

Microfinance Investment Funds

Ingrid Matthäus-Maier
J. D. von Pischke
Editors

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Leveraging Private Capital
for Economic Growth
and Poverty Reduction

With 12 Figures and 23 Tables

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PREFACE:

Introductory Remarks: The Purpose of Our Endeavour

Ingrid Matthäus-Maier

Member of the Board of Managing Directors, KfW Bankengruppe

The KfW Financial Sector Symposium series began in 2002 when KfW recognised the importance of establishing a unique international forum for leaders in financial sector development. Our objective was to establish key principles that would promote communication and innovation.

- First, we wanted to invite experienced, forward-thinking decision-makers who have been influential in shaping the new frontier of development finance.
- Second, we wanted the symposia to be highly interactive, centred on open and provocative discussion.
- Third, we wanted to communicate the wide-ranging expertise and professional diversity of our participants to a wider audience through publication of their insights in a variety of media.
- Fourth, we wanted the symposia to encourage new collaborative relationships by providing space for informal discussion and networking opportunities.

Our first symposium was regional in scope, consisting of an assessment of lessons in financial sector development in Southeast Europe. Our second was supra-regional, looking ahead to the region's accession to the EU and the creation of public private partnerships.

This symposium, our third, looked to the future of financial sector development. The 2004 Symposium was truly global, focusing on engagement with the private sector through the innovative application of an established financial instrument. It was the first-ever high-level meeting on microfinance investment funds. These funds have the potential to help realise the promise of microfinance by unlocking vast new sources of capital and financial know-how. These funds also lead us into an examination of mission-oriented investment and ways to engage commercial financiers in development finance.

Capital Initiatives

But why should KfW Bankengruppe, a financial institution, be interested in symposium discussions? The simple answer is because as a leader in the industry, KfW strives to stand at the frontier of innovation and product development, which of course also requires intellectual capital.

Innovation has been central to KfW's mission since it was founded as the German Bank for Reconstruction after World War II. Its structure is designed to promote financial innovation through its four divisions:

- KfW Mittelstandsbank promotes SMEs (small and medium enterprises), business start-ups, and self-employed professionals throughout Germany and Europe through classic promotional loans as well as innovative financing instruments.
- KfW Förderbank offers promotional programmes in housing and energy conservation, environmental protection, infrastructure, education and asset securitisation.
- KfW IPEX bank offers export and project financing focused on products such as airliners, ships and power plants.
- KfW Entwicklungsbank provides funds and expertise on behalf of the German federal government, whereas DEG, another part of KfW, directly promotes private investments. Within the framework of financial cooperation, both contribute to sustainable improvement in living conditions in many countries.

KfW Entwicklungsbank's task in financial sector development is to assist our partners in the design and creation of institutions and systems that contribute to the alleviation of poverty. Our efforts in this important adventure have been comprehensive because financial markets are sophisticated and complex.

We are convinced that microfinance plays a very key role in the alleviation of poverty. We insist on serving "the bottom end of financial markets," where transactions involve important target groups consisting of microentrepreneurs, small businesses, and households using deposit accounts to save and to receive or send money transfers.

Our commitment is to ensure that the development function of financial systems continues to unfold independently of continued donor support. Therefore, we work with an expanding array of partners to expand the commercial basis of the microfinance industry. With its partners, KfW has pioneered successful initiatives in microfinance around the world. For example:

- We were among the first to support the Grameen Bank in Bangladesh and its contribution to the feminist agenda.
- We were among the first to establish microfinance in Sub-Saharan Africa. Together with GTZ, we supported the emergence of village banks in Mali.

- In order to reach out to the poorest in war-torn countries, KfW worked with IFC, FMO, and Triodos to upgrade ACLEDA, a microfinance institution in Cambodia, from an NGO to a full-fledged microfinance institution.
- Our support of FEFAD in Albania helped to engage the international community in the creation of nineteen microfinance institutions worldwide, ten of them in Eastern Europe. This gave rise to IMI AG (now ProCredit Holding AG), which serves almost half a million microcredit clients.
- Recently, we were among the first to invest in microinsurance facilities with the SEWA Foundation of India.
- In close cooperation with IFC and FMO, we facilitated the founding of several microfinance investment funds such as the Global Microfinance Facility and ACCION Investments in Microfinance.

Beyond our financial investments, we also make an extraordinary investment in the creation and dissemination of knowledge. Most importantly, KfW specialises in empowering our local partners with this knowledge and know-how in the form of technical assistance. This emphasis has also benefitted women in partner countries by highlighting their important role and by opening new windows of opportunity.

While our symposia may have recurring themes, the Greek philosopher Heraclitus is credited with the observation that, “No man ever steps in the same river twice, for it’s not the same river and he’s not the same man.” With microfinance and financial sector development, we are never returning to the same river. Conditions around us are constantly changing, improvements are underway and setbacks may occur.

Innovation is doing. It has two parents: necessity and imagination. Our humanity obligates us all to continue in the work that we do, which is very much about putting the creation of wealth to work for the poorest in our world. For this to occur, we must jump into the cold river of knowledge to which Heraclitus refers, sharing wisdom from our experience and with bold new ideas that will engage a wider public in the campaign to eliminate poverty.

Investment in Innovation

Our 2004 Berlin Symposium focused on product innovations that will advance our vision for microfinance. This theme continues our efforts and those of our partners to explore the frontiers of finance, and the small end of financial markets in general, especially their capacity to assist poor households and to create employment.

The expectations and the institutions that KfW and a growing number of like-minded organisations inspired have grown almost beyond recognition compared to the structures that were in place and the standards that were applied a decade ago.

