Caja los Andes, Ecofuturo, Prodem and FIE), which are the institutional equivalent of finance companies found in other countries.[10] These five microfinance institutions can be readily compared to "normal" banks and private financial funds as they all operate in the same institutional and regulatory framework.

After more than 10 years of operating as a commercial bank, BancoSol looks much like other Bolivian banks on its funding side, at least in terms of the two main categories—deposits from the public and financing from other financial institutions. It receives 75.2 percent of its overall financing in the form of deposits from the public (compared to 78.5 percent for other banks) and 23.1 percent in the form of financing from other financial institutions (compared to 15.1 percent for other banks).

However, within these main funding categories there are significant differences between BancoSol and mainstream Bolivian banks. BancoSol obtains relatively more funding through term deposits from the public but less (in fact none) through checking accounts. Furthermore, its financing from other financial institutions is dominated by deposits rather than straight loans, which is the inverse of the pattern discerned in its more mainstream peers.

The lack of checking accounts in BancoSol is particularly noteworthy since it has been licensed as a bank since 1992. In other words, it has had 10 years to develop this service to its clients. This anomaly is explained by past management decisions rather than any particular reluctance of clients to have checking accounts with BancoSol. In fact, BancoSol decided, at the time of becoming a bank, not to offer checking accounts due to the com-

[10]The institutional form *Fondo Financiero Privado* was created in 1996 through presidential decree No. 24.000.

Comparing MFIs in Bolivia to their Mainstream Peers, December 2001

	Banks [a] (%)	BancoSol (%)	3 FFPs Non-MFIs [b] (%)	4 FFPs MFIs [c] (%)
Deposits from the public	**78.50**	**75.20**	**89.3**	**52.5**
Checking accounts	17.80	0.20	0.0	0.0
Savings accounts	19.60	13.70	10.5	7.2
Term deposits	37.40	59.30	75.0	43.9
Other	3.70	2.00	3.9	1.4
Loans/Deposits from other fin. inst.	**15.10**	**23.10**	**5.1**	**41.8**
Deposits ("obligaciones a la vista")	3.70	11.40	0.0	0.0
Loans	11.50	11.70	5.1	41.8
Second-tier financial institutions	5.60	6.60	0.0	13.8
Domestic financial institutions	0.00	0.00	4.8	13.2
External financial institutions	4.30	4.70	0.0	11.4
Other	1.60	0.40	0.3	3.5
Accounts Payable	**2.5**	**1.6**	**3.7**	**5.3**
Subordinated Debt	**2.6**	**0.0**	**1.9**	**0.4**
Other	**1.2**	**0.1**	**0.0**	**0.0**
Total Liabilities	**100**	**100**	**100%**	**100**

Source: Bank Superintendency of Bolivia, www.sbef.gov.bo

(a) 11 commercial banks, not including BancoSol.

(b) FFP Acceso, FFP Fassil, FFP Fondo de la Comunidad.

(c) FFP Prodem, FFP Caja los Andes, FFP FIE, FFP Ecofuturo

plexity and cost (in terms of information systems) of providing this services. Adding this information systems module subsequent to general installation turned out to be very expensive and BancoSol therefore decided to wait until it upgraded all its systems. It does not expect to offer this service in the near future.[11]

BancoSol's greater reliance on financing from other institutions (mainly in the form of deposits from other banks) is explained by its attractive deposit rates. To compensate for the public's perception of it as a lightweight compared to its larger domestic and international peers, BancoSol has to offer somewhat higher deposit rates to attract the public. Meanwhile, other banks, which are adept at assessing the financial condition and risk of their peers, perceive BancoSol's deposits to offer a very attractive risk/return profile. This difference in perception between the public and other financial institutions explains the somewhat lopsided nature of BancoSol's funding structure.[12]

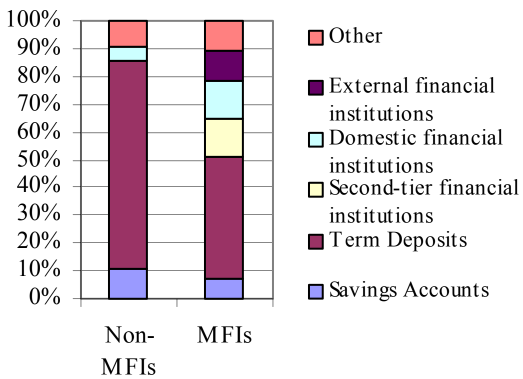
In the case of the private financial funds, the differences between microfinance institutions and mainstream companies are even more striking. The three private financial funds that are not the product of transformed non-profit foundations, and which focus mainly on consumer finance, receive almost 90 percent of their liabilities from the public,

[11] According to Gonzalo Valdés Garcia Meza, National Manager for Operations and Finances of BancoSol, the institution does not consider checking accounts to be an essential service given the characteristics and needs of its clients.

[12] Explanation provided by José Antonio Sivila, Superintendency of Banks and Financial Entities of Bolivia.

mostly in the form of term deposits. In contrast, the four private financial funds that are former nonprofits, and that specialize in microfinance, receive only little more than half (52.5 percent) their financing from the public. The difference is made up by loans from other financial institutions (41.8 percent), almost evenly divided among domestic, external and second-tier financial institutions.

Composition of Liabilites in Bolivian FFPs, Dec. 2001



Source: Superintendency of Banks, Bolivia

As in the case of BancoSol, these microfinance institutions need to offer high deposit rates to attract the public, which also ends up attracting a lot of institutional money. In contrast to BancoSol, however, the private financial funds are to a significant degree sourcing funds from second-tier financial institutions and international development organizations, which provide about 25 percent of their total liabilities.

Some observers have voiced concern and disappointment about the seeming slowness of transformed microfinance institutions to develop savings programs for low-income populations. Instead—it is lamented—microfinance institutions tend to rely on loans from financial institutions and a small number of large term deposits from wealthy individuals or socially motivated funds.

While it is true that microfinance institutions, including the Bolivian ones, tend to rely heavily on loans from other financial institutions, this picture seems to be changing. In the case of Bolivian microfinance institutions, the reliance on such loans is continually declining, while the importance of term deposits and especially savings accounts is continually increasing.

