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The Market for Microfinance Foreign Investment: Opportunities and Challenges

Gautam Ivatury
CGAP

Julie Abrams
Consultant

Introduction

During the last decade, international financial institutions and privately managed foreign investors have filled an important market gap in investment in microfinance. These and other "foreign investors"[1] have fueled the growth of leading specialized microfinance institutions (MFIs)[2] and helped launch greenfield microfinance banks, particularly in Eastern Europe and Latin America. For much of this period, commercial banks in most countries have been unwilling to lend to MFIs, domestic capital markets have been inaccessible to unknown MFI issuers, and only a handful of MFIs have been authorized to accept deposits. In this context, the roughly US$ 1.9 billion in commercial and quasi-commercial investment that foreign investors have allocated to microfinance has played a key role in financing the sector's growth and encouraging MFIs to improve their performance and professionalism.

However, microfinance banks and non-bank financial institutions (NBFIs), which have received nearly twice as much foreign investment as NGOs and cooperatives, are beginning to replace foreign financing with funding from domestic sources. In Eastern Europe, greenfield microfinance banks that have largely been financed by international financial institutions are replacing foreign-sourced debt with customer deposits. In Latin America, maturing NBFIs and microfinance banks facing declining portfolio yields as a result of competition are reducing their financing costs through greater deposit mobilization and through local currency borrowings. Unlike the majority of foreign debt investment in microfinance, these loans are safe from potentially costly foreign exchange fluctuation. As more MFIs become aware that the true cost of foreign currency borrowing includes a premium to hedge against exchange rate risk, they may find that local currency loans from domestic banks are less expensive than has been perceived.

MFIs, credit unions and cooperatives that accept foreign investment represent one slice in the broad spectrum of financial institutions that serve the poor. This paper examines the market for foreign investment within this narrow set of microfinance providers[2] to identify emerging opportunities for foreign investors. The findings are drawn from a review of the investment portfolios of 54 foreign investors[3], that have invested in 517 institutions, and a survey of 216 microfinance providers that identifies their financing needs and preferences. The findings include:

- Foreign investors have invested about US$ 1.1 billion in microfinance providers and US$ 543 million in privately-managed investment funds and other microfinance investment vehicles
- At least 72 percent of all foreign investment in microfinance providers has gone to regulated MFIs (microfinance banks and NBFIs)
- The top ten MFI recipients of foreign investment receive 39 percent of all funds invested in MFIs, totaling US$ 427 million
- Twenty countries, 17 of which are in Latin America or Eastern Europe, receive more than 80 percent of all foreign investment

[1] As will be discussed later, foreign investors in microfinance include a wide variety of entities, including private commercial banks, investment funds, special purpose vehicles, development finance institutions, and others.

[2] This paper uses "microfinance institution" and "MFI" narrowly, referring to not-for-profit non-governmental organizations (NGOs), non-banking financial institutions (NBFIs) and commercial banks that specialize in microfinance, as well as separate microfinance programs in full-service banks. The terms "microfinance provider" and "institution" refer to the broader set of organizations that provide financial services to the poor, including MFIs but also credit unions and cooperatives, and banks.

[3] See Annex I for a full list of these foreign investors.

- About 85 percent of all foreign debt investment to microfinance providers is loaned in hard currency, yet only about one quarter of MFIs with hard currency borrowings fully hedge the foreign exchange risk

Methodology
To understand the capital structure of financial institutions that serve the poor, and their funding needs, preferences and challenges, CGAP and the Microfinance Information eXchange (the MIX) issued an open invitation to MFIs and other financial institutions that serve the poor to complete a questionnaire that was made available online and in print format.[4] Two hundred and sixteen institutions from 60 countries participated in this survey.[5] Responses from these organizations were supplemented by balance sheet and financial performance data for 353 MFIs provided by major industry associations and service providers.[6]

CGAP, the MIX and ADA also conducted a joint survey of 54 microfinance foreign investors to understand, among other things, their legal structures, investment focus, and financial performance. The detailed portfolio information gathered from the survey yielded data on investments in 517 MFIs and investments in 38 microfinance investors (including other foreign investors, apex lenders, and national investment funds).[7]

The Market for Foreign Investment
Institutions that have the potential to accept foreign debt include NGOs, credit unions and cooperatives, NBFIs and microfinance banks. However, not all such institutions are eligible: regulation in several countries, such as India, restricts all MFIs from borrowing from foreign lenders.