But this change follows a logical path that may in fact be one of the greatest triumphs of development cooperation focused on the relatively poor. The combined efforts of these organizations assisted in empowering large numbers of people, households and firms.

What began as a variety of initiatives almost simultaneously in Asia and Latin America in the early 1980s was assisted by public sector and private funds. Continued efforts led to the creation of new institutional forms for the provision of microfinance, to the development of standards and best practice, and to an increasing number and variety of investment vehicles that promote retail microfinance institutions (MFIs). These trends spurred greater definition and coherence, in the sense that objectives and purpose became more precise while at the same time diversity created space for nuance. The variety of financial services offered has expanded greatly in response to competition in an increasingly professionalised environment, producing developmental impact.

The financial elements of microfinance are seamlessly permeating financial markets. What was once the preserve of charity and public sector donor funding has attracted venture capital. As this pace continues, it is quite probable that within the next decade the portfolios of individual retail investors will include microfinance investments, often by participation in microfinance investment funds (MFIFs). It is also possible that the retail arms of large financial groups will routinely include microfinance among their range of services.

Our Symposium was designed to assess progress and to explore possibilities in this exciting integration. Participants included private equity representatives, investment fund leaders, national and international development cooperation experts, representatives of microfinance institutions and funds, commercial bankers, scholars and others.

Acknowledgements

Finally, the efforts of those who have contributed to this book deserve acknowledgement. They include the authors, panelists, moderators and the many others who provided time and effort to gather and present data, to share experience and to offer their professional advice and criticism. Their efforts and commitment have made it possible to identify the principal mechanisms and that increasingly link microfinance to broader financial markets and to investors.

The 2004 Symposium was financed by four sources: ADA, BMZ, FEFAD and KfW. ADA – Appui de Développement Autonome – is a non-profit organisation based in Luxembourg that offers financial support and technical services to microfinance institutions in developing countries. BMZ is the Federal German Ministry for Economic Cooperation and Development. The FEFAD Foundation was established in the 1990s by the Albanian government and KfW to support micro, small and medium enterprise in Southeastern Europe. (The purpose, structure and activities of KfW were briefly summarised above.)

The editors are grateful to Wolfgang Kroh, Norbert Kloppenburg, Hanns-Peter Neuhoﬀ, Doris Köhn and Klaus Glaubitt of KfW for their consistent support in promoting the commercialisation and the financing of microfinance. We also oﬀer our thanks to Mark Schwiete, Haje Schütte, Roland Siller and Lauren Day for their eﬀorts in planning the Symposium, developing its concepts and themes, engaging partners, enlisting authors and managing a large logistical challenge. Jana Aberle assisted in the compilation of this book. Tina Butterbach’s outstanding organisational and managerial talents were invaluable throughout, from the planning of the Symposium through the development of the manuscript.

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CHAPTER 1:

Microfinance Investment Funds: Where Wealth Creation Meets Poverty Reduction

Norbert Kloppenburg

Senior Vice President, KfW Entwicklungsbank

An unacceptably high proportion of the world's population lives in dreadful conditions that consign them to Malthusian lives that are "nasty, brutish and short." While relief and other donations surely help to alleviate poverty temporarily, poverty can be fought decisively only by the creation of wealth where wealth is most lacking, which is among the poor. Wealth creation in this context is broadly defined as improvements in human productivity.

Wealth Creation?

Accordingly, wealth creation is a concept that deserves scrutiny by everyone who seeks to reduce poverty. In fact, it is a more positive and buoyant concept than poverty reduction because it provides a historically productive solution to poverty that has universal application. It includes the poor in a process that empowers them based on the things they can do. This is important because microfinance has shown that the working poor can create significant benefits for themselves with quite small loans. Describing their achievement as wealth creation enhances their dignity in a subtle way that contrasts with poverty reduction, a tough job with a heavy burden that singles them out as poor, unfortunate "others" (even though they constitute the majority of the world's population). Wealth creation may also be a bit more focused than poverty reduction.

The condition of the poor is all the more unacceptable because societies that make up a relatively small proportion of the world's population have found ways, over very lengthy periods of time, that have permitted them to create great wealth, to prosper and enjoy opportunities that would have been unimaginable in earlier generations. This dichotomy – between rich societies and poor ones – is the largest economic and social issue of our time, and also the largest disgrace.

Addressing the possibility of creating wealth among the poor is difficult and slow. One reason for this halting progress is that the institutions that create wealth

are only imperfectly understood. Even where wealth creation has worked relatively well, as measured by various common standards, *perceptions* of the manner in which wealth is created make it very difficult in the current era for the process to be widely admired. Regardless of whether such perceptions are valid, gulfs in levels of wealth remain also in rich societies, causing conflict and violence. Wealth creation is a contentious business. This is highly unfortunate in view of its potential.

Dimensions of wealth creation that are especially difficult for modern society to place in context include sustainability and distribution. Because wealth creation is slow and uncertain, especially in economies that remain stubbornly poor, it is often difficult to comprehend. A central feature of wealth creation is the trade-off between the present and the future, or welfare now versus welfare later, that lies at the heart of every investment and other human endeavour. This conundrum is compounded by concerns about concentration – how is it possible to expand the wealth-creation process to include as many households as possible as rapidly as possible, especially since wealth creation is inherently uneven because capacities to create wealth vary, as does the willingness to take risks?

In view of these concerns and challenges in societies where technology, institutions and location have made wealth creation a matter of routine, what can be said about stimulating wealth creation in poor societies? Here the problems are more complex. Transforming or transplanting into poor societies the institutions that have created wealth in rich ones is subject to even more uncertainty, doubt, and conflict. This is the short history of development cooperation worldwide.