For example, by November 2002 Caja los Andes had attracted 26,000 savings clients with an average balance of about $200.[13] It may not yet compare to the institution's loan

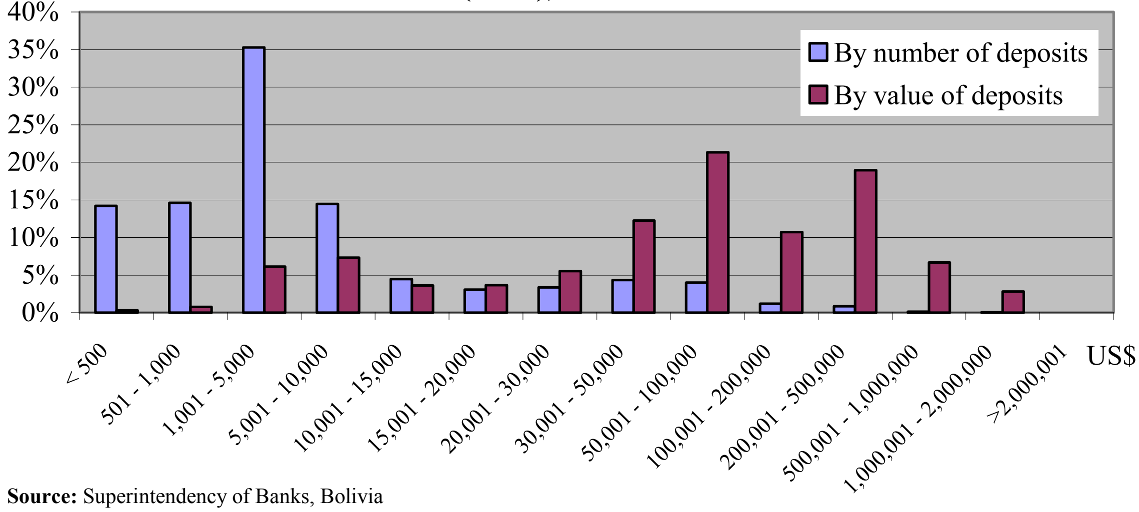
Evolution of Funding Patterns in Microfinance Institutions, Bolivia[(a)]
(as %)

	Nov 2002	Dec 2001	Dec 2000	Dec 1999
Savings accounts	11.6	7.2	2.2	2.8
Term deposits	45.7	43.9	42.8	34.2
From financial / int'l. institutions	34.3	41.8	48.2	54.7
All other sources	8.4	7.1	6.8	8.3
Total	**100.0**	**100.0**	**100.0**	**100.0**

Source: Bank Superintendency of Bolivia, www.sbef.gov.bo
(a) FFP Prodem, FFP Caja los Andes, FFP FIE, FFP Ecofuturo

[13] According to Pedro Arriola, General Manager of Caja los Andes, the institution will continue to grow its savings program though he expects term deposits and bank financing to remain more important in the foreseeable future.

Stratification of Term Deposits in 4 Bolivian Microfinance Institutions (FFPs), Nov. 2002



Source: Superintendency of Banks, Bolivia

portfolio (approximately 45,000 borrowers), but this is to be expected since the savings program has only operated for a few years. The critics, who assert complacency or even failure on the part of microfinance institutions to develop savings services for the poor, would probably be wise to hold off a little on their claims.

As for the size of term deposits, it is true that the average amount of term deposits among the four Bolivian microfinance institutions is fairly high ($16,576). However, this figure is driven up by a few large deposits, because 79 percent of all term deposits are actually smaller than $10,000 (and 64 percent are smaller than $5,000), hardly indicating an exclusive focus on the rich. But regardless of the size of the term deposits, it seems counterintuitive to criticize microfinance institutions for attracting funds from institutions and wealthy individuals as long as those funds are overwhelmingly channeled to low-income populations. Furthermore, with savings accounts freely offered and increasingly used by low-income populations, the criticism appears even more unjustified.

The Case Of Peru

As was mentioned earlier, Peru constitutes the second mature microfinance market in the region and hosts a large number of important microfinance institutions. However, for various reasons the majority of these institutions are not really comparable to commercial banks or finance companies as far as their funding side is concerned.

Some of these institutions are fully owned by municipalities (14 Cajas Municipales), others are very small and operate only in rural areas (12 Cajas Rurales) and yet others are not allowed to capture deposits (9 EDPYMEs). Furthermore, the only finance company focused on microfinance, Financiera Solución, was not created from the transformation of a nonprofit foundation but is majority-owned by Banco de Crédito del Perú (55 percent) and forms part of Credicorp, an important Peruvian financial group. Consequently, the only transformed nonprofit foundation really comparable to mainstream financial institutions is Mibanco, which was constituted as a bank in 1998 by Acción Comunitaria.

Perhaps surprisingly, Mibanco looks more like the Bolivian private financial funds than

Comparing Mibanco in Peru to its Mainstream Peers, Dec. 2001
(as %)

	Banks[a] 2001	Mibanco 2001	Mibanco 2000	Mibanco 1999
Deposits from the public	**79.8**	**45.7**	**30.8**	**32.0**
Checking accounts	12.7	0.0	0.0	0.0
Savings accounts	21.1	7.5	4.6	0.3
Term deposits	42.4	36.1	26.3	31.7
Other	3.7	2.1	0.0	0.0
Deposits from fin. inst. and int'l. orgs.	**1.7**	**0.8**	**0.0**	**0.0**
Loans from other financial institutions	**10.2**	**39.2**	**59.6**	**49.7**
Domestic institutions	2.4	32.7	n/a	n/a
External inst. & int'l organizations	8.0	6.5	n/a	n/a
Interbank funds	**0.6**	**6.0**	**0.0**	**0.0**
Bonds / Tradable debt	**4.6**	**0.0**	**0.0**	**0.0**
Accounts payable	**1.2**	**4.9**	**0.0**	**0.0**
Other	**1.8**	**3.4**	**9.6**	**18.3**
Total	**100.0**	**100.0**	**100.0**	**100**

Source: Bank Superintendency of Peru, www.sbs.gob.pe
(a) 8 commercial banks, not including Mibanco.

it does BancoSol. Deposits from the public amount to less than half its liabilities (45.7 percent) while loans from other financial institutions are almost as important (39.2 percent).[14] This likeness to the Bolivian private financial funds may be related to the fact that they have operated as regulated financial institutions for about the same amount of time (4 to 6 years), whereas BancoSol has been in operation (as a regulated financial institution) for more than 10 years. Like BancoSol, Mibanco has so far made little use of its authorization to offer checking accounts, and rather relies on term deposits as its primary funding modality from the public. However, Mibanco opened its first checking accounts during 2002.