Segmentation of Foreign Investment Recipients
Institutions that receive foreign investment can be categorized in two primary segments: a) regulated MFIs (microfinance banks and NBFIs) or "Segment I" institutions eligible to receive both debt and equity investment; and b) unregulated MFIs (such as NGOs and trusts) plus credit unions and cooperatives, or "Segment II" institutions that are legally structured to receive only debt, and not equity, investment.[8]

Segment I and Segment II institutions represent a relatively small slice of the broad spectrum of "alternative financial institutions" that provide financial services to the poor, many by intermediating public deposits. State agricultural and development banks, postal savings banks and community banks generally don't require foreign debt or equity financing, and

[4] The assistance of the Microfinance Centre (MFC) in Poland, CAPAF in Senegal, and a number of microfinance foreign investors and MFI associations was invaluable in obtaining these responses.
[5] The English version of the survey is accessible at http://www.surveymonkey.com/s.asp?u=33938560773.
[6] The authors thank Glenn Westley of the Inter-American Development Bank (IDB), Damien von Stauffenberg and Todd Farrington of MicroRate, and Isabelle Barrès of the Microfinance Information eXchange (the MIX) for their assistance in gathering this data.
[7] The authors wish to thank Isabelle Barrès of MIX, and Patrick Goodman, consultant to ADA, for their collaboration on the survey of investment funds.
[8] Foreign investors have made equity investments in transforming NGOs: the investor and the NGOs capitalize a new for-profit company to continue the NGO's microfinance operations as a regulated institution.

many are not permitted to access it. In many countries these institutions serve far more clients than do NGOs, credit unions, microfinance banks and NBFIs.[9]

Non-traditional providers of microfinance services represent a small third segment of the market for foreign investment. These institutions include commercial banks that are "downscaling" into microfinance, mobile phone operators exploring joint ventures with banks, and consumer credit companies broadening their focus to make microentreprise loans. Although these entities represent only a tiny percentage of the total number of microfinance providers, many already have sizeable numbers of clients and are emerging in larger and more mature financial sectors including in Brazil, South Africa and India. Since these ventures are often sponsored by formal financial institutions or large corporations, they may be difficult to identify for foreign investors focused on traditional microfinance, and are likely to need less capital from these investors than do Segment I and Segment II institutions. Some, such as downscaling banks, may be entire self-funding and require no foreign investment capital.

Segmentation of Foreign Investors

The 54 foreign investors that participated in the joint survey can be segmented as follows: a) 9 development banks and investment arms of bi-lateral and multi-lateral development agencies ("public investors") financed with government funds or from the capital markets at low cost due to their official status; and b) 45 foreign investors and foundations ("private funds") financed by both public and private sources of capital.[10] Both types of investors generally take a commercial approach in the rigor of their investment analysis and monitoring, but are not fully commercial in the sense of trying to maximize profit. They take greater risks and accept lower returns than purely profit-maximizing investors.[11]

[9] Christen, Robert Peck, & Rosenberg, Richard, & Jayadeva, Veena (2004). Consultative Group to Assist the Poorest (CGAP) Occasional Paper No. 8. *Financial Institutions with a "Double Bottom Line": Implications for the Future of Microfinance*. Washington, D.C.: CGAP.

[10] Other literature on this subject categorizes foreign investors as either: a) "microfinance investment funds," specialized investment structures that invest only in microfinance; or b) development agencies, foundations and NGOs that invest in microfinance among other areas.

[11] The survey did not take into account international banks such as Societe Generale, Citigroup and others that have made cross-border investments in financial institutions that serve the poor.

Table 1: Allocation of Foreign Investment in Microfinance (in US$ millions)

	Private Funds	Public Investors	All Investors
Segment I and Segment II Institutions	$497.8 42.9%	$663.0 57.1%	**$1,160.8** **100.0%**
Other Investors (includes foreign investors, apex institutions)	$143.2 22.9%	$483.0 77.1%	**$626.2** **100.0%**
Microfinance Associations (international and national networks)	$58.6 65.0%	$31.5 35.0%	**$90.1** **100.0%**
TOTAL	**$699.6** **37.2%**	**$1,177.5** **62.7%**	**$1,877.1** **100.0%**

Source: CGAP Analysis of Microfinance Foreign Investors (2004).

Public investors finance nearly two-thirds of all microfinance foreign investment, although private funds appear to play the leading role in financing microfinance associations. In addition to amounts already invested, public investors and private funds hold at least US$ 80 million in uncommitted funds for microfinance and are expected to increase their capital by about $104 million in the near term. Five new private funds are expected to become operational in the next six to twelve months with about US$ 129 million. This makes the total additional near term foreign investment available for microfinance about US$ 313 million.

Approximately 33 percent of all foreign equity and debt investment in microfinance is made by public investors and private funds into other investors, including private funds, and regional and national apex institutions. Nineteen of the forty-five private funds identified in this study received US$ 87.6 million from public investors, and US$ 73.5 million from other private funds, for a total of US$ 161.1 million.

In many cases, public investors that invest in private funds have both direct and indirect exposure to the equity of microfinance providers. BIO, the public investor that is owned by the government of Belgium, owns 15.08% of Caja los Andes, a Bolivian MFI. BIO also owns 6.7% of the equity of IMI (a private fund), which in turn owns 68.52% of Caja los Andes. This increases BIO's direct and indirect ownership of the MFI to approximately 20%. A separate chain of investments adds even more to BIO's exposure to Caja los Andes.[12] These overlapping investments mean that some foreign investors, particularly public investors, may be surpassing limits on exposure to individual institutions, countries or regions that they have set to ensure overall portfolio diversification.