Financial Markets and the Creation of Wealth

Financial markets are subtle institutions based on risk and trust. They are often popularly thought of as the embodiment of wealth, but this perception requires qualification. Wealth in financial form represents only a fraction of a society's wealth, which consists of infrastructure, institutions, and values, all of which determine ways of and scope for transacting. In fact, financial assets are not really wealth. They do nothing on their own; their usefulness lies only in their capacity to stimulate activity and manage risk in the "real" or nonfinancial sectors of an economy. However, financial markets integrate real markets through rates of interest or rates of return that provide a basis for separating good investment proposals, or prospective uses of finance, from poor ones. These rates also help to determine the trade-off between investment and consumption now, and investment and consumption in the future. This gives financial markets considerable power and social utility, and the ways in which financial markets operate have important consequences for the creation of wealth. Other things remaining equal, societies with reasonably efficient financial markets fare better than those without.

Since the 1970s, wealth creation has been made easier by the liberalisation of financial markets. Liberalisation reformed repressive state policy. Reform allowed

interest rates to be determined in financial markets rather than in government bureaux, permitted deposit-taking institutions to lend a larger portion of their funds from deposits rather than passing them on to the central bank, reduced government allocation of credit in favour of market allocation, and opened financial markets to greater competition. The result has been creative and, as might be expected, a bit disorderly. Crises have occurred, which have led to new insights into risk management and financial market regulation.

More importantly, great gains, widely distributed, have materialised. The costs of offering and using financial services are lower, permitting more people to transact. The variety of financial instruments and services has exploded, also expanding participation and outreach. The feature of financial markets that makes gains possible is their relentless quest for information and their capacity to price risk. As a result, financial intermediation makes it possible to assemble large sums and to disburse or intermediate these funds to specific projects and purposes. These projects and purposes increasingly include the creation of wealth among the poor. Microfinance is a part of this process, a vehicle that can achieve this objective when certain wealth-creating conditions apply. These conditions are increasingly better and more broadly understood.

Creating Wealth Through Microfinance

Microfinance, as it is known today, began with small experiments around 1980 that attracted official development assistance or cooperation. Official donors adopted microfinance as an exciting and worthwhile means of helping poor people in their commercially productive activities. Tiny businesses can create wealth where none existed before. The German government has been a leader in supporting microfinance through development cooperation. An important motive has been to create jobs in economies in which socialist state enterprises collapsed under their own weight and that of competition, and in developing countries where the working poor can be assisted by well-structured relationships with microfinance institutions (MFIs) that provide credit and, increasingly, accept deposits and offer payment services.

German efforts have been broad and diffuse because financial markets are intricate and complex. Specific objectives in this important adventure include institution-building, “picking winners” through experimentation with different models, defining regulations that are productive, balanced and effective, and also providing business development services. Well-structured and efficiently operated financial institutions, which are systems that create information and incentives, have significant potential to create wealth, even where framework conditions are somewhat unfriendly. Institutions have been designed to create confidence among all parties concerned, based on consistently good behaviour and on meeting reasonable expectations in a dependable way. Incentives that promote these qualities

are highly valued and essential in well-functioning financial markets, especially at the high end where large investments occur.

Since the mid-1990s, it has become increasingly possible to link directly the high end of financial markets with the bottom end, where transactions involve microentrepreneurs, small businesses, and households using deposit accounts to save and to receive or send money transfers. This has occurred with the formation of microfinance investment funds (MFIFs). Some MFIFs have been created by MFIs and networks of MFIs as vehicles for attracting investment from outside parties, often official donors. These “house” MFIFs are complemented by independent MFIFs that invest in MFIs or networks selected on the basis of criteria that include investment returns, and in many cases also development impact. Dual-objective investors concerned about development impact are very prominent. In all cases, private investors, both individual and corporate, are increasingly courted and viewed as the natural owners of MFIFs.

The arrival of MFIFs extends the funding chain that provides wealth creation opportunities among the poor and others of modest means. This chain may be roughly characterised as follows, with broad estimates of the numbers of participants that could be expected in 2015:

- millions of private investors and thousands of institutions hold shares,
- in hundreds of microfinance investment funds (many organised as mutual funds),
- that lend and provide equity capital to thousands of retail microfinance institutions,
- that lend to hundreds of millions of microentrepreneurs and small and medium scale firms,
- in almost 150 developing countries and transition economies.

This exciting scenario for 2015 is possible because of several fundamental facts. First, microentrepreneurs and SMEs (small and medium enterprises) are excellent clients for MFIs that structure relationships with these clients in a manner that is productive for both lender and borrower. In poor countries and transition economies, clients’ loan repayment rates, for example, are near-perfect for many MFIs with commercial orientations – superior to those of the commercial banking segment of these financial markets. Second, regulatory structures have been modified to enable MFIs to operate in ways that seem unconventional. These include the lack of solid tangible collateral, because the poor have few suitable tangible assets, and the absence of water-tight secured transactions in most developing countries and many transition economies.

Public sector support has enabled some MFIs to become sufficiently seasoned to engage capital markets and the rigorous discipline that these markets impose in order to function efficiently. The relatively new focus on private investment

indicates that public sector support for MFIs has been catalytic. Based on the power to tax, public sector initiatives may be launched with less concern about risk than private sector initiatives that by definition are based on voluntary action and higher levels of risk aversion. Public sector assistance is therefore useful for experimentation and for getting things started, which is certainly the history of microfinance. Public sector donors and investors tend to seek new fields of activity as their older efforts mature. Exit permits them to undertake new investments. The shift from public sector to private sector ownership is also a response to the fact that financial markets have enormous funding capacity while public funds are limited.