The Larger Trend

Not surprisingly, the developments in Bolivia and Peru seem to be part of a larger trend in the region. Transformed microfinance institutions are relying less and less on subsidized funds and more and more on deposits with the public. Over the past five years, a sample of 10 deposit-taking microfinance institutions show a decline from 10 percent to 2 percent in subsidized funding, and an increase from 51 percent to 69 percent in deposits (including checking, savings and term deposits). Over the same period, commercial borrowing in these institutions appears to have declined somewhat.[15]

The changes in funding sources have also brought changes in the characteristics of the funding obtained by microfinance institutions. Short-term borrowings (<1 year) have

[14] About 95 percent of this institutional financing comes from COFIDE, a second-tier national development bank.

[15] This information is based on MicroRate evaluations and represents the largest *consistent* sample that could be gathered from this data. Though MicroRate now follows more than 30 Latin American microfinance institutions, there are only 10 institutions in that sample that (a) are fully specialized, (b) capture deposits, (c) are regulated/supervised, and (d) have operated (in this form) since 1996.

Evolution of Funding Sources of 10 Deposit Taking MFIs [(a)]
(as %)

	2001	2000	1999	1998	1997
Commercial Borrowing	30	23	29	43	39
Subsidized Borrowing	2	10	11	5	10
Deposits (savings and term deposits)	69	68	60	51	51
Total	**100**	**100**	**100**	**100**	**100**
Short-term borrowings	50	48	42	45	42
Long-term borrowings	50	52	58	55	58
Total	**100**	**100**	**100**	**100**	**100**
Local currency borrowings	52	69	58	56	66
Foreign currency borrowings	48	31	42	44	34
Total	**100**	**100**	**100**	**100**	**100**

Source: MicroRate data for Caja los Andes (Bolivia), Banco Sol (Bolivia) Bolivia; Financiera Calpiá (El Salvador); Visión de Finanzas (Paraguay), and 6 Cajas Municipales (Peru).
(a) All included microfinance institutions were transformed prior to 1997.

increased while long-term borrowings (>1 year) have declined; meanwhile local currency borrowings have declined and foreign currency borrowings have increased. The increase in short-term borrowings may not come as a surprise given the gradual decline in subsidized borrowing and second-tier borrowing, which tend to be long-term in nature, but the reasons for the increase in foreign currency borrowing may be less obvious. In fact, what is driving the increase in foreign currency borrowing is the emergence of specialized investment funds, such as the Latin American Challenge Investment Fund (LACIF) and the Dexia Microcredit Fund, that lend in US dollars.

From a risk management perspective, these trends have both positive and negative implications. On the positive side, the increasingly short-term nature of funding liabilities better matches the term structure of microfinance institutions' relatively short-term portfolio, typically the bulk of its assets. The rise in the proportion of foreign currency borrowings may be appropriate in economies where lending is highly dollarized, such as Bolivia and Ecuador. But higher foreign currency liabilities in non-dollarized economies such as Peru and the majority of Latin America add risk due the increased asset/liability currency mismatch.

Though it may be presumptuous to extrapolate the preceding information to the Latin American microfinance industry as a whole, it appears possible to draw a few relatively general conclusions.

First, differences in funding obtained by microfinance institutions, as compared to mainstream banks or finance companies, seem to persist long after transformation from non-profit foundations to financial institutions. Most notably, transformed microfinance institutions tend to rely relatively less on deposits from the public and relatively more on financing from other financial institutions. However, this dependence appears to decrease over time as microfinance institutions develop and expand deposit programs targeting individual savers. Not only does the relative importance of loans from other financial institutions seem to decrease over time, but the characteristics and composition of these borrowings also change, from subsidized toward commercial, from local toward foreign currency, and from long term toward short term.

Second, within the general category of deposits, savings accounts are becoming more important, though term deposits still dominate. While this is certainly a positive development, it also implies that the overall term structure of liabilities is changing for these institutions, as savings accounts are more liquid than either term deposits or bank financing. While savings accounts may be as stable as term deposits under normal circumstances, they can become highly unstable if the institution is perceived as illiquid or insolvent and depositors try to withdraw their funds. This in turn can make matching assets and liabilities a significant challenge for those microfinance institutions that want to provide longer-term financing to their clients, for example in the form of housing loans.

Third, the microfinance institutions permitted to offer checking accounts, BancoSol and Mibanco, are not offering this service on any significant scale. This is a complex service that requires time and infrastructure to develop. It seems that the natural tendency is to start with term deposits and then add savings accounts and, ultimately, checking accounts. As in the case of savings accounts, checking accounts can complicate the liquidity management of the institution.

MATCHING ASSETS AND LIABILITIES

The changing composition of liabilities in microfinance institutions has important implications, because it contrasts with what is happening on the asset side of these institutions. While most microloans indeed tend to be short-term in nature, the average tenor of these assets is nevertheless increasing in most microfinance institutions.[16] This is a natural consequence of having a greater number of recurring clients on the books, who tend to receive larger and longer-term loans, as compared to new clients, who tend to get started with short-term loans. If microfinance institutions also start offering mortgage loans, increasingly discussed in the industry, the average tenor of their portfolios (assets) will lengthen even further.

These diverging trends, of longer-term assets and shorter-term liabilities, mean that microfinance institutions will have to focus more of their efforts on matching assets and liabilities and, eventually, developing long-term funding sources. Since long-term financing is often in short supply in Latin American markets, such an endeavor is likely to be a significant challenge to most microfinance institutions, which are smaller and less recognized than most other financial institutions.

During 2001 and 2002 a number of microfinance institutions met this challenge by reaching out directly to capital markets. Mibanco in Peru, Compartamos in Mexico and FinAmérica in Colombia all successfully issued bonds to domestic investors. The bonds, whose tenors range from 2 to 3 years, will help these institutions match their assets and liabilities, introduce greater stability in their funding costs, and allow them to expand longer-term lending to their clients. A couple of years earlier, BancoSol in Bolivia successfully launched a $3 million bond program in three separate issues.