[12] BIO owns equity in Alterfin (a private fund), which in turn owns equity in SIDI (a private fund), which in turn owns of equity in ProFund (a private fund), which in turn invests in Caja los Andes.

Pattern of Disbursed Foreign Investment
Private funds have allocated the bulk of their funding to Latin America, while public investors have primarily financed MFIs in Eastern Europe. Together, these regions represent nearly 90 percent of all foreign investment disbursed.

Table 2: Disbursed Foreign Investment and Number of Recipients (in US$ millions)

	Private Funds		**Public Investors**		**All Investors**		
	Debt	Equity	Debt	Equity	Guaran-tees	**Total**	Number of Recipients
Eastern Europe/ Central Asia (ECA)	$35.6 13%	$73.5 47%	$323.0 67%	$68.2 71%	$2.0 2%	**$502.2** **46%**	90 17%
Latin America/ Caribbean (LAC)	$162.8 59%	$67.4 43%	$150.9 31%	$13.4 14%	$63.3 76%	**$457.9** **42%**	195 38%
Sub-Saharan Africa (AFR)	$31.2 11%	$14.9 9%	$1.7 0%	$6.1 6%	$9.0 11%	**$62.9** **6%**	112 22%
East Asia/ Pacific (EAP)	$23.9 9%	$1.2 1%	$6.0 1%	$3.7 4%	$0.9 1%	**$35.7** **3%**	64 12%
South Asia (SA)	$21.7 8%	$1.0 1%	$0.0 0%	$5.3 5%	$1.1 1%	**$29.0** **3%**	48 9%
Middle East/ North Africa (MENA)	$1.8 1%	$0.0 0%	$0.0 0%	$0.0 0%	$7.0 8%	**$8.8** **1%**	8 2%
TOTAL	**$276.9** **100%**	**$158.0** **100%**	**$481.6** **100%**	**$96.6** **100%**	**$83.3** **100%**	**$1,096.5** **100%**	**517** **100%**

Source: CGAP Analysis of Microfinance Foreign Investors (2004). Investments in microfinance providers only. Differential in total from Table 1 due to exclusion of US$ 64.3 million in investment for which identity of recipients is unknown.

Within these two regions, a handful of MFIs have received the lion's share of foreign investment. The 10 institutions that have received the most foreign investment of all microfinance providers (39 percent) are in Latin America and Eastern Europe, and have received 45 percent of all investment in these regions.

Segment I institutions account for about 72 percent of all foreign investment, although there are far more Segment II institutions (NGOs, credit unions and cooperatives) that provide microfinance services worldwide. The "unclassified institutions" in the table below are institutions for which no information on legal status was available. Most of these institutions are likely to be Segment II institutions.

Table 3: Foreign Investment in Microfinance by Segment (in US$ millions)

	Private Funds		Public Investors		All Investors		
	Debt	Equity	Debt	Equity	Guaran-tees	**Total**	Number of Recipients
Segment I	$101.3 37%	$134.1 85%	$424.1 88%	$80.6 83%	$53.5 64%	**$793.6** **72%**	**114**
Segment II	$33.9 12%	$0.5 0%	$5.5 1%	$0.6 1%	$7.7 9%	**$48.2** **4%**	**110**
Unclassified Institutions	$141.7 51%	$23.4 15%	$52.0 11%	$15.4 16%	$22.2 27%	**$254.7** **23%**	**293**
TOTAL	**$276.9** **100%**	**$158.0** **100%**	**$481.6** **100%**	**$96.6** **100%**	**$83.3** **100%**	**$1,096.5** **100%**	**517** **100%**

Sources: CGAP Analysis of Microfinance Foreign Investors (2004) and CGAP/MIX Survey of Funding Needs (2004). Investments in microfinance providers only. Differential in total from Table 1 due to exclusion of US$ 64.3 million in investment for which identity of recipients is unknown.

The 18 IMI ProCredit institutions, all in Segment I, have received about one-third of all microfinance foreign investment, and about 42 percent of all equity investment.

Table 4: Foreign Investment in IMI ProCredit Institutions (in US$ millions)

	Private Funds		Public Investors		All Investors		
	Debt	Equity	Debt	Equity	Guaran-tees	**Total**	Number of Recipients
18 Institutions	$6.4	$92.3	$210.9	$58.4	$4.8	**$372.8**	18
% of TOTAL	2%	58%	44%	60%	6%	**34%**	3%

Source: CGAP Analysis of Microfinance Foreign Investors (2004).