Perspectives

However, all of this is still in the early days. Only an extremely small proportion of MFIs around the world are oriented towards commercial sustainability, although their asset market share is disproportionate to their number. Most that are currently without a commercial orientation will resist changes in their strategies. In addition, microfinance remains an ugly duckling at the high end in capital markets – it has not yet matured into an asset class that can attract hordes of mainstream investors. However, progress is highly visible and wealth creation is increasingly apparent at the small end, where microentrepreneurs and SMEs go about their daily affairs.

Before going further, an explanation is required: why are SMEs grouped with microfinance? The answer is that SMEs commonly also lack access to finance for expansion and that financial structures can be created that give SMEs incentives to honour loan contracts. Another answer is that a few micro businesses grow into small businesses and a few small businesses grow to medium scale, which is good news for the financial institutions that serve them. Yet another is that these also create jobs and improve community welfare. Finally, in what respect does size really matter when enterprise in general is unable to attract credit on reasonable terms? Is not the more important objective to create more efficient financial markets that serve society more broadly and more efficiently?

Some observers fear abandonment of microenterprise finance in favour of larger clients because of economies of scale in lending and other transactions. Some also fear that consumer lending, which uses statistical methods to issue loans without attempting to determine the debt capacity of each borrower, will crowd out microfinance that is based on this determination and also lead to the over-indebtedness of poor households. But microfinance has established itself as a market, if not an asset class, and its continuation can be assumed with a high degree of confidence. The number of new micro clients engaged, not the intake of all new clients, should be the criterion for evaluating lenders' commitment to "microfinance."

This Book and Its Structure

This book has three subsequent parts. The first explores the market for investment in microfinance, which is rapidly growing but until recently not comprehensively documented. Microfinance investment funds (MFIFs) that invest in microfinance institutions (MFIs) are playing an increasingly important role. MFIFs have a variety of forms, objectives and modes of operation. Part I includes compilation of data on what might be termed the early days of a rapidly growing industry with a structure that is increasingly complex. MFIs stand up well in times of crisis, offering a positive feature for investors.

Part II examines risk and governance of investment in microfinance. An important focal point is microfinance as an asset class. The authors of the chapters of Part II agree that investment in microfinance could be greatly expanded if microfinance were better defined as an asset class. For microfinance to become an asset class, a number of fiduciary issues have to be addressed, along with the determination of benchmarks that can guide potential investors and fund managers in their strategies and expectations. The microfinance funds market is highly inefficient in an economic sense, as also explored in detail in Part II. Promotional investors such as KfW are making this market more efficient by structuring deals that will attract more private investors. Relatively small proportions of funds from mainstream finance would constitute large injections into microfinance. At the same time, finance from local sources, including depositors, will surely play an important role. An anomaly arising from the institutional structure of microfinance investment is large open positions in foreign exchange. Funding is largely in USD and EUR while transactions by MFIs are conducted largely in local currencies. More attention to this risk is inevitable.

Part III looks ahead. The development of microfinance institutions and markets for their equity and debt has an interesting and instructive history, which has been largely donor-driven. KfW has written some of the most creative parts of this history. The thrust is essentially to deepen and broaden microfinance investment so that it becomes part of mainstream finance, using its efficient structures. Private capital is being attracted, but still at a relatively modest pace. Dual-objective investors, seeking financial returns and development impact, are an important source with diverse intentions and motives.

Financial engineering is increasingly important in attracting new private funding though deals that include different levels of risk and return for various classes of investors. KfW's approach is well-suited for this purpose based on its capacity to innovate and take risks while engaging private investors on a consistent basis over the long term. At some point donor-investors will seek exit as the trickle of private capital becomes a torrent. Unresolved questions include the types of exit vehicles chosen and, of greater importance, their implication for continued service to target groups of microentrepreneurs, small businesses and others who do not have access to the leverage provided by formal financial services.

PART I:

The Market for Investment in Microfinance

Introduction to Part I

Chapter 2 by Patrick Goodman and Chapter 3 by Guatam Ivatury and Julie Abrams describe the state and extent of the new emerging microfinance industry. These researchers provide classifications of microfinance investment funds (MFIFs) based on a variety of factors and indications of their size and orientations. Goodman has assembled the first comprehensive compilation of the microfinance investment fund industry, creating relatively detailed and valuable points of reference. Ivatury and Abrams document various dimensions of the debt and equity flows to, and also guarantees for, microfinance investment funds and the implications of these flows. They identify areas of geographic and institutional concentration. As might be expected, international financial institutions have played a substantial role in the promotion of microfinance. Much of Ivatury and Abrams' work is based on their analysis of a large survey conducted in 2004.

Thierry Benoit Calderon uses Latin American data and experience in Chapter 4 to explore a very important feature of microfinance, which is its stability in times of crisis. This characteristic presents interesting opportunities for investors. It also provides insights into a dimension of poverty and its dynamics as expressed in financial or transactional terms: the everyday economy of the household and microenterprise is surprisingly robust.

Chapter 5 offers the perspectives of a commercial bank that has invested in a number of specialised banks that cater quite successfully to microentrepreneurs and small and medium businesses in Southeast Europe. The author is Peter Hennig, the bank is Commerzbank, and the Southeast European banks form part of ProCredit Holding AG (formerly IMI AG).