Though the tenors are still relatively modest, bond issuance seems to be an attractive option for larger microfinance institutions that want to obtain medium-term funding. The amounts are relatively large (compared to other funding mechanisms) and the transaction can introduce new investors to the institution. However, not all microfinance institutions believe bond issuance is the preferred strategy. Caja los Andes in Bolivia, for example, believes itself better served by expanding the amount and extending the tenor of term deposits. Term deposits require less up-front effort and can be tailored to each client. They are also tradable in the local market, just like bonds. For Caja los Andes,

[16] Appreciation supported in evaluations conducted by MicroRate, a rating agency specializing in microfinance.

Characteristics of Four Microfinance Bond Issues

	Mibanco	**Compartamos**	**FinAmérica**	**BancoSol**
Year of issuance	2002	2002	2001	1997
Type of bond	Straight	Straight	Convertible Bond	Straight
Amount (USD)	$6 million[(a)]	$15 million [(b)]	$2 million	$3 million [(c)]
Currency	Soles	Pesos	Pesos	Bolivianos
Coupon	12%	CETES + 2.5% [(d)]	DTF [(e)]	9%
Tenor	2 years	3 years	2 years	2 years
Credit Enhancement	50% USAID	None	None.	50% USAID
Sale mechanism	Dutch auction [(f)]	Private placement	Private placement	Private placement
Main buyers	Local pension funds (82%)	70% institutional 50% individuals	Only existing shareholders	Bolivian institutions
Raters	Equilibrio, Apoyo & Asociados	Standard & Poor's	Duff & Phelps / Fitch	N/a

Source: Interviews with executives in Mibanco, Compartamos, FinAmérica and BancoSol.

(a) First issuance in a planned $30 million program over the next few years.

(b) Two separate issues, the first for $10 million and the second for $5 million. In the first issue 70 percent of investors were individual and 30 percent institutional; in the second issue the ratio between institutional and individual investors were 50/50.

(c) Three separate issues of $1million each.

(d) CETES are Mexican treasury bills. When adding taxes and fees the final cost to Compartamos was 13.08 percent.

(e) DTF: Average of the 90-day certificates of deposits in the market.

(f) In a Dutch auction format, bids are accepted from lowest to highest interest rate, but the highest accepted rate is the rate paid to all investors.

bonds would be more attractive only if they offered clearly longer maturity *and* were accompanied by external credit enhancement.[17]

Some observers have proposed other capital market instruments, like securitization, as a possibly attractive financing mechanism for microfinance institutions. Securitization, which implies packaging many loans into one security, is used extensively in the United States, primarily by mortgage lenders but also by credit card companies. However, a cursory analysis of this financing instrument reveals that it may not be an attractive or even feasible option for the great majority of microfinance institutions.

First, for securitization to be cost-effective, the amount in question needs to exceed about $25 million[18]. Needless to say, this is more than most microfinance institutions have in their loan portfolios. Only about 10 specialized microfinance institutions in Latin America have portfolios of this size or greater.

Second, the legal frameworks in many Latin American countries make securitization difficult and costly, if not impossible, by not enabling the filing of a security interest in accounts receivables (in this case, the cash flow from the loans). Instead, Latin American legislations normally require the individual transfer and debtor notification for each individual loan, which can be a costly process for microenterprise portfolios that contain thousands of loans. In contrast, in the United

[17] As of December 2001, the average term of Caja los Andes' $17.5 million in term deposits was 389 days; about half of the $17.5 million is concentrated in term deposits of 360 to 720 days.

[18] Estimate provided by Dr. Heywood Fleisig, Director of the Center for the Economic Analysis of Law,

States, the ownership is never transferred, not even of the portfolio as a whole; instead, a security interest in the portfolio is filed, which is a relatively fast and inexpensive process.[19]
Third, securitization is used primarily by companies that cannot mobilize funds from the public in the form of term-deposits or savings. Transformed microfinance institutions generally have this option at their disposal, though in some countries (Peru and Brazil) there are companies that are not permitted to capture from the public.

While securitization of individual portfolios may be out of reach for Latin American microfinance microfinance institutions, some think that a "global" securitization may be feasible. Instead of securitizing $25 million from one microfinance portfolio in local markets, a global issuance would securitize $2 to 5 million from 10 microfinance portfolios in international markets. This arrangement has the potential to engage commercial investors and provide fresh funds to microfinance institutions while avoiding the legal obstacles inherent in local legislations.[20] In fact, there are people in the industry working on exactly this type of proposal.

Connecting Barrios with Wall Street: Global Microfinance Securitization

A new initiative foresees the issuance of a $35 million debt security based on loan portfolios of several microfinance institutions, most of which are Latin American. This *collateral debt obligation*, as it is also called, would bridge the gap between the high finance world of New York and London and the poorest neighborhoods of developing countries.

The debt obligation would provide long-term funding to participating microfinance institutions at several percentage points above Libor, a very attractive rate compared to their alternative funding sources. To attract a variety of investors, the debt obligation would be structured in three different notes, targeting commercial investors, multilateral agencies and poverty alleviation foundations respectively. Each note would have a different risk/return profile.

Source: Excerpted from actual investment proposal. Exact source witheld by request of company.

The Search for Equity

Nonprofit foundations continuously search for grant money to build up their equity base. However, for most microfinance institutions, the search for equity starts in earnest when they aim to transform themselves from nonprofits to shareholder-based financial institutions. Bank supervisors require the presence of strategic shareholders other than the original nonprofit foundation, so convincing new shareholders to participate in the institution is a basic and fundamental step in the transformation process.

Sometimes this can turn into a problem because it is hard to find commercial for-profit investors prepared to invest in these institutions, especially before they have a track record as regulated and supervised financial institutions. Instead, shareholders are typically semi-commercial specialized funds, multi- or bilateral donors and international nonprofits. Understandably, it may take a while for bank supervisors to understand the nature, motiviations and capacities of these types of shareholders.

In most cases, the originating nonprofit foundations retain controlling stakes in the new institutions. In a sample of five leading microfinance institutions, the originating nonprofit foundations control between 20.2 per-

[19] According to Dr. Heywood Fleisig, many Latin American legal frameworks add confusion to cost by not requiring the registration of these transfers. As a result, it is nearly impossible for any potential creditor to verify that the loans in the portfolio have not already been offered as security interest in another transaction.

[20] One drawback from a development point of view is that a global securitization does not do much to develop local capital markets, as the investors are all located in industrialized countries.