Three hundred and seventy-six institutions, or about 73 percent of all recipients of foreign investment, have only one foreign investor, yet these institutions account for only one-quarter of all foreign investment. For about 160 of these institutions (or nearly one-third of all recipients of foreign investment), the investor is one of two Dutch private funds that have carved a niche out of servicing segment II institutions (Oikocredit and Rabobank Foundation).

Most private funds and public investors appear to compete with each other to service a relatively small group of Segment I institutions. More than one-third of all private funds are investors in Banco Solidario (Ecuador) and Confianza (Peru), and two-thirds of public investors co-invest in several ProCredit institutions in Eastern Europe.

Table 5: Number of Foreign Investors in Selected Segment I MFIs (in US$ millions)

Institution	Private Funds		Public Investors		All Investors	
	Number (45 Total)	Amount Invested	Number (9 Total)	Amount Invested	Number (54 Total)	Amount Invested
Banco Solidario (Ecuador)[13]	17	$21.7	6	$34.1	**23**	**$55.8**
Confianza (Peru)	16	$4.8	1	$0.3	**17**	**$5.1**
Caja los Andes (Bolivia)[11]	4	$9.0	8	$24.7	**12**	**$33.7**
ProCredit Bank (Moldova)	3	$1.7	6	$6.4	**9**	**$8.1**
ProCredit Bank (Georgia)	1	$6.7	6	$32.8	**7**	**$39.5**
ProCredit Bank (Ukraine)	1	$9.4	6	$38.9	**7**	**$48.3**

Source: CGAP Analysis of Microfinance Foreign Investors (2004).

Market Opportunities for Foreign Investment in Microfinance

On a broad scale, the size of the market potential for further foreign investment in microfinance will be determined by three primary factors: a) the growth of the market for financial services for the poor in countries where foreign investment in microfinance is permitted; b) the market share that Segment I and Segment II institutions will hold relative to other financial institutions such as postal savings banks and development banks; and c) the capital structures that Segment I and Segment II institutions will use to finance these operations.

Quantifying this market potential is difficult due to the heterogeneity of microfinance sectors around the world. In some countries, MFIs are growing at over 50 percent per year and often have the largest market share in providing loans to micro-entrepreneurs. In many of these countries, foreign investors play a major role in financing equity and debt for these MFIs due to the lack of local sources of commercial financing. In other countries, credit unions and cooperatives finance microfinance loans using their members' deposit liabilities, and do not see value in foreign debt (nor accept equity).

The strong growth of microfinance providers[14] around the world would seem to imply that foreign investors will have the opportunity to make larger loans and equity investments in the

[13] The 19 investors in Caja los Andes and 21 investors in Banco Solidario don't necessarily share risk according to the relative amounts of their investments. Some are more exposed than may be apparent: IFC has direct exposure to both institutions, as well as indirect through two private funds, *Accion Investments in Microfinance (AIM)* and *ProFund*.

[14] The 216 MFIs and financial institutions that responded to CGAP's survey reported an average historical annual growth rate in assets of 106 percent from fiscal 1999 to fiscal 2003, and an average projected growth in assets of 71 percent from fiscal 2004 to fiscal 2007.

Segment I institutions in which they have already invested heavily. However, as these institutions mature and increasingly share the microfinance market with commercial banks, they are shifting the bulk of their liabilities to domestic sources such as deposits and local currency loans to reduce their cost of funds and take advantage of liquidity in domestic banks and financial markets. There is also evidence that these institutions are building reserves rather than taking on new equity infusions, partly due to leverage that is considerably lower than permitted levels. These trends are particularly true of the Segment I institutions in Latin America and Eastern Europe that have received the majority of foreign investment.

The Market for Foreign Investment in Segment I

As Segment I institutions mature and respond to greater competition, they will increase leverage up to levels permitted by national regulators, reduce foreign currency borrowings that may be more expensive than local debt on a risk-adjusted basis (other things equal), seek term deposits from individuals and institutions, and search for ways to efficiently mobilize broad scale retail deposits.[15] As this transition towards domestic liabilities takes place, foreign investors will continue to be attractive to institutions that require financing at terms unavailable from domestic sources.

Emergence of Competition
Peru's microfinance sector offers an interesting case study of the potential effects of competition among MFIs and banks in the microenterprise lending business. It is also an important market to foreign investors: Peru's microfinance providers have received more debt investment from private funds than institutions in any other country, and Peru ranks fourth among all countries in total volume of microfinance foreign investment received.