CHAPTER 2:

Microfinance Investment Funds: Objectives, Players, Potential

*Patrick Goodman*¹

Consultant

Introduction

Microfinance investment funds (MFIFs) are increasingly seen as a core part of the funding of microfinance institutions (MFIs). MFIFs take various legal forms and structures set up by a variety of players. But all serve the same purpose, which is to channel increasing funding to micro-entrepreneurs via MFIs in developing countries and transition economies.

MFIFs are also a convenient tool to invest collectively in a wide and diversified range of MFIs. Suppliers of funds are able to reach a larger number of local institutions through such diversified vehicles. The latest developments demonstrate that whenever a microfinance investment fund is structured appropriately for its targeted investors, there is no lack of financial resources. Even private donors and development agencies that have been the traditional sources of funding for microfinance are increasingly keen to create such structures in order to attract additional providers of financial resources.

An interesting parallel can be seen in the development of MFIs and microfinance investment funds. The requirements of private donors, development agencies and microfinance investment funds encourage the most advanced MFIs to evolve into true commercial entities having a specific objective: providing financial services to the poor. MFIFs are following the same pattern but are slightly less advanced in their move towards commercialisation. Ironically, microfinance investment funds sometimes require evolutions and improvements from MFIs which

¹ In collaboration with ADA, Luxembourg. This publication was prepared by Patrick Goodman as an independent consultant. ADA has sponsored the preparation of this study with the support of the Luxembourg Development Cooperation, as a contribution to the debates between the development aspects of microfinance and its increasing commercialisation. The opinions expressed are those of the author and do not necessarily represent the views of any other party.

they are not ready or are not prepared to undertake themselves. In any case there is a sound evolution for both types of institutions.

The next section of this chapter analyses the parties engaged in MFIFs. KfW initiated comprehensive surveys to collect data from all the major investment structures in microfinance. These were conducted jointly by CGAP, The MIX and the author on behalf of ADA in Luxembourg between July and October 2004. The characteristics of the funds, their product mix, the origin and destination of their funding are analysed in this paper. A following section examines the forms microfinance is taking as it becomes increasingly commercial, the new structures being established, and how the traditional financial sector is gradually taking an interest in microfinance. The concluding section summarises the main benefits of microfinance investment funds.

Parallels Between the Development of Microfinance Institutions and the Development of Microfinance Investment Funds

This section explores the way in which investment funds follow a pattern that is similar to that of the MFIs as they gradually become more commercial. While a large number of MFIs and some investment funds will continue to focus on social aspects, institutions of both types which are ready for a more sustained growth should do so through a broader participation in the general financial markets.

Initial Social and Development Objectives

Microfinance institutions very often began as non-profit enterprises with essentially a social objective: helping the poorest through access to credit and to deposits. These institutions have made loans, often at modest interest rates, and those that took deposits did so at little or no interest (in some cases even at a cost) but their primary objective was social. Their activities were made possible mainly through grants and donations.

Similarly, the first financial structures put in place to lend to MFIs were established by private donors and development agencies, again with a development objective in mind. Even Profund, which could arguably be considered as the first microfinance investment fund established with the objective of obtaining a financial return, was initiated and essentially owned by development agencies. Many lessons were learnt from this early initiative that invested mainly in equity participations in MFIs. This was seen as quite risky when the fund was launched in 1995. Probably only a few of the original participants expected to see a decent return on their investment. With an internal rate of return expected to be at least between 7 and 8 % p. a. over the 10-year life of the fund, this is certainly quite an achievement.

Realisation That a Financial Return May Also Be Necessary

Gradually, with the search for additional resources, some MFIs started to generate their own resources through profits and realised that a sustainable operation provided a sound basis for a continued provision of services to the poor. The central notion of microfinance is to hand over to an individual entrepreneur the responsibility for her/his own development, assisted by a loan. The same applies to MFIs. The more independent an institution is from initial subsidies and the more capacity it has to create the basis for its own growth, the better equipped it is to fulfil its original development mission.

The requirement of a financial return for most MFIFs was also probably less apparent as the stakeholders did not create them for a financial return, but mainly for a social return. Later in this paper the various investment philosophies of microfinance investment funds will be explored, and it will be clear that commercially oriented investment funds can be very complementary to socially oriented funds. The MFIFs with a commercial orientation would target precisely the MFIs which are more sustainable while the MFIFs focusing on social returns would try to ensure that the MFIs that are primarily motivated by social concerns also become sustainable.

The first dual-objective investment fund seeking both a financial return and a social return which was not launched by private donors or development agencies is the Dexia Micro-Credit Fund. It was established in 1998 by Dexia-BIL in Luxembourg. This fund was created later than many donor or development agency sponsored funds, but it grew faster, especially after its microfinance portfolio started to be actively and professionally managed in 2000. Many funds with a less commercial orientation have grown more slowly. Bigger is not necessarily better, but providing US\$ 34 million in loans to MFIs in 20 countries (as of 31st December 2003²), starting from less than US\$ 1 million at the beginning of 2000, certainly goes a long way in contributing to micro-entrepreneurship in developing countries.

Institutionalisation and Professionalisation

Formal Structure

Microfinance has gradually become more formal with the transformation of NGOs into regulated MFIs, the creation of new MFIs and the transformation of MFIs into banks. There are several advantages to transformation. In many countries, only regulated financial institutions or banks can take deposits. Providing deposit-taking facilities expands the services offered. More generally transformation allows MFIs to reach more customers.

Transformation also usually enables institutions to attract more commercial funding in the form of loans or equity capital. This provides greater stability in the

² Dexia Micro-Credit Fund – Annual Report as of 31st December 2003.

long term. Setting up a more formal structure also has a positive impact on governance and management accountability. The profitability of the institution is improved, which opens the door to innovation, product diversification and more professional services for clients.