Ownership Composition in Selected Microfinance Institutions, Dec. 2002 (as %)

Category of Owner	Mibanco	BancoSol	Caja los Andes	Compartamos	Financiera Calpiá
Original NGO	60.3	20.2	46.9	36.6	21.7
Multilateral Agencies / Bilateral Donors	3.8 (a)	22.0 (b)	20.0 (a)	10.0 (c)	36.4 (d)
Specialized Funds	19.8 (e)	33.8 (f)	26.7 (g)	5.8 (e)	41.6 (h)
International NGOs	6.82 (i)	13.3 (i)	-	17.1 (i)	-
Commercial investors (e.g. local banks)	6.0 (j)	-	-	-	-
Private individuals	3.1	10.7	6.4	30.5	0.3
Other	2.5 (k)	-	-	-	-
Total	**100%**	**100%**	**100%**	**100%**	**100%**

Source: Information from the microfinance institutions themselves.
(a) Corporación Andina de Fomento; (b) Commonwealth Development Corporation; (c) International Finance Corporation (IFC); (d) IFC (12%), FMO (12%) and KFW (12.4%); (e) Profund International; (f) Profund International (23.17%) and Acción Gateway Fund (10.63%); (g) Internationale Micro Investitionen (IMI); (h) IMI (28.5%) and Internationale Projekt Consult GmbH (IPC, 13.1%); (i) Acción International; (j) Banco Wiese-Sudameris & Banco de Crédito del Perú; (k) owned by Mibanco to give to executives.

cent (BancoSol) and 60.3 percent (Mibanco) of the shares. Other key shareholders include specialized funds such as Profund, Internationale Micro Investitionen (IMI), and Acción International's Gateway Fund,[21] which have taken significant stakes in several different microfinance institutions. Private individuals and commercial investors, typical shareholders of mainstream financial institutions, are few and far between. Even in Compartamos, where 33 individuals own 30 percent of the shares, the influence of new and previously unconnected shareholders is small (18 of the 33 individuals are employees).

Subsequent to transformation, additional equity needs will tend to be quite modest. As mentioned earlier, the low leverage of non-profit foundations prior to their transformation implies that debt will be the main type of funding needed for any further expansion. Only when their leverage ratio reaches the ceiling imposed by the supervisory authorities (or perhaps at earlier levels if actual and potential creditors will not accept such risk) does equity really become a constraint to continued expansion.[22]

A sample of microfinance institutions indeed shows that their leverage increase after they transform into licensed and supervised financial institutions. Though some institutions have received additional equity contributions subsequent to their transformation, for example Caja los Andes and FIE in Bolivia, most microfinance institutions have not reached the point where lack of equity is constraining growth or putting them in conflict with bank regulations.

Judging by the evolution of transformed microfinance institutions, it seems to take them about 5 to 10 years to reach full leverage (that is about 10:1). The length of this "ramp up" period naturally depends on the demand for credit in the real economy and ability of

[21] Profund (www.profundinternacional.com) has investments in 12 Latin American microfinance institutions, 11 of which are partially or completely in the form of equity or quasi-equity; IMI (http://www.imi-ag.com/01.htm) is a shareholder of four microfinance institutions in Latin America and 13 in Africa and Asia.

[22] Bank supervisors impose so-called capital adequacy requirements, calculated as the percentage of equity in relation to risk-weighted assets. In most Latin American countries, bank supervisors have set this limit at between 8 and 11 percent, which corresponds to a debt-equity ratio of between 7.5:1 and 11.5:1.

Evolution of Leverage Ratios in Selected Microfinance Institutions [a]

Institution	Country	Year of Transformation	2001	2000	1999	1998	1997
Compartamos	México	2001	1.57	0.14	N/a	N/a	N/a
Confia	Nicaragua	2000	8.47[b]	3.10	N/a	N/a	N/a
Mibanco	Peru	1998	3.68	2.02	1.13	1.04	N/a
FIE	Bolivia	1998	5.62	5.07	4.25[c]	6.46	N/a
Financiera Calpiá	El Salvador	1995	3.77[d]	3.53	3.50	3.33	3.28
Caja los Andes	Bolivia	1995	7.91	7.78[e]	8.34	7.61	6.69

Source: Bank Superintendency of Peru, www.sbs.gob.pe; Bank Superintendency of Bolivia, www.sbef.gov.bo; Microrate, www.microrate.com

(a) The leverage ratio is defined as: total liabilities/equity.
(b) The high debt-equity ratio of Confia in spite of its short time as a licensed and supervised financial institution is a result of its merger with a local finance company at the time of transformation.
(c) FIE's decline in leverage in 1999 was due to a $1.5 million additional equity contribution.
(d) The relatively slow increase in the leverage ratio of Financiera Calpiá is due to modest portfolio growth during the past few years as well as a drive to raise additional equity to qualify for licensing as a commercial bank. In 2002 the ratio (liabilities/equity) increased to 5.3.
(e) Caja los Andes' decline in leverage in 2000 was due to a $1.28 million additional equity contribution.

these institutions to attract deposits from the public or financing from institutional creditors. If demand is strong and funding accessible, the leverage of the institutions will increase rapidly. In less dynamic markets, the process will tend to be slow.

Since the majority of transformed microfinance institutions are relatively young and not yet fully leveraged, few of them have attempted to attract new shareholders. Since the need for additional equity among transformed microfinance institutions has so far been modest, their ownership composition has also remained largely stable over time. Once in a while shareholders exit/enter, but overall the changes have been small. The exception to this rule are BancoSol in Bolivia and Financiera Calpiá in El Salvador, which have experienced significant changes to their ownership since they were licensed in 1992 and 1995 respectively.

In the case of BancoSol some events have unfolded as expected, while others have not. For example, as expected, the ownership of the original nonprofit foundation—Prodem—declined significantly between 1992 and 2002, from 45 percent to 22 percent. However, other changes in the shareholder composition have perhaps not unfolded as expected. Instead of acquiring commercial oriented shareholders, BancoSol appears to have come under greater influence of multilateral donors and specialized funds (which in turn are largely funded by donors). Meanwhile, many of the private sector investors (mainly banks) that were present in 1992 have now exited.

The evolution of ownership in Financiera Calpiá has perhaps followed a more expected trend. There, multilateral donors and the original NGO, which at beginning held more than 80 percent of the shares, now control less than 60 percent. Also, other local NGOs, which at the beginning held about 20 percent of the shares, had by 2002 completely exited the institution. The remainder—about 40 percent—has been picked up by specialized funds and the like.