Banco de Crédito de Peru (BCP), the country's largest commercial bank, began a microenterprise lending program (Financiera Solución) in 2001 that now has 14 percent of the market in micreoenterprise lending. BCP had earlier invested in Mibanco, a specialized microfinance bank and the largest MFI in Peru, but divested its stake after launching Financiera Solución. Today, BCP's program, renamed Solución, has a microenterprise loan portfolio that is 73 percent larger than Mibanco's.[16]

According to Fitch Ratings Peru, seven commercial banks in the country now hold 39 percent of the microenterprise lending market. This competition has contributed to declining portfolio yields and MFI profit margins.[17] Portfolio yields for eleven Peruvian MFIs declined 20 percent from 1997 to 2003.[18]

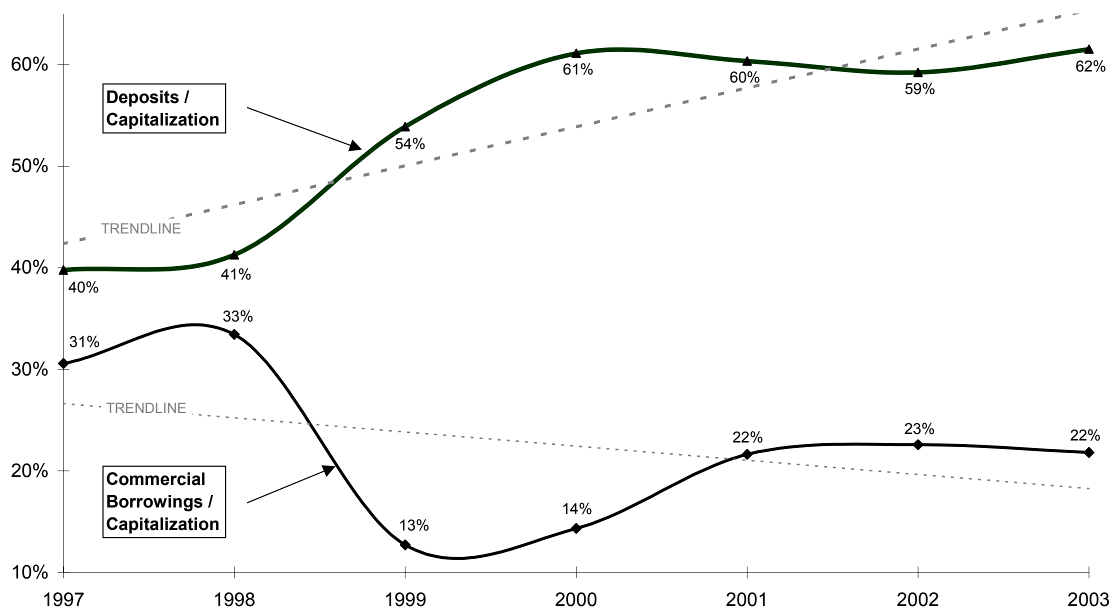
In Eastern Europe, partnerships between banks and specialized microfinance providers may lead to competition between the two, as it has done in West Africa. The Microfinance Centre (MFC) in Poland recently found that almost 50 percent of the 125 microfinance providers it

[15] Jansson, Tor. (2003). *Financing Microfinance: Exploring the Funding Side of Microfinance Institutions.* Sustainable Development Department Technical Paper Series. Washington, D.C.: Inter-American Development Bank.
[16] Chowdri, Siddhartha & and Alex Silva, editor. (2004). *Downscaling Institutions and Competitive Microfinance Markets: Reflections and Case Studies from Latin America*. Toronto: Calmeadow.
[17] Izquierdo, Johanna, Fitch Ratings Perú, Apoyo & Asociados (2004). *El Fondeo de las Instituciones de Microfinanzas: Oportunidades y Desafios*. Presentation at IADB Foro, Cartagena, Colombia, September 2004.
[18] Analysis of 1997-2003 MicroRate data.

surveyed outsourced their teller function to one or more banks in their area of operations. One-fourth of the respondents referred clients to banks if they felt the client could benefit from the bank's services, and over 15 percent of respondents had borrowed from commercial banks or were finalizing such loans. In Benin, in West Africa, *Financial Bank* maintained partnerships such as lending wholesale to microfinance providers and renting out space in its branches for three years before it became convinced of the potential profitability of a microenterprise lending business. In 1998, the bank set up an internal division to compete with the microfinance providers it had previously partnered with, and eventually spun off this division as a separate company with investment from public investors.[19]

Increasing Deposit Mobilization
In part as a result of competition, Segment I institutions in Latin America and Eastern Europe that have historically relied on foreign debt investment for a large portion of their liabilities are increasingly turning to deposits while reducing commercial borrowings.

Figure 1: Deposits and Commercial Borrowings as a Percent of Capitalization (Average of 6 Segment I Institutions in Peru)



Source: Analysis of 1997-2003 MicroRate data.

The thirty-seven Segment I institutions that participated in CGAP's survey of funding needs viewed an ideal ratio of deposits to total liabilities as 1.5 times as high as actual levels.[20]

ProCredit greenfield microfinance banks in Eastern Europe are also turning to deposits and other domestic capital sources to finance growth, rather than increase commercial borrowings from the public investors that have historically provided the bulk of their equity and debt financing. According to a recent rating report on IMI Ag (a private fund and the sponsor of these banks), "retail deposits are regarded as the main source of future growth and it is hoped that the recent adoption of a unified 'ProCredit' brand and group logo, and the confidence

[19] CGAP MFI-Bank Linkage profiles (forthcoming).
[20] 2004 CGAP Survey of MFI Funding Needs.

inspired by the "foreign" elements of the ProCredit network (e.g. Western managers, Frankfurt-based head office) will facilitate the attraction of retail deposits by the individual banks."[21] In June 2004, ProCredit Bank (Ukraine) issued 3-year bonds in the amount of US$ 6.8 million, taking advantage of a liberalizing domestic capital market and an opportunity to diversify sources of capital. The bank has received nearly US$ 50 million in investment from public investors and private funds.

Sensitivity to Cost of Funds

Segment I institutions are clearly interested in foreign debt investment as a substitute for domestic financing where it is perceived as too expensive or requires onerous forms of collateral. Foreign investors report that Segment I institutions are increasingly aggressive about "price-shopping" to obtain the lowest possible rate.

Table 6: Why Segment I institutions Seek Foreign Investment (36 respondents)

Motivating Factor for Foreign Investment	% of Segment I Respondents Rating this Factor as "Extremely Important" or "Very Important"
Lower interest rate	86%
Easier or lower amount of collateral	69%
[Investor's] Willingness to negotiate	69%
Tenor (length of loan)	61%
Speed of disbursement	56%
Ability to attract other lenders and investors	56%
Better choice of products	44%
Technical assistance provided with foreign capital	32%
Prestige	31%

Source: CGAP/MIX Survey of Funding Needs (2004)

Unfortunately, most recipients of foreign debt investment appear to perceive foreign currency loans as less expensive than they actually are. Of the 105 institutions that participated in CGAP's survey that have foreign currency loans, only 25 fully hedged this foreign exchange rate risk. If more institutions realized that the true cost of foreign currency borrowings must include a premium to cover the risk of foreign exchange movements, perhaps more would cover this risk or seek local currency borrowings. Spectacular exchange rate movements (such as the Dominican peso's 40% devaluation in 2003), and greater focus on the issue by industry associations and investors are likely to increase this awareness among institutions. As this happens, these institutions will put pressure on foreign investors to bring down the total cost of foreign currency loans or to lend in local currency.

Even if more expensive than local currency loans, foreign debt investment can contribute to reducing the overall cost of capital for Segment I institutions. Some microfinance providers

[21] Fitch Ratings report on IMI Ag, September 28 2004.

feel that loans or equity investment from foreign investors gives greater confidence to their depositors, and reduces the amount they must spend to attract deposits. More than half of the Segment I respondents to CGAP's survey of funding needs felt that foreign investment can help attract other lenders and investors, and some report using loans from foreign investors to negotiate lower rates from domestic lenders.[22]

Market Potential for Debt Investment in Segment I
Despite the continued growth of Segment I institutions, the size of the market potential for foreign debt investment is likely to reach a ceiling as MFIs shift the bulk of their liabilities towards deposits, where possible, and towards local currency loans where these are less expensive than foreign currency loans on a risk-adjusted basis. However, investors offering Segment I institutions the right products will continue to find opportunities to invest.

In particular, Segment I institutions will increasingly look to foreign investors for liability products that are not available in local markets: large term loans and longer maturity borrowings. According to the managers of the Dexia Microcredit Fund, the larger Segment I institutions in Latin America no longer entertain foreign investors that offer loans of less than US$ 1 million. In addition, the handful of institutions that are diversifying their products to include long term housing and business loans will pay greater attention to funds that can offer debt at longer maturities to match the maturities of these assets.

Even among deposit-taking MFIs, investors may find a near-term window in which shorter-term foreign loans remain in demand. For these MFIs to make deposits the major portion of their liabilities, many are likely to need technical assistance for product design and information system adaptation. Until they have built their base of depositors, these MFIs may find that deposits are more expensive than would have been expected after accounting for the costs of adapting operations and meeting reserve requirements.

Foreign investors in countries with developed financial systems with deep capital markets (where long-term capital is available) will be the main source for the longer-term, higher volume financing that growing Segment I institutions will require. Those investors with the expertise and credibility to tap private sources of capital to secure a large pool of financing will have a significant advantage. Blue Orchard (managers of the Dexia Microcredit Fund) partnered with J.P. Morgan and Developing World Markets, a US-based firm, to structure a US$ 40 million securitization of nine large MFIs. The vehicle offers public and private investors a tiered risk and return structure that provides sufficient comfort for purely profit-oriented investors to take long-term (seven year), high volume exposure to MFIs.

Market Potential for Equity Investment in Segment I
Only Segment I institutions offer equity investment opportunities to foreign investors, since the NGOs and cooperatives that comprise Segment II institutions are not structured as joint stock companies. A recent research report of the Council of Microfinance Equity Funds revealed that of the thousands of microfinance providers operating today, only 115 can be considered candidates for foreign investment, given their legal status, profitability and size.[23].

However, Segment I institutions still maintain low levels of leverage, and will first seek to increase liabilities rather than raise new equity as they attempt to reduce their overall cost of

[22] Interview with Louise Schneider of Women's World Banking (WWB) in reference to its Colombian affiliates.
[23] Kadderas, James & Elisabeth Rhyne (2004). *Characteristics of Equity Investment in Microfinance*. Council of Microfinance Equity Funds. Boston, MA: Acción International.

capital. NBFIs reporting to the MicroBanking Bulletin maintain a 2.9x debt-to-equity ratio and specialized microfinance banks maintain a 5.6x ratio.[24] A recent report of the Council of Microfinance Equity Funds revealed that in oral and written interviews of general managers at eight leading MFIs, seven of the eight reported that they have no need for additional equity capital over a three-to-five year time period. These managers indicated a preference to use deposits or profits to finance growth.[25] CGAP's survey of funding needs among microfinance providers also found limited potential for investors to increase their stakes in Segment I institutions that already have foreign equity. The twenty-six Segment I respondents that described their current ownership patterns indicated that local ownership represents about 55 percent of their shareholding, and foreign ownership 45 percent. These MFIs reported that in an ideal case, foreign shareholding would be 48 percent, an increase of only 3 percent from actual levels.

The Market for Foreign Investment in Segment II

Segment II institutions (NGOs, credit unions and cooperatives) represent a smaller market for foreign debt investment than Segment I in terms of total volume, and are not eligible for foreign equity investment due to their legal status. However, Segment II institutions appear to value the perceived lower cost of foreign debt, and also seek easier forms of collateral than domestic banks require:

Table 7: Why Segment II Institutions Seek Foreign Investment (112 respondents)

Motivating Factor for Foreign Investment	% of Respondents Rating this Factor as "Extremely Important" or "Very Important"
Lower interest rate	78%
Easier or lower amount of collateral	72%
Tenor (length of loan)	66%
[Investor's] Willingness to negotiate	66%
Speed of Disbursement	65%
Ability to attract other lenders and investors	60%
Better choice of products	56%
Technical assistance provided with foreign capital	54%
Prestige	40%

Source: CGAP/MIX Survey of Funding Needs (2004)

Segment II institutions may offer foreign investors the opportunity to selectively make a higher number of smaller debt investments. On average, Segment II institutions have received average loans of about US$ 309,000 from private funds, while Segment I institutions have received loans from the same set of investors that average three times as

[24] MicroBanking Bulletin, Issue No. 9 (2003). Washington, D.C.: Microfinance Information eXchange (MIX).
[25] Kadderas and Rhyne, page 25.

large (US$ 905,000).[26] While there are many more Segment II institutions worldwide than Segment I institutions, they tend to be smaller in asset size, have less international recognition, and are less transparent: most lack high-quality information systems and independently-audited financial statements and have not been rated by mainstream or microfinance rating agencies.

Since most NGOs have been funded primarily through grants, they retain very low levels of leverage (the MicroBanking Bulletin reports an average debt-to-equity ratio of 1.0x for non-profit organizations). Unlike Segment I institutions, which can borrow from domestic banks and accept deposits, NGOs are usually prohibited from taking public savings. Since Segment II institutions don't have clear equity-holders that local banks can hold accountable in case of default, few domestic banks will lend to these institutions beyond a 1x debt-to-equity ratio, and most require a mortgage on property as collateral for loans[27]. In this context, foreign lenders that are willing to leverage Segment II institutions organizations beyond a level of 1.0x debt-to-equity while requiring less burdensome collateral will be attractive to these institutions.

In some countries, banks are finding ways around the scale and leverage constraints inherent in Segment II institutions to increase their presence in the microfinance market. If these models become widespread, the market for foreign debt investment among Segment II institutions could decline. In India, rather than lend directly to NGOs up to a maximum of 4.0 or 5.0 times debt-to-equity, two of the largest private sector banks have contracted NGOs to act as "service agents" to help build the bank's own microfinance portfolio. The NGOs identify potential microfinance borrowers, make credit decisions, disburse loans to borrowers on behalf of the bank, and monitor and service the loans. In return, the NGOs are permitted to charge the microfinance borrower a service fee. Since the bank holds the loan portfolio on its own balance sheet, it can grow its exposure to microfinance far faster than by lending limited amounts to NGOs that then on-lend this funding. Two years after pioneering this model, ICICI Bank now has more retail microfinance clients than the largest MFI in the country, which began operations twelve years ago.

Foreign investors that can find ways to inexpensively identify, appraise and support promising NGOs and cooperatives will hold a competitive advantage in this market segment. Through a network of field officers based in eleven regional offices, Oikocredit has financed 140 of the 517 Segment I and II institutions that have received foreign investment. Rabobank Foundation has invested in 90 institutions, of which 84 are debt investments with an average transaction size of just over US$ 100,000. Private funds often use partnerships with national and international microfinance associations to identify Segment II investment opportunities and reduce the transaction cost of investing in small institutions. The Calvert Foundation (which has an average loan size of about $200,000) prefers to invest in institutions that are already members of microfinance associations, and that have received microfinance ratings to reduce its due diligence and evaluation costs.