Another form of transformation is from a portfolio to a structured investment fund or the creation of an MFIF. Based on the surveys referred to above, there are 38 microfinance investment funds (with another 5 which were expected by the first quarter of 2005³) in addition to the development agencies and private donors. Most of these funds, and all of the most commercial ones, have been created since the mid to late 1990s. The creation of these structures has mobilised funding to MFIs which otherwise would not have been invested in this sector.

These structures also help private donors or development agencies to pool their assets and diversify their investments, rather than holding direct investments in MFIs. The participation of the most active private donors and development agencies has prompted others to join these initiatives.

Microfinance investment funds specifically targeted at private and institutional investors are just starting to emerge. Such potential investors willing to invest in microfinance may not be comfortable with the existing structures or alternatives being offered. We have seen that MFIs are transforming into more formal structures in order to appeal to potential investors in order to provide a solid basis for their continued growth. Similarly, transparent investment fund structures with clear development and financial objectives should continue to be launched by promoters to respond to this nascent demand from private and institutional investors.

Professional Managers

The development of MFIs and MFIFs has been accompanied by a professionalisation of those managing loans and portfolios. Loan officers and office managers are now an integral part of an MFI. They are being trained by MFIs that are doing their best to attract and retain good staff. An MFI manager requires skills different from those of a bank manager, but MFIs are in strong competition with local banks and local branches of foreign banks to fill middle and senior management positions.

Microfinance portfolios are increasingly being managed by professional fund managers who have worked in traditional financial markets. Independent fund management firms are being set up to manage microfinance portfolios, but there are still very few of them. There will certainly be a growing demand for such firms, established by a few individuals with development and financial backgrounds or set up by traditional investment management firms. These firms need to strike a delicate balance between the traditional financial competencies the microfinance sector needs in order to professionalise itself and the overall social and development objectives of microfinance.

³ Most of these five funds have actually been launched in the course of 2005.

Better Governance, Greater Transparency, Accountability

Providers of funding for MFIs put significant emphasis on assessments, ratings, standardisation of financial ratios, reviews and comparisons. Even those MFIs that start from a low base but that have good governance, transparency and that are fully accountable for their performance are more likely to be supported than those MFIs lacking these characteristics. A number of initiatives are aimed at standardising reporting tools in order to contribute to greater transparency. This is a logical trend in efforts to obtain access to commercial funding, although private donors and development agencies often do not require as much transparency and standard reporting or indicators.

The third edition of one of the first guides to performance indicators was put together in July 2003 by MicroRate together with the Inter-American Development Bank (IDB)⁴. Another initiative led by the SEEP Network published its guidelines in 2005⁵. These financial indicators provide very useful guidance to MFIs in presenting their numbers, highlighting those that are most important to providers of funds.

A CGAP/IDB initiative, the Microfinance Rating and Assessment Fund, partially supports ratings and assessments of MFIs, which helps small but growing MFIs to learn more about their strengths and weaknesses. The reports are prepared by recognised microfinance agencies.

Few studies have been made on microfinance investment funds. An early one was published by ADA in 2003⁶, followed shortly by another by CGAP⁷. Both helped to provide a better understanding of the players active in the increasing commercialisation of microfinance. But it is quite apparent that there is a lack of consistency in the way financial data, portfolios and ratios are presented. There was a need to harmonise ratios for MFIs. There would equally be a need for standardised definitions applicable to microfinance investment funds.

A striking example of the current disarray is the valuation of equity participations, which may be at book value, at purchase value or at market value. One institution published its equity holding in another institution at 130,000 (for sake of argument), while the second institution valued it at 100,000. The difference is most probably the premium which the first institution paid to participate in the capital of the second. Yet another institution that invested in the second showed its

⁴ MicroRate & IDB: Technical Guide – Performance Indicators for Microfinance Institutions – July 2003.

⁵ SEEP Network: Measuring Performance of Microfinance Institutions – A Framework for Reporting, Analysis, and Monitoring (2005).

⁶ Goodman, Patrick: International Investment Funds – Mobilising Investors towards Microfinance – ADA Luxembourg – November 2003.

⁷ CGAP Focus Note Nr 25 – Foreign Investment in Microfinance: Debt and Equity from quasi-commercial investors – January 2004.

participation for the same number of shares at 115,000, possibly reflecting an earlier purchase date and hence a smaller premium over book value. Neither the second nor the third institution re-valued their investments. Some microfinance investment funds have a policy, either by choice or by law, of stating the purchase value of their equity holdings in their annual accounts, which understates the true value if the investee company has generated profits and retained them. Others attempt to show the market value of their investment.

The capital of some of MFIFs and of most MFIs is highly illiquid. The market price is basically what an investor is prepared to pay. A greater consistency between microfinance investment funds will be necessary as they increase their equity investments and as more commercial investors buy into them.

In the traditional investment fund industry, for example, the total expense ratio (TER) is increasingly used to indicate the percentage of total expenses to total assets. This ratio is hardly used by MFIFs. Return indicators are also very diverse: some microfinance investment funds treat subsidies received as operating income. Here again, as more commercial investors are approached to fund microfinance, greater transparency as well as a greater consistency will be required. This will allow investors to make comparisons using all the information available, as is customary when selecting a traditional equity or bond investment fund.