In the case of Financiera Calpiá, the management feels quite satisfied with the current ownership structure. It values shareholders who are business oriented but not guided

Evolution of Ownership in BancoSol and Financiera Calpiá (as %)

Category of Owner	BancoSol		Financiera Calpiá	
	2002	1992	2002	1995
Original NGO	20.2	45	21.7	30[c]
Multilateral Agencies / Bilateral Donors	22.0	-	36.4	50[d]
Specialized Funds	33.8	-	41.6	
International NGOs	13.3	16	-	
Commercial investors	-	32[a]	-	
Private individuals	10.7	1.6	0.3	0.3
Other	-	6[b]	-	19.7[e]
Total	**100%**		**100%**	

Source: BancoSol and Financiera Calpiá executives.

(a) B.H.N. Multibanco, Inbosa, Banco Industrial, BISA, Banco Boliviano Americano, COMSUR

(b) Ecos Holding Ltda.

(c) Fundación Calpía

(d) Central American Bank for Economic Integration (25 percent); Inter-American Development Bank/MIF (25 percent).

(e) Fundasal (10.1 percent); Adel Morazan (4.8 percent); Adel Chalatenango (4.8 percent).

solely by profit motives, and consequently is not courting any pure commercial investors or local banks.

The cases of BancoSol and Financiera Calpiá are not typical. As mentioned earlier, ownership changes have been relatively small in most transformed microfinance institutions. Perhaps over time ownership in these institutions will show a trend toward more private sector for-profit involvement, but so far there is little evidence of it. Also, while increased commercial ownership is probably desirable for the microfinance industry, existing shareholders should not be sold short, to use an investment term. They have been crucial in the transformation and survival of numerous microfinance institutions and largely demonstrated themselves to be interested and able investors.[23]

But will noncommercial investors be able to keep up with the needs of the industry? Theoretically, a combined portfolio of $914 million, growing at 24 percent per year, would imply equity needs of about $11 million in 2002, $13.5 million in 2003 and $17 million in 2004 if a leverage of 5:1 is assumed.[24] The actual need for external equity may be somewhat more modest, since some of the required equity will be provided in the form of retained earnings. However, as leverages increase among specialized microfinance institutions, eventually so will their need for external equity.

[23] There are two concerns commonly expressed in relation to these types of investors. First, since they are not driven primarily by profit motive, are they sufficiently diligent in their oversight of the institution? This concern is particularly acute in relation to development banks but also, to a lesser extent, in relation to social investors. Second, in case the institution suffers large losses and needs a capital injection, are the shareholders able to provide these additional funds on a timely basis. This concern refers primarily to the original nonprofit foundation, which typically has a controlling stake in the institution but little additional capital to contribute in case of problems. However, development banks are also weak on this point because while they certainly have substantial resources, they are unlikely to be able to provide these within the time frame needed to save the institution.

[24] ($914 x 1.24-$914)/20=$11 million; ($914 x 1.24 x 1.24-$914 x 1.24)/20=$13.5 million; ($914 x 1.24 x 1.24 x 1.24-$924 x 1.24 x 1.24)/20=$17 million

WHERE ARE THE "REAL" INVESTORS?

The previous section showed that specialized microfinance institutions will have an estimated overall funding need of approximately $278 million in 2003. Perhaps 5 percent to 10 percent of this, or $13.5 to $27 million, will have to be provided in the form of additional equity. This does not include the funding needs of NGOs and downscaling commercial banks. Taking these institutions into account, total funding needs for the sector may approach $500 million in 2003, with equity perhaps accounting for $25 to 50 million.

Who will provide these funds and how will they be provided?

Judging by the experience of microfinance institutions in Bolivia and Peru, as well as other countries, it would seem that local institutions and individual depositors are able and willing to provide much of the debt financing required by microfinance institutions over the next decade. Nonprofit foundations will undoubtedly continue to depend on donor resources, but transformed microfinance institutions and downscaling banks will likely have a range of funding options available to them.

Until now, multi- and bilateral donors have been instrumental in the development of the microfinance industry, providing equity and quasi-equity through grants, direct investments and via specialized investment funds. But with yearly equity needs in the tens of millions of dollars just for transformed microfinance institutions in Latin America, can donors keep up?

The professed hope of most donors is that they will not have to keep up, that their past efforts will be rewarded in the form of an industry that no longer needs their help. That may indeed happen, but so far there are few mainstream social and commercial investors ready to step in; in fact, there is not a single *retail* social investment fund with significant investments in microfinance in emerging markets.[25] In other words, there is little connection between microfinance institutions in Latin America (or any other emerging market) and small-scale individual investors in industrialized countries.

Why doesn't this connection occur?

First the disconnect does not appear to be caused by any general lack of funds in industrialized countries. Just looking at four countries—United States, Canada, United Kingdom, and Australia—indicates that there are about 40 socially responsible mutual funds that actively invest in emerging markets. Together, they hold assets of about $2.9 billion.[26] If continental Europe were added, the numbers would undoubtedly be higher.

Mutual Funds Specializing in Socially Responsible Investments

	USA	Canada	UK	Australia	Total
Total International SRI Mutual Funds	17	22	27	14	**80**
Int'l SRI Mutual Funds with EM Holdings	6	13	17	4	**40**
Total Assets of SRI Mutual Funds with EM Holdings (US$ million)	240	1,783	846	41.6	**2,911**
Assets in Emerging Markets (US$ million)	26	61	18	1	**106**
Assets in Emerging Markets (as %)	10.8	3.4	2.1	2.4	**3.6**

Source: Adapted from de Sousa Shields (2002).

[25] Retail ... d: a fun ... at raises ... oney dire ... from the ... ic.

[26] Note that Continental Europe is not included in these numbers. The large size of the Canadian social investment mutual fund industry is a consequence of certain tax incentives provided by the Canadian government.

Barriers to Microfinance and Small Enterprise Investment in Emerging Markets

	All	Institutional Investors	Financial Planners	Brokers
Lack of Country Intelligence	3.0	3.1	0.5	2.8
Lack of Experience in Emerging Market Investments	2.8	3.5	2.0	3.0
Insufficient Social Impact Measurement	2.7	3.3	2.0	4.0
Inadequate Risk/Return Profile	2.3	2.2	1.9	2.6
Lack of Appropriate Vehicle	2.0	1.8	2.0	2.5

Source: de Sousa-Shields (2002).
Note: Survey respondents were asked to rate the options on a scale from 1 to 5 (with 5 representing the highest level of concern). 34 SRI professionals responded: 17 institutional investors, 9 financial planners, 7 brokers, 1 other.