Conclusion: Seizing Opportunities in Microfinance Foreign Investment

CGAP believes that the future of microfinance lies with domestic financial intermediaries, that is, sustainable financial institutions that harness public deposits and the liquidity

[26] Data for 110 Segment II institutions and 114 Segment I institutions, from CGAP Analysis of Microfinance Foreign Investors (2004).
[27] 2004 CGAP Survey of MFI Funding Needs.

available in domestic banks and capital markets to offer financial services to the poor. These financial intermediaries may be specialized MFIs, commercial banks, credit unions, or other institutions. Although public investors, in particular, have financed the growth (and often birth) of 100 to 200 Segment I institutions, these maturing institutions will increasingly finance their liabilities from domestic sources. As they gradually find ways to collect small deposits efficiently and recognize that loans in foreign currency are often more expensive than local currency borrowing, foreign debt investment among Segment I institutions will, at best, increase in absolute terms as a smaller portion of a growing pie.

To adapt to this trend, foreign investors must re-examine their strengths and identify distinct market segments that they are best suited to serve. These segments could include smaller, less mature MFIs that require debt investment plus technical assistance, leading microfinance banks looking for large loans, or promising NGOs that seek investors to help capitalize new for-profit institutions to continue their operations. In some cases, foreign investors may have to tailor their existing products (such as by combining plain-vanilla loans and equity investment into convertible debt), to meet the needs of these segments. As foreign investors better define their market positioning, the concentration of private funds and public investors in a relatively small number of Segment I institutions will likely decline.

Those foreign investors that aim to play a catalytic role in microfinance must find the "next generation" of institutions that have the opportunity to reach massive scale. Non-traditional microfinance providers, such as "down-scaling" commercial banks, microfinance technology ventures and *service companies* that provide microfinance portfolio services to commercial banks, may be part of this next generation. These investment opportunities, while few and far between, may offer the same relatively high risk profile that public investors confronted when they first capitalized greenfield MFIs in the late 1990's. Non-traditional microfinance providers will probably require more technical assistance than capital, but they and their formal sector sponsors (banks, corporations) would benefit from the experience that microfinance foreign investors have gained over the past decade. Public investors, which benefit from government funding or low-cost financing from capital markets, and which have a higher risk appetite than many of the investors in private funds, may be best suited to explore these opportunities.

With the right products and positioning, foreign investors can specialize their product offerings, meet the needs of a variety of institutions in the market, and continue to play an important role in the evolving market for microfinance investment.

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Annex I

Foreign Investors Surveyed by CGAP/MIX/ADA

ACCION AIM
ACCION Gateway Fund
ACCION Latin American Bridge Fund
AfriCap Microfinance Fund
Alterfin
ASN/Novib Fund (ANF)
AWF Development Debt
BIO
Calvert Social Investment Foundation
Cordaid
Corporacion Andina de Fomento (CAF)
CreSud
Deutsche Bank Microcredit Development Fund (DBMDF)
Developpement International Desjardins (Fonidi Fund)
Developpement International Desjardins (Guarantee Fund)
Developpement International Desjardins (Parternship Fund)
Dexia Microcredit Fund
DOEN
Etimos
European Bank for Reconstruction and Development for Small Business (EBRD)
FinnFund
FMO Nederlandse Financierings-Maatchappij voor Ontwikkelingslanden NV (FMO)
Fonds International de Garantie (FIG)
Global Microfinance Facility
GrayGhost
Hivos-Triodos Fund (HTF)
ICCO (Inter Church organization for development Co-Operation)
Incofin
International Finance Corporation (IFC)
Internationale Micro Investitionen Aktiengesellschaft (IMI-AG)
Kolibri Kapital ASA
Kreditanstalt für Wiederaufbau (KfW)
La Fayette Participations, Horus Banque et Finance (LFP)
La Fayette Investissement (LFI)
LA-CIF Latin American Challenge Investment Fund, S.A. (LA-CIF)
Luxmint - ADA
Microvest (CARE/Sarona/MEDA)
Multilateral Investment Fund (MIF) of the Inter-American Development Bank (IADB)
NOVIB
Oikocredit
Opportunity International - Opportunity Microcredit Fund
Partners for the Common Good
PlaNet Finance Fund
Profund
Rabobank
ResponsAbility Global Microfinance Fund

Sarona Global Investment Fund, Inc (SGIF)
ShoreCap International
Societe d'Investissement et de Developpement International (SIDI)
Triodos Fair Share Fund (TFSF)
Triodos-Doen Foundation
United States Agency for International Development (USAID) Development Credit Authority (DCA)
Unitus
Blue Orchard Securities