Diminishing Requirement for Subsidies

Subsidies form an integral part of the microfinance sector in its early stages of development, either for an MFI or for an investment fund. As these institutions mature, subsidies are no longer necessary. Some MFIs refuse subsidised lending. For example, Padmaja Reddy, the director of Spandana, a fast-growing MFI in India, mentioned early in 2003 that she had started to gradually decrease the number and the amount of subsidised loans to ensure that the MFI and her staff would operate more efficiently.

Most MFIFs have been subsidised in one way or another. Some are managed by private donors that provide grants and subsidies to the same regions. Managing a portfolio as well as grants and subsidies, even to different entities, saves travel expenses and time.

Another subsidy that is seldom mentioned is the one provided by investors who receive a lower financial return mainly due to the size of the investment fund. In most cases, MFIFs are too small to achieve economies of scale and to be viable on their own in the long term. The start-up costs and the fixed costs of small funds represent a relatively high proportion of their assets. The investor is usually the one who suffers from excessive costs. As commercial funds grow to sustainable sizes, this form of subsidy will diminish. Private investors will be able to choose MFIFs with the most attractive cost structure, which is one of the components in the determination of the overall return.

Better Use of Subsidies

Subsidies are often available when development agencies encourage greater participation by the commercial sector. For example, subsidies can take the form of first loss tranches.

Technical assistance is also used by some investment funds, creating a clear conflict of interest. To what extent does the provision of technical assistance influence or even interfere with investment management decisions? Some funds provide technical assistance because it is indispensable for some MFIs and some regions. An example would be a venture capital fund investing in the capital of green-field or start-up MFIs. Some form of technical assistance, seen as an “intelligent” use of subsidies, may be required to assist the development of such MFIs. Other investment funds, in growing numbers, will take investment decisions based upon the intrinsic value of MFIs. These MFIFs will most likely be attractive to investors seeking reasonable financial returns in addition to a social return.

Balance Between Social Return and Financial Return

One of MFIs’ main fears about formalisation and shifting from grants and donations to inviting other investors to participate in their capital and liability structure is that their social and development mission may be at risk. Commercial funding is seen by some as necessarily diminishing social objectives. While clearly an issue, most transformed MFIs have found that it is possible to combine social objectives with financial sustainability.

Consider the case of MFIs which charge interest rates of 25 % to 50 % or more in relatively low inflation countries: Is the social objective being maintained? Is the main reason for such seemingly high interest rates really the high costs of reaching clients? If this situation is due to a quasi-monopolistic situation, the market will probably develop automatically with the entrance of competitors, decreasing interest rates progressively. This is the nature of financial markets: if there is a price distortion, someone will fill the gap, lowering interest rates in this case.

MicroRate’s study in 2004 of the 30 leading MFIs in Latin America⁸ showed that microfinance services can be a profitable business, in many cases exceeding the return on equity (ROE) of Citigroup and of local banks.

What constitutes a reasonable ROE for an MFI is beyond the scope of this paper, but the debate about the balance between the financial and the social aspects is probably the one which divides the most the MFIF community. For some funds the social aspect is paramount, reflected for example in the legal form of a non-profit company or a cooperative, or in the dividend distribution policy. Others stress the need to provide more commercial funding at competitive interest rates for the most mature MFIs.

⁸ MicroRate: The Finance of Microfinance – September 2004.

As with the MFIs, the ability to maintain a development objective within a commercial investment structure is questioned. Commitment to development objectives can be stated in the statutes of the company or in the prospectus or equivalent documents. The domicile of the investment fund, the applicable regulations and the supervisory authorities have a crucial role to play in an MFIF's effort to maintain development objectives, making the choice of jurisdiction or domicile very important.

The need of the microfinance sector worldwide is huge and growing. The net investments in microfinance of the 43 existing and scheduled investment funds surveyed for this paper, excluding investments in other investment funds, reach € 501 million with a combination of equity participations, loans and guarantees⁹. Development agencies and foundations surveyed provide an additional net amount of € 884 million of microfinance investments. There is definitely room for a wide diversity in investment funds, from those that are socially oriented to those with more commercial objectives.

Search for Funding and for Investors

Growth for MFIs and investment funds can be sustained only with additional capital or loans. This realisation has led a number of MFIs to transform into commercial institutions. But most MFIFs have not yet realised that in many cases their corporate structures and objectives cause them not to be an interesting investment target for investors having commercial as well as social objectives. Even private investors seeking some financial return in addition to a social return have a very limited choice of funds worldwide.

An example is Incofin, a small cooperative company in Belgium with microfinance assets of just over € 1.4 million. As a cooperative company it can attract private and institutional investors who mainly have a social objective, in line with the cooperative's mission. But the Belgian cooperative structure has limitations: dividends are capped and investors exiting receive only their initial investment at best. There is no participation in profits although there is a participation in losses. As its portfolio grew, Incofin realised that the cooperative structure was inappropriate for some investors. In response, it convinced partner institutions to set up an investment company which was expected to mobilise between € 5 and € 10 million.

Another even more striking case is the securitisation initiative put together during 2004 by BlueOrchard Finance S.A. (based in Geneva), Grameen Foundation USA and Developing World Markets, based in the USA. A Special Purpose Vehicle (SPV) was launched with the sole objective of making seven-year loans to nine MFIs. Notes were issued for an initial amount of US\$ 40 million, with several tranches of subordination depending on risk and potential return. A US\$ 30 million

⁹ Please refer to the appendices to this paper.

tranche bearing the least risk carries a guarantee from the US government and was bought by institutional investors. In a second closing targeting a total size of US\$ 75 million, the fund finally managed to raise US\$ 87 million in total.

Distribution – access to the final investor – is a key determinate of success in the traditional investment fund market. It will also become so in microfinance as new investment vehicles are structured to appeal to commercial investors.