However, this is not the whole picture, because the overwhelming share of the $2.9 billion is actually invested in industrialized countries, not emerging markets. In fact, only $106 million, or 3.6 percent, ever reach emerging markets. While certainly significant and probably somewhat understated, this amount is not sufficient to even closely cover the actual or future funding needs of the microfinance industry, even if all of it were dedicated solely to Latin American institutions.

Though socially responsible mutual funds are only one of several possible funding sources for microfinance institutions, the amounts available are nevertheless disappointing. Part of the reason is that mutual funds typically operate under regulations that require them to invest overwhelmingly in publicly traded securities. Since there are currently no specialized microfinance institutions, nor specialized microfinance investment funds, whose shares are publicly traded, this potential source of funds is currently very limited.[27]

There are several reasons why socially responsible investment flows do not reach microfinance institutions, including lack of country intelligence, social impact measurements, emerging market experience, investment vehicles, as well as inadequate risk/return profile. Different types of actors perceive these issues differently, with institutional investors and brokers finding emerging markets investments somewhat more problematic than financial planners.

Surprisingly, risk and return considerations appear relatively unimportant to social investment professionals (see above table), though this view is not shared by everyone. The Calvert Group and its associated Calvert Social Investment Foundation, which both have active investments in microfinance and raise funds from the general public, insist that risk and return considerations do indeed matter.[28]

[27] For example, and as is discussed below, the Calvert Group directs some of the funds it raises from the public to community investments; these funds (about $14 million in 2002) constitute a mere 0.175 percent of its overall $8 billion portfolio. The $14 million is administered by Calvert Social Investment Foundations, whose overall $52 million portfolio had 18 percent invested in microfinance in 2002 and directed some 16 percent of its investments to emerging markets.

[28] The Calvert Group's Social Investment Fund has a $1 million investment in Profund. According to Shari Berenbach, Executive Director of Calvert Social Investment Foundation, emerging market microfinance investments must yield more than 10% to start overcome the adverse risk perception associated with these investments.

CONCERNS OF SPECIALIZED FUND MANAGERS

Some of the concerns expressed by social investment professionals are mirrored within the narrower microfinance investment community. Today, specialized funds like Profund, IMI, Acción Gateway, LACIF and the Dexia Microcredit Fund occupy an important space between donors and mainstream investors. They operate largely on commercial terms and have been absolutely essential in providing timely and demand driven financing for a host of microfinance institutions.

Notwithstanding their central role in the development and growth of the microfinance industry, specialized funds do not generally represent the interest of commercially oriented investors. In fact, in the cases of Acción Gateway, LACIF, IMI and Profund the main shareholders/funders are multi- and bilateral donor agencies[29]. While it certainly seems better to have donor funds channeled through commercially operated funds, it is still largely the same donor money going around.[30]

The fact that these specialized funds operate largely on commercial terms makes them a proxy for determining the preferences of commercial investors. Though specialized funds may have a higher risk-tolerance than commercial investors, they nevertheless share many of the same priorities and concerns. Consequently, if the donor community is serious about its proclaimed goal of promoting greater involvement of private capital, they should take seriously the opinions of the specialized funds.

As it turns out, specialized fund managers have identified several issues, some of which mirror the obstacles perceived by the broader social investment community in industrialized countries. For example, for the specialized investment funds tapping private investors (such as Dexia), the relative dearth of

Calvert Social Investment Foundation: Raising Funds from the Public

Through its Community Investment Notes, the Calvert Social Investment Foundation has raised about $38 million from the American public. Presently, there are approximately 1,500 investors. The notes – which have a minimum denomination of $1,000, yield from 0 to 3 percent (investor's choice) and are offered with 1,3 or 5–year terms – are sold directly by the Foundation as well as through broker-dealers. Calvert also offers the notes on behalf of eight other funds involved in microfinance and community investing.

The Calvert Social Investment Foundation has a portfolio of $52 million ($38 million financed from notes and $14 million administered on behalf of the Calvert Group) in community investments, of which about 18 percent is geared toward microenterprise and 23 percent toward small business. Of the $52 million, 84 percent is placed in the United States and 16 percent in international markets.

Two of the largest challenges facing the Calvert Foundations are how to cost-effectively deal with foreign exchange risk on its asset side, and how to integrate the operations with broker-dealers and electronic clearing-houses on its liability side (which in turn facilitates access to individual retail investors). This latter problem is mostly an issue of cost and size: a fund must have about $50 million before it can bear the cost and broker-dealers are willing to offer it to their clients.

Source: Berenbach, Shari. Executive Director, Calvert Social Investment Foundation.

[29] The Dexia Microcredit Fund is somewhat of an exception to this rule, as it obtains its funding from individual investors with a social/development interest.

[30] Clearly, the next step for these specialized funds, and by extension the microfinance industry as a whole, is to start attracting money from a broader cross-section of investors. Considering the respectable returns of these funds, and the underlying returns on equity of 20 to 30 percent of some of the microfinance institutions, this should not be an impossible task.

useful social impact indicators makes it difficult to convince prospective investors that their money will have a double bottom-line impact—not only financial, but also social.

Specialized funds have identified a number of additional concerns related to social and commercial investment in microfinance. These issues include foreign exchange risk, subsidized donor funding to sustainable microfinance institutions, lack of industry statistics and transparency, insufficient rating capabilities, and miscellaneous adverse local regulations.

Foreign exchange risk is mentioned as one of the more pressing concerns, as it is something that neither investors nor microfinance institutions want to take. For investors, local currency loans make the risk/return calculation much harder; for microfinance institutions, hard currency loans complicate asset-liability management since they typically lend in local currency.
In some cases, investors get around this problem by depositing a dollar-denominated loan in a local bank, which is then used as collateral for a local currency loan (from the local bank) to the microfinance institution. While this arrangement seems to essentially solve the foreign exchange problem, it appears to be associated with significant administrative hassles and lower returns.[31] Furthermore, not all countries allow their local banks to receive dollar denominated deposits, while others prohibit lending in foreign currencies to nonregulated entities.[32]

[31] For example, according Shari Berenbach at the Calvert Social Investment Foundation, it can take several months for an investor to open the dollar-denominated account in the local bank. Moreover, the local bank typically takes big cut out of the transaction by offering modest rates on the dollar denominated deposit and charging relatively high rates on the local currency loan to the microfinance institution.

[32] India prohibits short-term foreign currency lending to nonprofit organizations; however, no country in Latin America appears to have this particular prohibition.

A more common problem associated with local regulations is that they raise the cost of lending to or investing in microfinance institution in a number of ways. For example, if the investment fund is chartered in a country that does not have a double-taxation treaty with the country in which the recipient institution operates, proceeds could be taxed twice. Until recently the Dexia, Microcredit Fund, which is based in Luxemburg, had this problem in relation to its investments in Mexico.

In other cases, local regulations may raise costs by requiring the recipient microfinance institution to set aside a significant percentage of a foreign currency loan in reserves at the Central Bank. For example, if a nonbank entity makes a foreign currency loan to a Rural Savings and Loan Institution in Peru (Caja Rural de Ahorro y Crédito), the Caja needs to reserve a full 33 percent of the amount, which significantly raises the actual cost of the transaction.

Another obstacle to greater participation of social and commercial investors in microfinance is related to the lack of industry statistics and insufficient transparency. Volume, or absorption capacity, is an important issue to larger investors, so information on the size and growth rate of the microfinance industry is a necessary input to their decision-making. Industry-wide default rates, to name another issue, are also of great importance in their decision making. Latin America has come further than other regions in this regard, but information is still spotty compared to what normally is available in mainstream financial markets.

The lack of industry statistics standards is compounded by barely sufficient information on microfinance institutions at the company level. For example, given less than fully transparent accounting systems in some countries, it may hard to analyze financial statements correctly. Furthermore, mainstream rating firms are only beginning to discover microfinance and have not yet adapted their evaluation methodologies. Meanwhile, specialized microfinance assessment/rating firms, who know the sector well, lack recognition among all but the most specialized investors.

Finally, a major frustration expressed by all specialized investors is the continuing presence of subsidized funding to commercially viable microfinance institutions. Even though subsidized funding seems to be declining among Latin American microfinance institutions, specialized investment funds nevertheless often see themselves undercut by below-market funds, sometimes even provided by one of their own shareholders!

THE ROLE OF DONOR AGENCIES

The increasing involvement of the public (through savings) and commercially oriented entities in the financing of microfinance puts donor agencies in complicated situation: how do they support the funding of the industry without crowding out the private sector?

To define their role in the financing of microfinance, donor agencies must understand their relative position vis-à-vis other possible funders in terms of risk tolerance. No other potential funders are (or should be) as risk tolerant as donor agencies, for which risk taking is an implicit part of their mandates and which are able to absorb the potential losses that can result from high-risk investments.

Given their presumably greater risk tolerance, donor agencies should provide the type of funding that social or commercial investors are not willing to offer. Conversely, they should step away from the type of funding that more commercially oriented funders are willing to provide. In today's world, this means, at a minimum, that donor agencies should avoid providing conventional loans to transformed microfinance institutions.[33] This type of funding is already provided for by specialized funds, some of which were created by and are largely owned by donor agencies. Providing loan funds to nonprofit microcredit organizations might still be justified, but doing it to regulated and profitable microfinance institutions undermine their savings programs and displace specialized funds and other potential creditors.

On the other hand, there still seems to be a clear role for donor agencies in providing seed equity for microfinance institutions at the moment they transform into regulated financial institutions. Few social or commercial investors have so far dared to enter at this level of risk, though the industry may see greater activity by specialized funds in the future.[34] Donor agencies can also support the efforts of microfinance institutions to launch new and "innovative" funding initiatives in local and international markets, for example by providing credit enhancements to bond issues or investing in the global microfinance securitization described earlier.[35] Finally, there is still a major role for donor agencies in providing technical assistance to support the development and expansion of savings services in microfinance institutions.

However, it is important to realize that the frontier between justified donor financing and commercially oriented operators is not static, but keeps moving. Five years ago it made sense for donors to provide loans to transformed microfinance institutions; today, with a trail to financial markets already blazed, such funding is much harder to justify.

[33] The argument that there is space for donor agencies to provide long-term funding to these institutions is becoming harder and harder to make convincingly.

[34] Cyrano Mangement, fund manager of LACIF, plans to launch a fund within the near future that will offer equity instruments.

[35] Donors can provide credit enhancement for first-time bond issues, as a way of introducing microfinance institutions to capital markets and extending the average tenor of their obligations. However, indiscriminately and repeatedly providing credit enhancement to commercially viable microfinance institutions does not seem substantially different or more justified than providing direct debt financing.

Donor agencies might serve the industry better by shifting the focus away from direct funding and onto removing barriers that currently prevent sustainable microfinance institutions from accessing funding from the public, from financial institutions, and from commercial and social investors. In other words, donors could see their mission increasingly as market facilitators, providing the infrastructure and information that private actors need, but cannot easily be provided by the market itself.

This kind of support can take many forms, but the comparative advantage of donors (relative to private sector actors) is their willingness to absorb risks/losses, their access to governments and their ability to fund initiatives where the private return is small but the public good is significant. The willingness to absorb losses enables donors to participate in arrangements (such as the global securitization initiative described earlier) that include commercial interests, introducing the latter to the microfinance industry; the access to governments gives donors a possibility to positively influence regulatory and policy frameworks; and the ability to finance initiatives with low private returns allows them to provide crucial industry information that microfinance institutions and commercially oriented investors need in their decision making.

Donors should also consider supporting the research and set-up of market-wide mechanisms that address the concerns of a broad range of investors, such as foreign exchange risk, to take one issue. A foreign exchange facility could allow creditors to lend in hard currency and microfinance institutions to borrow in local currency. The existence of such a facility, if feasible and justified, could significantly increase the flow of commercially oriented funds to microfinance institutions.

The current trend of increasing commercialization in the financing of microfinance is progressively diminishing the suitable range of action for donor agencies. Though the donor community in general appears to recognize and respect this development, the transition to market facilitating activities can be challenging.

Donor agencies have strong incentives to show results in terms of number of operations and their combined volume. In this context, lending to microfinance institutions is a particularly attractive option as the numbers and amounts add up quickly. Not surprisingly, many donor agencies have been slow to adjust their lending programs. Nevertheless, if donor agencies are to continue to play a positive and useful role in the development of the microfinance industry, they will have to accept its changing landscape and their changing role within it.

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