Analysis of Microfinance Investment Funds

Microfinance investment funds are vehicles or institutions that channel funds to the microfinance sector. The term covers a diversified range of vehicles with different missions, objectives and types of shareholders. MFIFs' sponsors range from NGOs or development agencies to commercial players. A useful definition is that microfinance investment funds are vehicles which have been specifically set up to invest in microfinance assets (in some cases with trade finance investments) in which social or commercial, private or institutional investors can invest. Foundations would not qualify as investment funds, but they would qualify as investors in microfinance and take stakes in microfinance investment funds.

The results of a survey of investment funds are summarised in this section, with additional details in appendices to this paper. The survey, as noted previously, was conducted jointly by CGAP, The MIX and the author, on behalf of ADA in Luxembourg, between July and October 2004. It also identified the most active development agencies and donor institutions investing in microfinance. Summaries were prepared for all the investment funds which responded to the survey, and validated by the respective investment managers. A list of these institutions is provided in Table 1. These survey results highlight key characteristics of each investment fund in a consistent format. The target audience, in addition to microfinance practitioners, are potential investors in microfinance and MFIs seeking descriptions of potential investors.

A Summary of Survey Findings

Of the 43 microfinance investment funds identified, 38 were existing entities and 5 were new structures to be established in 2005, most of which have been launched since the surveys were conducted. The purpose of this study was to identify investment fund assets invested specifically in microfinance. The overall asset size of an investment fund tells little about how much is actually invested in MFIs. There are funds which invest actively but which include trade finance or similar activities. Some funds invest only in microfinance but hold a relatively high portion of cash, liquid assets or committed amounts not yet disbursed.

The total assets of the 38 MFIFs amount to € 700 million, but their combined microfinance portfolio is € 338 million. A small portion of these assets consists of investments in other funds (e.g. the responsAbility Global Microfinance Fund

Table 1. Key Players: Microfinance Investment Funds Surveyed between July and October 2004

• Accion Gateway	• Gray Ghost Microfinance Fund
• Accion Investments in Microfinance (AIM)	• Hivos-Triodos Foundation
• ADA-Luxmint	• Incofin
• Africap	• Investisseur et Partenaire pour le Développement
• Alterfin	• Impulse (Incofin) (New)
• ASN-Novib Fund	• Kolibri Kapital ASA
• AXA World Funds – Development Debt	• La Fayette Participations
• BlueOrchard Microfinance Securities I, LLC	• La Fayette Investissements (New)
• Calvert Social Investment Foundation – Community Investment Notes	• Latin American Bridge Fund (Accion)
• CreSud	• Latin American Challenge Investment Fund
• Deutsche Bank Start-up Fund (New)	• MicroVest
• Deutsche Bank Microcredit Development Fund	• Oikocredit
• Développement Int'l Desjardins – Partnership Fund	• Opportunity International (OTI)
• Dvt Int'l Desjardins – Guaranty Fund	• Solidus (New)
• Dvt Int'l Desjardins – FONIDI Fund	• PlaNet Finance – Revolving Credit Fund
• Dexia Micro-Credit Fund – Blue Orchard Debt Sub-Fund	• ProCredit Holding (formerly IMI)
• Etimos	• ProFund
• Fonds International de Garantie (FIG)	• responsAbility Global Microfinance Fund
• Global Microfinance Facility	• Sarona Global Investment Fund
• Global Commercial Microfinance Consortium (Deutsche Bank) (New)	• ShoreCap International
	• SIDI
	• Triodos Fair Share Fund
	• Triodos-Doen Foundation

investment in ProCredit Holding). Eliminating these duplications, the estimated net investment in MFIs by these 38 funds is € 321 million. Some funds are actively seeking further investment opportunities. Together with the 5 new funds, their liquid resources waiting to be placed will boost investment funds' net investments in microfinance by € 180 million. In total, the 43 microfinance investment funds' net investments in microfinance equal € 501 million.

The most active development agencies, foundations and NGOs acting as investors in microfinance have also been surveyed to assess the overall level of investments in this sector. These institutions are listed in Table 2.

Table 2. Investors in Microfinance: Development Agencies, Foundations and NGOs

Development agencies:	
• BIO (Belgian Investment Company for Developing Countries)	• FMO
• Corporacion Andina de Fomento (CAF)	• International Finance Corporation (IFC)
• European Bank for Reconstruction and Development (EBRD)	• Kreditanstalt für Wiederaufbau (KfW) / DEG
• FinnFund	• Multilateral Investment Fund of the Inter-American Development Bank
	• USAID
Foundations and NGOs:	
• Cordaid	• NOVIB
• DOEN Foundation	• Partners for the Common Good
• Inter Church Organization for Development Co-operation (ICCO)	• Rabobank Foundation
	• Unitus

The 16 development investors listed in Table 2 have a total microfinance portfolio of € 1,010 million. Eliminating the investments these institutions have in microfinance investment funds (such as IFC's investment in the Global Microfinance Facility), direct investments in MFIs by these development agencies, foundations and NGOs reach € 884 million. This means that, based on figures collected during the surveys, the total net microfinance portfolio invested by all these parties (microfinance investment funds, development agencies, foundations and NGOs) amounted to € 1,385 million, as listed in Table 3.

Table 3. Net Investments in Microfinance: All Institutions

	Net amounts invested in MFIs
43 existing and new microfinance investment funds	€ 501 million
16 development agencies, foundations and NGOs acting as investors	€ 884 million
Total	€ 1,385 million

Types of Investors

The main types of investors in microfinance investment funds are illustrated in Figure 1 and described below: