



Appui au
Développement
Autonome

EMPOWERING THE WORLD'S POOR

Microfinance Investment Funds

Key Features

Luxembourg
Patrick Goodman
Consultant ADA/KfW
February 2005



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This publication was prepared by Patrick Goodman as consultant for ADA and KfW. It was originally presented at the 2004 Financial Sector Development Symposium organised by KfW on 11th and 12th November 2004 in Berlin. An edited version of this publication will be published by KfW and Springer together with other papers presented at the Symposium.

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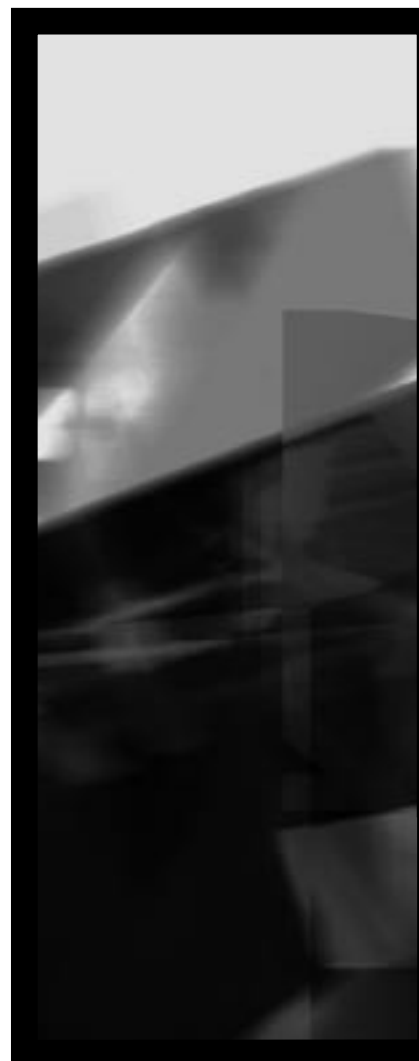
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ADA





Introduction



Microfinance Investment Funds are increasingly seen as a core part of the provision of funding to Microfinance Institutions (MFIs). They take various legal forms, various structures have been set up by a variety of players in the microfinance industry but all serve the same main purpose: they channel an increasing source of funding to micro-entrepreneurs via MFIs established in developing countries.

Microfinance Investment Funds are also seen as a convenient tool to invest collectively in a wide and diversified range of MFIs. Providers of funding are able to reach a larger number of local institutions and in a more diversified way through such vehicles. The latest developments demonstrate that whenever a microfinance investment fund is structured appropriately based on the targeted investors, there is no lack of financial resources. In fact it seems that increasingly even the traditional providers of funding to microfinance, private donors and development agencies, are keen to contribute to the creation of such structures in order to attract additional providers of financial resources.

This paper will initially look into the interesting *parallel which can be made between the development of MFIs and of Microfinance Investment Funds*. Under the requirements of private donors, development agencies and more recently microfinance investment funds, the MFIs are evolving from donor funded institutions to true commercial entities (for the most advanced of them) with a specific objective: providing financial services to the poor. *Microfinance Investment Funds are following the same pattern but are slightly less developed in their move towards a greater commercialisation*. The irony of the matter is that the investment funds are sometimes requiring evolutions and improvements from the MFIs which they themselves are not yet ready nor prepared to follow. In any case there is a sound evolution for both types of institutions, the MFIs and the microfinance investment funds.

In a second section *we will analyse the various actors in the field of Microfinance Investment Funds*. In preparation of this November Symposium and initiated by KfW, comprehensive surveys have been conducted jointly by CGAP, the MIX and the author, on behalf of ADA in Luxembourg, between July and October 2004, to collect data from all the major investment structures in microfinance. The various characteristics of the funds, their product mix, the origin and destination of their funding will be analysed in this section.

The third section will *look into which forms this increasing commercialisation of microfinance is taking, which new structures are being established and how the traditional financial sector is gradually taking an interest in microfinance*.

As a conclusion, the last section will summarise the main benefits of microfinance investment funds.

Parallel between the development of Microfinance Institutions and the development of Microfinance Investment Funds

There have been many papers written on the development of MFIs. The aim in this section is not to break into new grounds in better understanding MFIs but to *see how the investment funds are also following a similar pattern to the MFIs, as they become gradually more commercial*. There will certainly still be a need for some time to come for a large number of MFIs and for some investment funds to focus more on social aspects. Nevertheless the institutions ready for a more sustained growth should be allowed to do so with the participation of the more general financial markets.

Initial social and development objectives

Microfinance Institutions very often started as non-profit oriented enterprises with essentially a social objective: helping out the poorest by giving them access to a scarce resource, credit or the ability to place their deposits in a safe place. These institutions extended loans with interest and/or took deposits at little or no interest (even in some cases at a cost) but the primary objective was social. This was made possible thanks to grants and donations which were provided to these institutions.

Similarly the first financial structures put in place in order to extend loans to MFIs were established by private donors and development agencies, again with a development objective in mind. Even what could arguably be considered as the first investment fund established with the objective of some financial return objective, Profund, was initiated and essentially owned by development agencies. Many lessons were learnt from this early initiative, especially as this fund mainly invested in equity participations in MFIs. This was certainly seen to be very risky when the fund was launched in 1995. Probably only a few of the original participants expected to see any 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 of a potential and necessary financial return in addition to the social return

Gradually, with the increased need for additional resources, *some MFIs started to generate their own funds through profits and realised that a sustainable operation provided a sound basis for a continued provision of services to the poor. The very notion central to microfinance which is to hand over to an individual entrepreneur the responsibility for her/his own development with the necessary help of a loan also applies to the MFIs.* The more independent an institution is to the providers of the initial subsidies and the more reliant such institution is on its own ability to create itself the basis of its growth, the better equipped it is to fulfil its original development mission.

The requirement for a financial return for most microfinance investment funds was probably less apparent as the underlying stakeholders did not create them for a financial return, but mainly for a social return. We will see later in this paper what are the various investment philosophies of microfinance investment funds. We will also see that commercially oriented investment funds can be very complementary to more socially oriented funds. The first group would target precisely the MFIs which are more sustainable while the others would focus on ensuring the next level of MFIs becomes sustainable.

The first investment fund with the aim of a financial return as well as a social return and which was not launched by private donors or development agencies is the Dexia Micro-Credit Fund, established in 1998 by Dexia-BIL in Luxembourg. Although this fund was created after many donor or development agency sponsored funds, it grew faster than others especially after its microfinance portfolio started to be actively and professionally managed from 2000. Many other funds with a less commercial view have grown more slowly. Bigger is not always necessarily better but providing \$ 34 million of loans to MFIs in 20 countries (as of 31st December 2003¹), from less than \$ 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

- From creation of MFI or from NGO to regulated MFI and from regulated MFI to Bank

The provision of microfinance services 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 such a transformation process. In many countries, only regulated financial institutions or banks can take deposits. Providing deposit taking facilities allowed to expand the services offered to clients. More generally the transformation process often allows the MFIs to reach a larger number of customers.

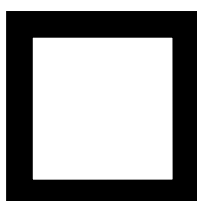
The transformation usually enables the institutions to attract more commercial funding, either in the form of loans or in the form of equity capital. This provides a greater stability of funding in the long term. Setting up a more formal structure also has a positive impact on governance and on the accountability of the management. The overall profitability of the institution is also improved, which opens the door to innovation, product diversification and more professional services towards clients.

- Transformation from portfolio to structured investment fund or creation of microfinance investment fund

Based on the surveys referred to above, there are currently 38 microfinance investment funds (with another 5 expected by the first quarter of 2005) in addition to the development agencies and the private donors present in this field. Most of these funds, and all the most commercial ones, have been created since the mid to late nineties. In many cases, the creation of these structures has enabled additional funding to MFIs which otherwise would not have been invested in this sector.

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

We have only just started to see the beginning of a series of microfinance investment funds which will be specifically targeted at private and institutional investors. A number of such potential investors are willing to invest in microfinance but they are currently either not comfortable with the existing structures or there are not enough alternatives being offered. We have seen that MFIs are transforming themselves in more formal structures to appeal to potential investors in order to provide a solid basis for their continued growth. In a similar way, transparent investment fund structures with clear development and financial objectives should continue to be launched by promoters also active in the traditional investment fund market to respond to this nascent demand. The advantages of a microfinance investment for these private and institutional investors will be covered in section 4.



¹ Dexia Micro-Credit Fund – Annual Report as of 31st December 2003

• Professional managers

For the MFIs as well as for the investment funds, their development has been accompanied by a *professionalisation of the people involved in managing the loans and the portfolios*. Loan officers and office managers are now an integral part of the process of an MFI. They are being offered the best training by the MFIs who are doing their best to attract and retain their best elements. Although being an MFI manager requires different competences than being a pure bank manager, MFIs are in strong competition with local banks and also local branches of foreign banks for the middle to senior management positions.

Microfinance portfolios are increasingly being managed by professional fund managers, many of which have worked in the traditional financial markets. Although a number of independent fund management firms have recently been set-up to manage these microfinance portfolios, there are still very few of them. There will certainly be a growing need for such firms, either established by a few individuals with development and financial backgrounds or set-up by traditional investment management firms. Here also there is a delicate balance to strike between the competencies the microfinance sector needs to attract to professionalise itself while being consistent with the overall social and development objectives.

• Better governance, greater transparency, accountability

- Under way for MFIs: assessments, ratings, standardisation of financial ratios, reviews, comparisons, etc.

Providers of funding to MFIs are putting significant emphasis on these aspects. An MFI which may be starting from a low basis but which has put in place good governance, is eager to be transparent with funding partners and is fully accountable for its performance is more likely to be supported than an MFI lacking these characteristics. *In the last few years, there have been a number of initiatives in microfinance aimed at standardising reporting tools which contribute to the greater transparency of the sector. This is a logical trend to get access to commercial funding but private donors and development agencies investing in MFIs often do not require such transparency and standard reporting or indicators.*

The third edition of one of the first guides to performance indicators was put together in December 2002 by MicroRate, together with the Inter-American Development Bank, CGAP, USAID, M-Cril and PlaNet Rating². *These financial indicators provide very useful guidance to MFIs in learning to present their numbers and to realise which indicators are important to which kind of providers of funds, from donors to commercial investors.*

The CGAP/IDB initiative in partially funding ratings or assessments of MFIs, the Microfinance Rating and Assessment Fund, is also a very useful initiative in allowing small but growing MFIs to learn more about their strengths and weaknesses. The reports, prepared by recognised microfinance agencies, are partially subsidised by this Fund.

- Very new for Microfinance Investment Funds

Very few studies have been made yet on microfinance investment funds. An initial study was published by ADA in 2003³, followed shortly after by another study by CGAP⁴. Both papers helped to have a better understanding of the players active in this increasing commercialisation of microfinance. But in collecting data and gathering information of the various microfinance investment funds, it is quite apparent that there *is a lack of consistency in the way financials, portfolios, ratios, etc are presented.* There was a need to harmonise ratios for MFIs. *There would equally be a need for industry definitions which would be applicable to investment funds in microfinance.*

² Technical Guide – Performance Indicators for Microfinance Institutions – MicroRate & IDB – December 2002

³ International Investment Funds : Mobilising Investors towards Microfinance – ADA Luxembourg – Nov 2003

⁴ CGAP Focus Note Nr 25 – Foreign Investment in Microfinance : Debt and Equity from quasi-commercial investors – January 2004

A striking example is the valuation of the equity participations in the portfolios. Do you value these participations at book value, at purchase value or at market value? One of the surveyed institutions published its equity holding in another institution at 130.000 (for sake of argument). In the books of the second institution, this equity participation is mentioned at 100.000. The difference between the two numbers is most probably the premium which the first institution agreed to pay to enter into the capital of the second. Yet another institution, having also invested in the second, shows its participation, for the same number of shares, at 115.000, evidencing probably an earlier purchase date and hence a smaller premium over book value. Neither the second nor the third institution have re-valued their investments. Some microfinance investment funds have a policy, either by choice or by law, of maintaining the purchase value of their equity holdings in their annual accounts, which understates the true value of their holding if the investee company has generated profits over time. Others make an attempt at showing the market value of their investment.

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

Unlike in the traditional investment fund industry where for example the Total Expense Ratio (TER) is a recognised and increasingly widely used indicator of the percentage of total expenses to total assets, this ratio is hardly used for microfinance investment funds. Return indicators are also very diverse with some microfinance investment funds mentioning subsidies received as operating income, in one specific case making the difference between an operating loss and a profit. Here again, as more commercial investors are approached to provide additional funding to microfinance, a greater transparency will be required from microfinance investment funds as well as a greater consistency between them. Just what is expected of a mature and sustainable MFI! This will allow investors to make comparisons and to be able to chose the right microfinance investment fund with all the information available, as it is most often the case when selecting a traditional equity or bond investment fund.

• **Diminishing requirement for subsidies as MFIs and Microfinance Investment Funds become more sustainable**

Subsidies form an integral part of the microfinance sector in the early stages of development, either for an MFI or for an investment fund. *As these institutions mature, there is less of a need for subsidies.* In fact some MFIs knowingly refuse subsidised lending. Mrs 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 of the microfinance investment funds surveyed have been subsidised one way or another. Some funds are managed by private donors which provide grants and subsidies to the same regions as the investments of the funds. Managing an investment portfolio as well as grants and subsidies, even to different entities, is a cost advantage in terms of travel expenses and time spent, over an investment manager which solely focuses on its portfolio of investments.

We are starting to see a better use of subsidies: those subsidies, provided for example by development agencies, which encourage a greater participation of the commercial sector. Such subsidies can take the form of first loss tranches, as we will see later on.

Technical assistance is also an integral part of the creation of some of the investment funds. There can be a clear conflict of interest in this case. *To what extent does the provision of technical assistance influence or even interfere with the investment management decisions?*

There will probably be a segregation in the types of investment funds, with some funds pursuing this route of also providing technical assistance because it is still indispensable for some MFIs and some regions. An example would be for example a venture capital fund investing in the capital of green-field or start-up MFIs. Some form of technical assistance, which could also be seen as an “intelligent” use of subsidies, may be required to assist such MFIs in their development. *Other investment funds, in growing numbers, will ensure that the investment decisions they take are based upon the intrinsic value of the MFIs and will most likely be the ones chosen by investors seeking some reasonable financial return in addition to the social return.*

Another subsidy which is seldom mentioned in the one provided by the investors in receiving a lower financial return than could be offered, mainly due to the size of the investment funds. We will see later in this paper a comparison between the various funds. In most cases the microfinance investment funds are too small to be viable on their own in the long term. Small funds mean that the start-up costs and the fixed costs represent a relatively high proportion of the assets of such funds than if they were larger. The investor is usually the one suffering from excessive costs. As the more commercial funds grow to sustainable sizes, this form of subsidy will diminish. Private investors will be able to choose the ones with the most attractive costs structure, which is one of the components of the overall return.

Balance between social return and financial return

One of the main fears of microfinance institutions in formalising their structure and in shifting from grants and donations to inviting other investors to participate in their capital and liability structure is the impression that their social and development mission may be at risk. More commercial funding is seen by some people as necessarily losing the social objectives. It is clearly an issue to pay attention to, but most transformed MFIs have realised that *it is possible to combine social objectives with a financial sustainability.*

In the case of MFIs which can charge interest rates from 25% up to 50% or even more in some cases to their customers in relatively low inflation countries, one could wonder whether the social objective is being maintained. Is the main reason for such seemingly high interest rates really high costs of reaching clients? If this situation is due to a quasi-monopolistic situation with very few other MFIs the market will probably develop automatically with the entrance of competitors with the consequence that interest rates will decrease progressively. This is also the nature of the financial markets: if there is a price distortion, someone else will fill the gap, with lower interest rates in this case.

MicroRate's study in 2002 of the 29 leading MFIs in Latin America⁵ showed that *providing microfinance services can also be a profitable business*, even exceeding in many cases the profitability (measured as return on equity - ROE) of Citigroup and of a number of local banks.

The debate of what would be a reasonable ROE for an MFI is beyond the scope of this paper but *this question of the balance of the financial and the social aspects is probably one which divides the most the microfinance investment fund community.* There are some microfinance investment funds for which the social aspect is paramount. They may be established in a legal form consistent with such an objective, such as a non-profit or a cooperative company. Considering the development and the growth of the major MFIs in the world, others stress the need to provide more commercial funding at more competitive interest rates to these institutions.

Similarly as for the MFIs, *the ability to maintain a development objective within a commercial investment structure is questioned. Such development objective can be secured either in the statutes of the company or in the prospectus or equivalent documents. The jurisdiction of*

⁵ The Finance of Microfinance – October 2002 - MicroRate

the investment fund, the applicable regulations and the supervisory authorities have a crucial role to play also in securing such development objectives. In this context, the choice of the jurisdiction is very important.

The need of the microfinance sector worldwide is huge and growing. Worldwide demand for micro-credit has been conservatively estimated in October 2004 at \$ 100 billion by Prof. Dr. Ernst A. Brugger and Bikram Duggal⁶. As we will see in section 3, the total net investments in microfinance of the 43 existing and scheduled investment funds surveyed for this paper, excluding investments in other investment funds, reaches € 501 million (or \$ 617 million at the exchange rates applicable for each portfolio) with a combination of equity participations, loans and guarantees⁷. In addition the development agencies and the foundations surveyed provide an additional net amount of € 884 million (or \$ 1,100 million) of microfinance investments⁷. There is definitely room for a wide diversity of investment funds from more socially oriented ones to more commercially oriented ones.



Search for funding and for investors

Continued growth for MFIs and investment funds can only really be sustained with additional funding either in the form of capital or in the form of loans. As MFIs have sought to transform themselves into more commercial institutions in order to attract fresh investments, it seems that most of the investment funds have not yet realised that, in many cases due to their corporate structure and objectives, they are not an interesting investment target for more commercial investors. Even private individuals seeking some financial return in addition to a social return have a very limited choice worldwide.

Incofin is a small cooperative company in Belgium with microfinance assets of just over € 1.4 million. As a cooperative company it can only hope to attract private and institutional investors who mainly have a social objective, in line with a cooperative's mission. In addition the structure of a cooperative in Belgium has limitations for the investor seeking some financial return. Dividends paid out are capped but more importantly investors exiting only receive their initial investment at best. There is no participation to generated profits although there is a participation in net losses, if any. As it gradually grew its portfolio and developed its contacts with MFIs, *Incofin realised there were investment opportunities which could not be materialised in the cooperative structure.* Incofin succeeded in convincing partner institutions to set-up another structure in the form of a Belgian investment company which will be launched by the end of 2004 or the beginning of 2005 and which is expected to collect between € 5 and € 10 million.

Another even more striking case is the new securitisation deal which has been put together during the summer of 2004 by BlueOrchard Finance S.A. (based in Geneva), Grameen Foundation USA and Developing World Markets, based in the USA. The company launched is a Special Purpose Vehicle (SPV) whose sole objective is to make seven-year loans to nine MFIs. Bonds were issued for a total initial amount of \$ 40 million, with a second closing in November 2004 expected to bring the total size close to \$ 75 million. Notes were issued with several tranches of subordination depending on the risk and the potential return. The tranche with the least risk carries a guarantee from the US government and amounts to \$ 30 million. It was bought by institutional investors.

Distribution, which is the access to the final investor, is key in the traditional investment fund market. It will also become key as new investment vehicles are structured in such a way that they appeal to more commercial investors. We will see in section 4 how the traditional financial markets can play a role in the further growth of the microfinance industry.

⁶ Micro-finance Investment Funds : Looking ahead – paper prepared for the KfW Symposium in Nov 2004 – Prof. Dr. Ernst A. Brugger & Bikram Duggal

⁷ Please refer to the Appendix

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Analysis of Microfinance Investment Funds

We will now be looking into the various funds investing in microfinance. *The term microfinance investment fund, which is used to characterise vehicles or institutions which channel funds to the microfinance sector, is misleading as it usually covers a range of vehicles which are very diversified.* It is used in a broader sense than for traditional investment or mutual funds. They can have very different missions and objectives. They can have very different types of shareholders which will have an influence on how the investment fund operates. They can have varying initiator companies which can range from NGOs or development agencies to commercial players. *We will consider here that microfinance investment funds are vehicles which have been specifically set up to invest in microfinance assets (in some cases together with trade finance investments) and in which social or commercial, private or institutional investors can potentially invest.* Foundations would for example not qualify as investment funds. They would qualify as investors in microfinance and do for example take stakes in microfinance investment funds. Such foundations have nevertheless been surveyed to assess the overall level of investments in microfinance.

A summary of the investment funds surveyed and of the most active development agencies and donor institutions acting as investors in microfinance as well as the related investment amounts can be found as an Appendix to this paper. In addition, based on the surveys which have been conducted jointly by CGAP, the MIX and the author, on behalf of ADA in Luxembourg, between July and October 2004, *summary information forms have been prepared for all the investment funds which have responded to the survey.* These forms have been validated by the respective investment managers and can be found at the end of the symposium papers. *The purpose of these forms is to highlight some of the key characteristics of each investment fund in a consistent format.* The target audience for these forms, in addition to microfinance practitioners, are (1) potential investors in microfinance to give them a flavour of each investment vehicle and (2) MFIs to give them an description of the potential investors in their institution.

Key players

The following are the microfinance investment funds surveyed between July and October 2004. For those which have responded, a summary information form can be found at the end of the Symposium papers. The Appendix to this paper contains key characteristics of each fund as well as the total assets and amounts invested in microfinance by each investment fund.

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

Of the 43 above microfinance investment funds, there are 38 existing entities and 5 new structures which should be established by the first quarter of 2005. *The aim of this study was to identify the investment fund assets which were specifically invested in microfinance. The overall asset size of an investment fund tells little about how much is actually invested in MFIs.* There are funds which are active investors but which have chosen to also invest in trade finance or other similar activities. There are also funds which only invest in microfinance but which have a relatively high portion of cash, liquid assets or committed amounts not yet disbursed.

The total assets of the 38 existing microfinance investment funds amount to € 700 million (\$ 870 million) at the relevant exchange rate for each fund). But they only have a combined microfinance portfolio of € 338 million (\$ 415 million). A small portion of these assets consists of investments in other funds (eg the responsAbility Global Microfinance Fund investing in IMI). By eliminating these duplications, one can estimate the current net investments of these 38 funds in MFIs at € 321 million (\$ 395 million).

Some of these existing funds have collected additional funding for which investment opportunities are actively being sought by the respective fund managers. Together with the 5 new investment funds which are scheduled to be launched by the end of the first quarter of 2005, this represents additional net investments in microfinance from investment funds of € 180 million (\$ 222 million).

In total, the 43 microfinance investment funds represent net investments in microfinance of € 501 million (\$ 617 million).

The following development agencies, foundations and NGOs acting as investors have also been surveyed to assess the overall level of investments in the microfinance sector, which will be analysed in the papers to this Symposium from CGAP and The MIX⁸:

Development agencies:

- BIO (Belgian Investment Company for Developing Countries)
- Corporacion Andina de Fomento (CAF)
- European Bank for Reconstruction and Development (EBRD)
- FinnFund
- FMO
- International Financial Corporation (IFC)
- Kredietanstalt für Wiederaufbau (KfW) / DEG
- Multilateral Investment Fund of the Inter-American Development Bank
- USAID

Foundations and NGOs:

- Cordaid
- Doen Foundation
- Inter Church organization for Development Co-operation (ICCO)
- NOVIB
- Partners for the Common Good
- Rabobank Foundation
- Unitus

These 16 development actors acting as investors have a total microfinance portfolio of € 1,010 million (or \$ 1,254 million at the relevant exchange rate for each fund). By eliminating the investments these institutions have in the above microfinance investment funds (such as IFC's investment in the Global Microfinance Facility), we reach *direct investments in MFIs for these development agencies, foundations and NGOs of € 884 million (\$1,100 million).*

The total net microfinance portfolio invested by all the above actors (microfinance investment funds, development agencies, foundations and NGOs) amount to € 1,385 million (\$ 1,717 million).

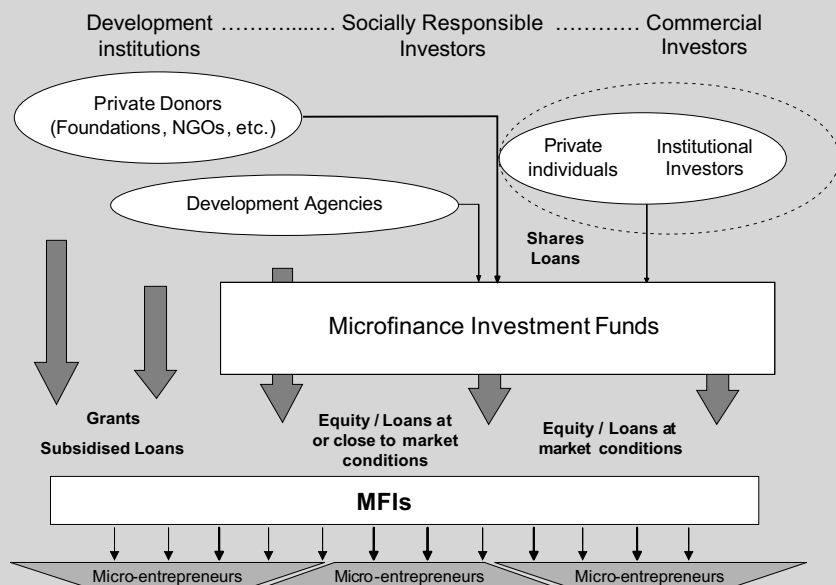
The following table summarises the situation regarding investments in microfinance from the above actors:

	Net amounts invested in MFIs
43 existing and new microfinance investment funds	€ 501 - \$ 617 million
16 development agencies, foundations and NGOs acting as investors	€ 884 - \$ 1,100 million
Total	€ 1,385 - \$ 1,717 million

⁸ CGAP paper : Market opportunities for microfinance investment funds, Gautam Ivatury, November 2004
The MIX paper : Risk and Return, Didier Thys, November 2004

Types of investors

The following graph illustrates the evolution of the provision of funds to the microfinance sector:



We will be reviewing the evolution of the microfinance sector, with the appearance of microfinance investment funds and the overall move towards a greater commercialisation of the sector.

The main types of investors in microfinance investment funds are the following:

- **Private Donors (Foundations, NGOs, etc.)**

Private donors, such as Foundations and NGOs, have been involved with microfinance for many years, directly supporting and creating MFIs in developing countries, initially through grants, donations, technical assistance and subsidies. These private donors are usually created by the private sector with donations from corporates and private individuals. They have been paramount in the development of the microfinance sector. They then gradually started to provide subsidised lending at little or no interest. Some private donors tend to bring interest rates closer to market conditions for the most mature MFIs they finance.

- **Development Agencies**

These institutions, also referred to as bilateral and multilateral agencies, comprise International Financial Institutions (IFIs) or Development Finance Institutions (DFIs), development banks and other institutions created by governments and supranational bodies to promote sustainable development in emerging countries. *Development agencies have also been instrumental in contributing to the development of MFIs, initially directly through grants, subsidised loans and equity participations.*

As the microfinance sector matured, specific vehicles such as Profund and LA-CIF, were set-up collectively by development agencies and private donors to share experiences and to diversify their risks. The shareholders and the lenders of these first generation microfinance investment funds were exclusively these kind of institutions.

• Private Individuals

Until the mid to late nineties private individuals had very few possibilities to make an investment in microfinance. Two Belgian cooperative companies were created in the early nineties and were both accessible to private individuals who could become shareholders of these companies. Incofin was established in 1992 and Alterfin in 1994. The Calvert Social Investment Foundation launched its Community Investment notes in 1995 which were made available to private investors either directly or through broker-dealers. The Fonds International de Garantie (FIG) in Geneva was established in 1996 and was also made available to private investors.

The real breakthrough for private investors in microfinance was the Dexia Micro-Credit Fund launched in 1998 in Luxembourg and marketed more actively since 2000. It offered all the advantages of a true investment fund similar for example to a traditional money-market or bond investment fund but with a definite advantage: this fund combined a social return with a potential financial return.

Since then other investment funds offering both a social and a financial return and targeting private individuals have been set up:

- Although created in 1996, *ASN-Novib*, a Dutch investment fund, was made available to private shareholders in 2000.⁹
- *Investisseur et Partenaire pour le Développement*, a Mauritius investment company, was created in April 2002 at the initiative of a group of French entrepreneurs.
- *The Triodos Fair Share Fund* was established in the Netherlands in December 2002 at the initiative of Triodos Bank to build upon the expertise it gained in managing two microfinance investment funds, one for the Doen Foundation and the other one for the Hivos Foundation.
- *The responsAbility Global Microfinance Fund* was launched in November 2003 at the initiative of responsAbility Social Investment Services Ltd, Zurich, founded by four Swiss banks and a social venture capital fund. The promoter of this Luxembourg investment fund is Credit Suisse.
- *Microvest I, LP* was founded in 2003 at the initiative of three non-profit organisations¹⁰: CARE, MEDA and SCDF, all based in the United States of America. It started its operations at the beginning of 2004.
- *Impulse*, a Belgian investment fund scheduled to be launched late 2004 or early 2005, at the initiative of Incofin, a Belgian cooperative company.

• Institutional Investors

The last group of investors in microfinance investment funds is certainly the most promising for the future of the sector. Institutional investors comprise pension funds, insurance companies, mutual and investment funds and any other such large-scale investors. A few pension funds are already investors in some of the investment funds but institutional investors are still extremely rare in microfinance, probably only doing so for image and visibility reasons or under the influence of a socially minded decision maker. Not only are institutional investors under extreme pressure for performance but they usually have little and biased understanding of the microfinance industry. It is the responsibility of the investment funds and of the microfinance community as a whole to make themselves known to this community and to demonstrate to them the advantages of such investments. It is a slow process but it is clearly under way.

⁹ Information published on Novib's website: www.novib.nl

¹⁰ CARE : Cooperative for Assistance and Relief Everywhere – MEDA: Mennonites Economic Development Association – SCDF: Seed Capital Development Fund

There are two interesting examples to mention with respect to traditional investment funds acting as investors in the microfinance sector:

- The first is the example of the Calvert Social Investment Fund family which has a policy of investing between 1% and 3% of selected mutual fund assets in the Community Investment Notes issued by the Calvert Social Investment Foundation. This currently represents \$ 20 million out of the total \$ 55 million, invested mainly in the United States of America but also in microfinance in developing markets (total microfinance portfolio: \$ 16.7 million).
- Another example is the AXA World Funds – Development Debt sub-fund of the Luxembourg fund, AXA World Funds, sponsored by AXA Investment Managers. This sub-fund has a policy of participating in the sustainable development of emerging economies, mainly through the purchase of debt instruments from Development Financial Institutions, but also by investing up to 10% of the sub-fund in commercial paper issued by MFIs. As of 15th September 2004, € 1.22 million out of total assets of € 19 million were invested in certificates of deposit issued by Latin American MFIs. As this sub-fund grows, so will the microfinance portion.

These two examples show that traditional investment funds can invest some portion of their assets in microfinance, either directly or through dedicated investment funds. AXA has allocated resources to have a small team of professionals knowledgeable about microfinance. For other institutional investors who do not wish to set-up their own microfinance expertise, microfinance investment funds are a convenient tool to make such investments by diversifying their risks.

The investment funds which were mentioned in the above section are also usually targeted at institutional investors but progress is still slow. It is necessary to *pursue the interaction with the traditional capital markets for the microfinance industry to fully understand what their requirements are and what they are concerned about.* First elements of responses seem to have been provided by the two recent structures which have established subordination tranches:

Structures	Global Microfinance Facility Ltd	BlueOrchard Microfinance Securities I, LLC
Promoters	IFC Cyrano Management SA	BlueOrchard Finance SA Dev. World Markets Microfinance Grameen Foundation USA
Type of structure	Cayman Islands investment cy	SPV in the form of a LLC
Duration	10 years	7 years
Size	\$ 30.1 million	\$ 40.1 million (First closing on 29 th July 2004)
Funding structure in subordination order		
Equity	Charitable Trust: \$ 1,000	Sponsors and investors close to MF: \$ 1.25 million MFI Commitment Reserve: \$ 95,000
First loss tranche	Promoters: \$ 2.1 million	Investors knowledgeable about MF: \$ 3.555 million
Second loss tranche	IFC, KfW: \$ 8 million	Socially responsible investors: \$ 3.67 million
Third loss tranche	NA	Institutional and private investors: \$ 2.2 million
Senior Note Holders	BIO, Crédit Coopératif and other commercial investors: \$ 20 million	One institutional investor and one investment fund: \$ 29.3 million of Notes issued by OPIC with US Govt guarantee

In the case of the Global Microfinance Facility established in April 2004, the senior Noteholders are protected by the first and second loss tranches which must represent at least 50 % of the senior tranche. In the case of BlueOrchard Microfinance Securities I, it is the issuer of the senior notes, OPIC, which is protected by the subordinated tranches and the share capital, which together represent approximately one-third of the senior tranche. The senior Noteholders carry notes with a guarantee from the US government.

These two examples represent a major evolution in structuring investment vehicles which appeal to commercial institutional investors. Their investments are safer than most of the other microfinance investment funds due to the subordination tranches. Although their return is roughly in line or only just above investment-grade debt securities, these are well publicised steps in involving commercial investors with microfinance.

Commercial institutional investors are gradually turning their attention towards microfinance. As the microfinance sector continues to innovate, to make itself understood by the traditional capital markets and to create adequate structures which maintain the necessary social goals, *this type of investor should grow gradually to provide in the years to come the bulk of the financing required to support the immense needs of micro-entrepreneurs worldwide.*

Distribution of Microfinance Investment Funds based on their objectives

In an attempt to distinguish between the various types of funds, it seems that *one of the most important criteria is the objective of the funds*: what is the balance between the financial objective and the social objective? What types of investors are involved with the fund? Which terms are offered to the MFIs? Which MFIs are targeted?

Microfinance investment funds can be classified in three main categories:

- Commercial Microfinance Investment Funds
- Commercially-oriented Microfinance Investment Funds
- Microfinance Development Funds.

The two first types of institutions are usually set up in the form of traditional investment funds or investment companies. *Their aim is to provide a financial return to socially responsible and commercial private and institutional investors, while maintaining key social and development objectives.*

• Commercial Microfinance Investment Funds.

The main distinction between these two first categories would be the nature of the investors targeted. *Commercial microfinance investment funds would be clearly targeted towards private and institutional investors.* Development agencies and private donors would only appear as initial investors or as facilitators for example in structures with subordination tranches. *These funds would be actively distributed by the original promoter as well as by external distributors.*

The nature of the investors targeted also implies that these investment funds have clearer objectives than others. *A commercial institutional investor will want to understand precisely which investment it is making, which financial return it can expect, which MFIs are being financed, etc.* The quality of the information provided in offering memoranda, prospectuses or annual reports very much depends on the targeted investors. Development agencies and private donors may not require such transparency and clarity in the official documentation. *Very few microfinance investment funds, for example, provide adequate and sufficient information on their financial return, on their cost structure, on their Total Expense Ratio¹¹, on their level of loan loss provision, etc.* This general lack of information makes it very

¹¹ Please refer to section 2.3. "Better governance, greater transparency, accountability"

difficult for traditional investors to compare such an investment with their mainstream investments. It also makes it difficult to compare microfinance investment funds between themselves. As commercial investors become more active in microfinance, the quality of the information provided will also increase.

Of the 43 microfinance investment funds in this study, the following could be considered as Commercial Microfinance Investment Funds:

- ASN-Novib Fund
- AXA World Funds – Development Debt
- BlueOrchard Microfinance Securities I, LLC
- Dexia Micro-Credit Fund – Blue Orchard Debt Sub-Fund
- Global Microfinance Facility
- Gray Ghost Microfinance Facility
- Impulse (Incofin)
- MicroVest
- responsAbility Global Microfinance Fund
- Triodos Fair Share Fund

It is interesting to note that the above funds mainly invest in loans. The investment funds investing in equity participations seem to be mainly held by development agencies and private donors. As the market matures further, we will see equity funds also targeted to institutional investors.

• Commercially-oriented Microfinance Investment Funds.

In this category, we would find the other investment funds which have clearly stated financial objectives but which are for the time being *targeted essentially to private donors, development agencies and other such actors in the microfinance industry.* A fund such as IMI (which is in fact a financial holding company) would become a commercial microfinance investment funds as it opens its capital to institutional investors, probably within the next two to three years.

The following microfinance investment funds could be considered as commercially-oriented microfinance investment funds:

- Accion Investments in Microfinance
- Africap
- Global Commercial Microfinance Consortium (Deutsche Bank)
- IMI AG
- Investisseur et Partenaire pour le Développement
- La Fayette Investissement
- La Fayette Participations
- Latin-American Bridge Fund
- LA-CIF
- Profund
- ShoreCap International
- Solidus

The distinction between the two above categories does not give any indication as to the profitability of each investment fund. In fact *some commercially-oriented investment funds have fared significantly better than the first category over the last few years, essentially due to their higher proportion in equity holdings.*

• Microfinance Development Funds

These institutions are most commonly found among co-operative companies or non-profit structures. *Their aim is to make capital available to MFIs through sustainable mechanisms to support their development and their growth without necessarily seeking a financial return. Typical financial targets for these institutions would be to maintain the original capital invested with a maximum financial return equivalent to inflation.* Financial conditions to MFIs would be below or close to market conditions. Technical Assistance may be provided by related institutions, alongside the fund. *The main investors would be private donors and development agencies but could also be private individuals and corporations. These investors seek to fund development projects by maintaining their original capital if possible. A marginal*

financial return may be provided by some of these microfinance development funds. Facilities providing grants and donations would not enter into this category as, in such a case, capital is depleted.

Even though some microfinance development funds do collect funds through donations, they still have a policy of providing funding to MFIs, rather than making grants. In this case funding is usually provided at subsidised or below market conditions. It can also be provided to green-field institutions.

The following microfinance funds could be considered as Microfinance Development Funds:

- Accion Gateway Fund
- ADA-Luxmint
- Alterfin
- Calvert Social Investment Foundation – Community Investment Notes
- CreSud
- Deutsche Bank Start-up Fund
- Deutsche Bank Microcredit Development Fund
- Développement Int’l Desjardins - Partnership Fund
- Dvt Int’l Desjardins - Guaranty Fund
- Dvt Int’l Desjardins - FONIDI Fund
- Etimos
- Fonds International de Garantie (FIG)
- Hivos-Triodos Foundation
- Incofin
- Kolibri Kapital ASA
- Oikocredit
- Opportunity Transformation Investments
- PlaNet Finance – Revolving Credit Fund
- Sarona Global Investment Fund
- SIDI
- Triodos-Doen Foundation

Due to the nature of their investor (or donor) base and due to their more social approach, microfinance development funds are very complementary to commercial and commercially-oriented microfinance investment funds. The first category should probably focus on MFIs which are approaching sustainability or which are green-field institutions in order to prepare them for the more general capital markets. When the MFIs would become sustainable, the more commercial investment funds would take over by providing larger resources at market conditions. There would obviously be overlaps but one can only question the necessity for a development fund to continue funding Banco Sol for example, as this type of institution clearly no longer needs funding below market conditions. These resources could be usefully redeployed to MFIs which are where Banco Sol was a few years ago, rather than competing with more commercial funding.

Distribution of Microfinance Investment Funds based on their overall risk profile

The purpose of this distribution is to identify where the various investment funds lie with respect to the two following dimensions:

- **Investment profile of the underlying investors**

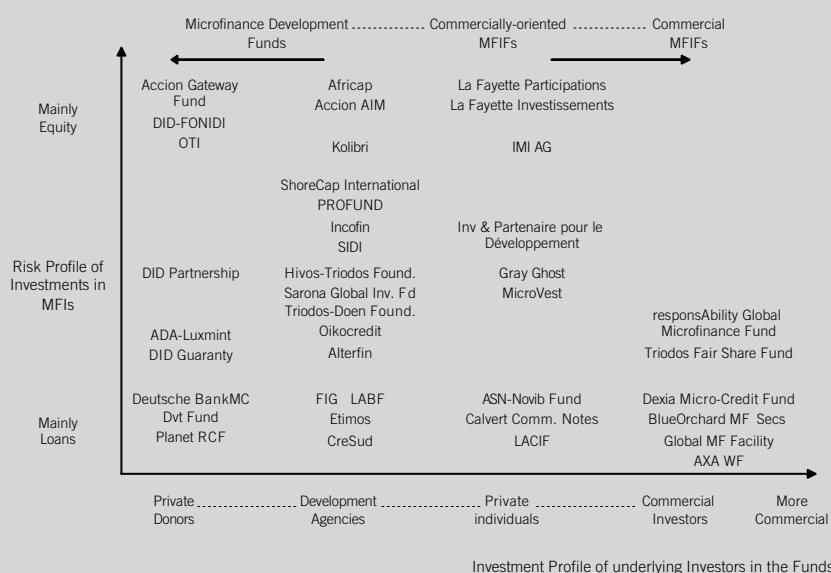
All the investment funds surveyed have been distributed on one axis of the following table according to the average type of their investors and according to the funds’ objectives. On the horizontal axis in the table, the most commercial investment funds are towards the right whereas the least commercial or most development oriented are towards the left of the axis. These two elements, financial and social, are not opposed but serve to measure the balance of the investment funds between these two objectives.

• **Risk profile of the underlying investments**

This is determined by the proportion of equities, loans and guarantees in the portfolios of the investment funds. The actual percentages can be found in the summary table in the Appendix.

Based on these two dimensions the risk profile of the microfinance investment funds can be distributed according to the following graph:

Risk profile of Microfinance Investment Funds (MFIFs)



We have already seen that the most of the investment funds had been created or were owned by investors such as private donors or development agencies. There is a good balance of these funds between equity funds and debt/guarantee funds. Concerning the most commercial funds, the majority of the investments is constituted of debt instruments or guarantees. The responsAbility Global Microfinance Fund and the Triodos Fair Share Fund both have a small portion of equity investments but considering the current overall size of these funds, one can say that the *equity investments from the most commercial investment funds is negligible*. This is a sign that the commercialisation of microfinance is still in its very early days.

Distribution of Microfinance Investment Funds based on their size

A former study¹² showed that most of the microfinance investment funds were smaller than the size required to be considered sustainable which we can still consider to be at least \$/€ 20 million. One year later the situation hasn't changed much with the exception of the most commercial investment funds which have grown the fastest together with a fund such as IMI. Although institutional shareholders (other than its founding members) represent little over 3 % of IMI's capital, this fund operates much like a commercial institution which is contributing to its substantial growth.

¹² Please refer to the section "Better governance, greater transparency, accountability"

The below table summarises the total assets and the size of the microfinance portfolios of the 38 investment funds surveyed:

Size of Microfinance Investment Funds (Total assets)	Value of MFIFs (\$ million)	% of size	Number of MFIFs	% of MFIFs
0-USD 5 million	15,1	1,7%	10	26,3%
USD 5-10 million	39,1	4,5%	6	15,8%
USD 10-20 million	178,5	20,5%	13	34,2%
Greater than USD 20 million	636,9	73,2%	9	23,7%
Total	869,6	100,0%	38	100,0%

Sponsors of traditional investment funds usually consider that the minimum size for a fund to be considered sustainable is at least \$/€ 20 –30 million. We can see that over 76% of the investment funds are below even \$ 20 million. Of these 9 funds, only 5 are commercial or commercially-oriented investment funds focused on microfinance.

The funds which have grown the most are the funds which were actively distributed either by the promoter of the fund itself or by external parties. The key to success in the traditional investment fund market is the distribution which is the access to the final investor. This market is moving increasingly to an Open Architecture where fund promoters are selling each other's funds, to the benefit of the largest and most profitable funds. Promoters of traditional investment funds are constantly examining their range of funds to assess whether it would not be more profitable for them to close down small funds and to sell similar funds from another provider.

We are currently in a situation where there is probably not enough offering in terms of commercial microfinance investments funds while at the same time there are many investment funds which are not viable on their own or which require subsidies in one form or another. Some form of consolidation may need to occur with the smaller funds merging into larger ones, but this may be difficult due to the nature of these funds. Instead a more active distribution of the structures which are attractive to private individual and institutional investors would need to be organised as we will see in the next section. Such investment funds are building a necessary bridge between the microfinance sector and the commercial sector. If an investment fund is small but is structured in such a way to be attractive to commercial investors, private or institutional, then it is not an issue. Such a fund "simply" needs to be actively distributed to the targeted investors. Such an example is the Triodos Fair Share Fund. It was launched in December 2002 and was targeted essentially at Dutch private investors. Although it was still small in June 2004 (€ 4.9 million), its investment portfolio (microfinance and trade finance) grew by 376% over one year and its fund size increased by 253%. It is certainly on the right track to become sustainable by itself in the next few years.

Increasing commercialisation of the Microfinance sector

Socially Responsible Investment and financial opportunities

The Socially Responsible Investment (SRI) market has grown tremendously over the last few years. The Social Investment Forum¹³ estimates that the SRI market in the US alone represents 11.4 % (or \$ 2.16 trillion) of the \$ 19.2 trillion in investment assets under professional management in the United States. According to the same study, *“socially responsible investing is an investment process that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis”*.

There is little doubt that investments in microfinance have their place in such socially responsible investments. Microfinance would be a new component of this universe. We have seen previously in this paper that institutional investors should provide an increasingly greater proportion of microfinance investments.

Those institutional investors with a keen SRI focus could also see further advantages to investing in microfinance: the International Monetary Fund has recently conducted¹⁴ hypothetical stress tests with the Dutch pension funds. The results show that their solvency ratios fall below 100 % (from 103.1%) in nearly all the tests carried out. “Pension funds are more sensitive to market risks because they hold a greater proportion of equity and are more internationally exposed compared to insurance companies,” the Washington-based body said. “In addition, results are more volatile because of longer duration fixed income assets that are marked to market.”

Microfinance investments would balance such portfolios as they are more stable and uncorrelated with world markets. The default rates are also very low especially when investments are conducted through investment funds. The issue seems to be that there are very few structures which would appeal to such investors. Hopefully the two recent ones reported on page 17, which have immediately attracted interest from such institutional investors, are the beginning of a series of investment funds structured specifically for such investors. *If appropriate structures, appealing to institutional investors, continue to be established, the potential for microfinance is significant. Only 1 % of the above mentioned SRI market in the US investing in microfinance would bring over \$ 20 billion to microfinance, which would be a significant step towards the estimated \$ 100 billion required for worldwide micro-loans¹⁵.*

Current situation: a growing involvement of the traditional financial sector in the international and in the local capital markets

We have seen over the last few years a growing involvement of the traditional financial sector into microfinance. *A number of these actors have been mentioned throughout this paper but it seemed useful to briefly summarise these institutions in a single section.* The following points will also be developed further in the paper by Prof. Dr. Ernst A. Brugger and Bikram Duggal as some of these recent developments establish the foundations of the future landscape of microfinance.

¹³ 2003 Report on Socially Responsible Investing Trends in the US – by the Social Investment Forum, December 2003

¹⁴ Reported on www.IPE.com – “Dutch pension funds fail IMF stress tests” – 30th Sep 2004

• Traditional banks involved with microfinance

A number of local banks are increasingly active in microfinance essentially by providing loans but also in some cases by participating in the capital of MFIs. One of the examples which was mentioned a number of times by the microfinance investment funds surveyed is the case of Société Générale (France) which is providing local currency loans in a number of African countries at quite competitive rates.

Due to local regulations in India, local banks are also very active in lending to MFIs. ICICI, the country's largest private financial institution, has also been active in securitisation deals as we will see later.

Other banks are also present in another capacity, that of distributor of these investment funds. Credit Suisse distributes the investment fund for which it is the promoter, the responsibility Global Microfinance Fund. Some Swiss banks ensure the distribution of the Dexia Micro-Credit Fund while some investment banks distribute the Calvert community notes. JP Morgan has ensured the placement of the notes from the BlueOrchard Microfinance Securities deal. The numbers of such distributors are still small but there is little doubt that as the microfinance sector moves towards a greater commercialisation, distributors will play an increasingly important role in placing such investment funds with their private and institutional customers, therefore contributing to the growth of this sector.

Although it is not a traditional bank as it was established with clear social and development objectives in mind, Triodos bank should also be mentioned as it has established two investment funds for two Dutch foundations and it has also launched *the Triodos Fair Share Fund*, targeted essentially at private individuals in the Netherlands.

• Securitisation

The two first ever securitisation deals in microfinance were conducted in India by ICICI. The first deal involved Basix, India's oldest MFI, with the securitisation of \$ 1 million of crop loans. The second deal, closed at the beginning of 2004, involved Share and the securitisation of \$ 4.3 million in micro-loans. In this latter case, Grameen Foundation USA brought \$ 325.000 in cash collateral which represented 93 % of the guarantee required by ICICI. The repackaged assets were bought, in the form of interest-bearing notes, by mutual funds and insurance companies such as Life Insurance corp. of India¹⁶.

The latest securitisation deal involved BlueOrchard Finance SA as the arranger together with Developing World Markets and the Grameen Foundation USA, as we have seen previously. The scale is much larger (minimum \$ 40 million and possibly moving up to \$ 75 million after a second closing in November 2004) and broader, since it covers nine MFIs in seven countries. The senior investors will have purchased notes guaranteed by OPIC, a US government agency, thereby giving it a AAA rating. OPIC is protected by subordinated investors who are willing to lose the first \$ 10 million of any potential loss.

• Subordination and senior tranches

The above BlueOrchard deal as well as the Global Microfinance Facility sponsored by the IFC¹⁷ involved senior tranches targeted at traditional institutional investors and subordinated tranches targeted at Development agencies and other investors knowledgeable about microfinance. Due to the high protection enjoyed by the senior Noteholders in both cases, the interest rate earned is very close to market rates. *The subordinated investors have nevertheless enabled a much higher level of financing to be directed to MFIs than if the deals had been done without the more commercial investors.*

¹⁶ High Commission of India website: <http://hcilondon.net/>

¹⁷ Please refer to table in the section Types of investors – Institutional Investors

• Traditional Investment Funds

We have given earlier¹⁸ the examples of two traditional investment funds making investments in microfinance: the AXA World Funds - Development Debt sub-fund and the Calvert Social Investment Fund. *We should similarly expect to see other socially responsible investment funds diversify their holdings in microfinance, because of the social impact of microfinance and also because of the own financial merits of an investment in microfinance.*

• Institutional Investors

We mentioned above the potential interest pension funds could have in investing in microfinance. Despite one or the other pension funds having made such investments, the process is still slow. *Structures with various risk tranches with senior tranches targeted at traditional institutional investors should certainly help build confidence in this new class of investments.*

• Funds of Funds

Although the responsAbility Global Microfinance Fund presented itself initially as intending to make investments in other funds, it has made only a few investments of this type. *There is indeed potentially an advantage for funds of funds in terms of diversification, especially in terms of investment manager diversification, but there is still the issue of overlapping costs.* There can of course be retrocessions between the investment funds to diminish the overall cost structure but the fund of funds needs to reach a certain size before the advantage of diversification outweighs the disadvantage of the heavier cost structure.

An area where there is a large number of funds of funds is the hedge fund market. One of the main differences is that there are a great variety of hedge funds to invest into which is not yet the case for microfinance investment funds. A fund of hedge funds may have up to forty or fifty positions in different hedge funds and may shift positions to other more attractive propositions. This is clearly not possible yet in the microfinance industry due to the small number of alternatives.

A concept which was interesting was the one proposed by the Positive Fund. This fund was initiated by a number of private individuals and saw its launching delayed. It proposed to invest in local domestic microfinance investment funds which would participate in the creation of such a domestic industry. Although there would also have been an extra layer of costs, such a fund would have provided an additionality to existing alternatives. These domestic funds would have made loans in local currencies which is one of the requirements of many MFIs. It seems that the concept is being fine-tuned before being launched.

The newly launched Gray Ghost Microfinance Fund is probably the first true fund of microfinance funds. It is committing \$ 40 million over the next few years and should therefore be able to carry enough weight to negotiate reduced fees from the funds it invests in, in order to reduce the overlapping management costs.

• Asset Managers

Asset managers, or investment managers, are also gradually realising the interesting perspectives presented to them by the microfinance industry. So far there have only been small investment management firms specialised in microfinance, initially set-up with a few individuals, but *it would not be surprising to see larger firms set up separate companies to start managing microfinance investment funds or portfolios.* AXA Investment Managers now has a dedicated team, albeit small, to manage the microfinance portion of its AXA World Funds - Development Debt sub-fund.

There is a choice to be made by investment managers willing to consider microfinance investments. Either they develop internal knowledge in order to reach the necessary level of

¹⁸ High Commission of India website: <http://hcilondon.net/>

specialisation in microfinance or they appoint investment firms specialised in microfinance. There is a third alternative which is to select and to recommend existing microfinance investment funds which would be appropriate for their customers.

Reaching critical size

- **Appropriate structure based on targeted investors**

The recent successes of some microfinance investment funds were mainly due to the *clear targeting of specific investors and the establishment of an adequate structure consistent with such target market*. These examples show that there is no lack of financial resources when the right structure is established.

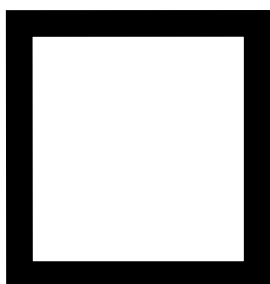
- **Distribution**

We have also seen that once an adequate structure has been established, *distribution and access to the final investor is also key for the success of any new investment fund*.

- **Large initial investment or gradual growth**

Reaching a critical size is also key when targeting institutional investors. Considering the size of these investors and their minimum investment requirements, most of the current microfinance funds are simply too small for these institutions to even consider such an investment. The rare institutional investors which have ventured in microfinance have recently done so through the larger structures available. These structures were either established with a certain critical size right from the beginning or gradually grew to a size attractive to such large investors.

These three aspects are of great importance in an investment fund's ability to reach a critical size in order to become sustainable in the long run and to be attractive to a wider range of investors.



Main benefits of Microfinance Investment Funds

Since the early to mid nineties, microfinance investment funds have increasingly been used to channel funding to MFIs and to scale-up the microfinance industry. Irrespective of the different types of investment funds and irrespective of the players involved, there are a number of benefits in continuing to use such structures in an increasing way:

- **Risk diversification:** Investors and donors are able to diversify their risks through investment funds by allocating resources to a wider and more diversified group of MFIs than by providing funding alone.
- **Investor and donor coordination and harmonisation:** Microfinance investment funds are an effective tool to ensure full coordination between the various participants in the funds. Such harmonisation is more difficult without such a common structure.
- **Wide range of financial and social objectives:** Investment funds can be tailored to a wide range of financial and social objectives. They can fund sustainable MFIs and be targeted to commercial investors, they can assist green-fields MFIs and be funded by development agencies or private donors, they can focus on loans or on providing capital, etc. The type of structure as well as the domicile of the investment fund will depend on such objectives and on the investors targeted.
- **Financial discipline:** The presence of investment funds can institute a greater financial discipline by fostering competition between the various actors in microfinance. A more effective use of resources would be the result with a reduction in the overall cost of providing funding to MFIs.
- **Flexible instruments:** Once investment funds have been set-up they are more flexible to operate than development or donor agencies. Once the approval has been obtained within such agencies to invest a certain amount in an investment fund, the investment decisions to fund the MFIs are more efficiently conducted essentially because of the lighter management structures and more flexible regulations of these vehicles. Development and donor agencies increasingly see investment funds as a more efficient process to provide funding to MFIs.
- **Effective Public Private Partnership:** Microfinance investment funds can be a powerful forum to leverage public funding by attracting additional private funds. The participation of public institutions such as development agencies can provide the initial critical mass, the expertise, the track-record and even guarantees or first-loss stakes which would encourage commercial investors to enter into the microfinance sector. No greater risk is necessarily taken by these development agencies (or private donors) but their involvement can contribute to the participation of the much larger commercial sector thereby contributing to the financing of a greater number of MFIs around the world. Microfinance investment funds can be the bridge between this sector and the traditional capital markets. The roles of the different parties should be clearly defined in order to avoid as much as possible conflicts of interest and/or market disturbances.





Appendix

Microfinance Investment Funds and other investors in microfinance



Fund Legal Name	Country of Incorporation	Legal status	Sponsor	Total Fund Assets	
				USD Million	EUR Million
Existing Microfinance Investment Funds					
ACCION Gateway Fund	USA	LLC	ACCION International	8.2	6.7
ACCION Investments in Microfinance (AIM)	Cayman Islands	Portfolio company	ACCION International	19.5	15.8
ACCION Latin American Bridge Fund	USA	Part of Accion, Non-profit 501(c) 3 corporation	ACCION International	7.0	5.7
ADA - Luxmint	Luxembourg	Non-profit organisation	NA	1.9	1.5
Africap	Mauritius	Private Equity Fund	Calmeadow	13.3	11.0
ALTERFIN	Belgium	Société coopérative à rl	NA	10.4	8.2
ASN-Novib Fund	Netherlands	Mutual Fund	ASN Bank & NOVIB	11.5	9.1
Axa World Funds - Development Debt Fund	Luxembourg	Sicav	Axa Investment Managers	23.3	19.0
BlueOrchard Microfinance Securities I, LLC	USA	Limited Liability Company	BlueOrchard Finance SA Gra-meen Foundation USA Dev World Markets	40.1	33.3
Calvert Social Investment Foundation - Community Investment Notes	USA	Public Charity - Non-profit 501(c) 3 corporation	Calvert Group	55.0	45.2
CreSud	Italy	Private Limited Company	NA	2.5	2.0
Deutsche Bank Microcredit Development Fund (DBMDF)	USA	Non-profit 501(c) 3 corporation	Deutsche Bank	2.4	1.9
Développement International Desjardins - FONIDI Fund	Canada	Limited Partnership	Développement International Desjardins	0.4	0.3
Développement International Desjardins - Guaranty Fund	Canada	Part of Développement International Desjardins	Développement International Desjardins	0.6	0.5
Développement International Desjardins - Partnership Fund	Canada	Part of Développement International Desjardins	Développement International Desjardins	5.7	4.7
Dexia Microcredit Fund	Luxembourg	SICAV	Dexia-BIL	47.8	38.8
Etimos	Italy	Consortium	NA	13.8	10.9
Fonds International de Garantie (FIG)	Switzerland	Non-profit Cooperative institution	NA	2.0	1.6
Global Microfinance Facility	Cayman Islands	Limited Liability Company	IFC & Cyrano Management S.A.	30.1	24.4
Gray Ghost Microfinance Fund LLC	USA	Limited Liability Company	Robert Patillo	13.1	10.6

As Of Date	Microfinance Portfolio		Fund Manager	Type of Fund/Structure	Shareholders	Financial products actually offered (in percentage)		
	USD Million	EUR Million				Equity	Loans, debt	Guarantees
30-Juin-04	7.8	6.4	ACCION International	Microfinance Development Fund	ACCION International	100	0	0
30-Sept-04	2.8	2.3	ACCION Investment Management Company	Commercially-oriented Micro-finance Inv Fund	Social Inst. Investors and private individuals - Min. \$ 250,000	100	0	0
31-Mai-04	1.5	1.2	ACCION International	Commercially-oriented Micro-finance Inv Fund	Social Inst. Investors and private individuals	0	0	100
31-Déc-03	1.8	1.4	ADA - Luxmint	Microfinance Development Fund	NA.	6	80	14
31-Juil-04	3.2	2.7	AfriCap MicroVentures Ltd, Dakar	Commercially-oriented Micro-finance Inv Fund	Social Inst. Investors	100	0	0
31-Déc-03	2.7	2.1	Alterfin	Microfinance Development Fund	Social Inst. Investors and private individuals	14	86	0
31-Déc-03	7.0	5.5	ASN Beleg. Beheer BV	Commercial Microfinance Inv Fund	Social Inst. Investors and private individuals	0	100	0
15-Sept-04	1.5	1.22	Axa Investment Managers, Paris	Commercial Microfinance Inv Fund	Private individuals and institutional investors	0	100	0
30-Juil-04	38.0	31.6	BlueOrchard Finance USA, Inc.	Commercial Microfinance Inv Fund	Social and commercial Institutional Investors and private individuals	0	100	0
30-Juin-04	16.7	13.7	Calvert Social Investment Foundation	Microfinance Development Fund	Social Inst. Investors and private individuals	0	100	0
30-Sept-04	1.5	1.2	CreSud	Microfinance Development Fund	Private individuals and Fair trade cooperatives	0	100	0
31-Déc-03	2.4	1.9	Deutsche Bank New York	Microfinance Development Fund	NA	0	100	0
31-Mars-04	0.4	0.3	Gestion FONIDI Inc.	Microfinance Development Fund	Four wholly-owned subs of the Desjardins Group	100	0	0
30-Juin-04	0.4	0.3	Développement International Desjardins	Microfinance Development Fund	NA	0	0	100
30-Juin-04	2.4	2.0	Développement International Desjardins	Microfinance Development Fund	NA	46	54	0
6-Oct-04	41.8	33.9	Dexia Asset Management and Blue-Orchard Finance S.A., Geneva	Commercial Microfinance Inv Fund	Private individuals and some commercial investors	0	100	0
31-Déc-03	3.7	2.9	Etimos	Microfinance Development Fund	Social institutional Investors (Churches, Foundations, NGOs, etc.)	0	100	0
31-Déc-03	1.7	1.3	Fonds International de Garantie	Microfinance Development Fund	MFI, Social Institutional Investors and private individuals	0	0	100
30-Sept-04	7.6	6.2	Cyrano Management S.A.	Commercial Microfinance Inv. Fund	Social and commercial Institutional Investors	0	100	0
15-Oct-04	4.0	3.2	Gray Ghost	Commercial Microfinance Inv. Fund	Private Social Investors	-	-	-

Fund Legal Name	Country of Incorporation	Legal status	Sponsor	Total Fund Assets	
				USD Million	EUR Million
Hivos-Triodos Foundation	Netherlands	Foundation	Hivos Foundation and Triodos Bank	16.2	12.8
IMI AG	Germany	Bank Holding Investment Company	Initiative of IPC	110.1	89.3
Incofin	Belgium	Co-operative Company	NA	4.0	3.3
Investisseur et Partenaire pour le Développement	Mauritius	Investment Company	NA	10.7	8.5
Kolibri Kapital ASA	Norway	Public Limited Liability Company	Korsvei	0.4	0.4
La Fayette Participations	France	Société par actions simplifiée	Groupe Horus	0.5	0.4
Latin American Challenge Investment Fund, S.A.	Panama	S.A.	Seed Capital Development Fund	16.3	12.9
MicroVest	Delaware USA	Limited Partnership	MEDA, CARE & SEED	15.0	12.5
Oikocredit	Netherlands	Co-operative Society	NA	277.5	219.7
Opportunity Transformation Investments Inc. (OTI)	USA	Investment company	Opportunity International	13.5	11.1
Planet Finance - Revolving Credit Fund	France	NGO	Planet Finance	0.4	0.37
PROFUND	Panama	Investment Fund as an S.A.	Calmeadow	12.6	10.3
responsAbility Global Microfinance Fund	Luxembourg	Fonds Commun de Placement	Crédit Suisse	6.8	5.6
Sarona Global Investment Fund, Inc.	USA	Nonprofit Corporation	MEDA	5.5	4.5
ShoreCap International	Cayman Islands	For-profit Investment Company	Shorebank Corporation, Illinois	23.3	19.1
SIDI (Solidarité Internationale pour le Développement et l'Investissement)	France	S.A.	Comité Catholique contre la Faim et pour le Développement	12.7	10.1
Triodos Fair Share Fund	Netherlands	Mutual Fund	Triodos Bank	5.9	4.9
Triodos-Doen Foundation	Netherlands	Foundation	Triodos Bank and Doen Foundation	29.7	23.5
Total for existing Microfinance Investment Funds (A1)				869.6	700.5
Total estimated duplications within A (A2)					
Total net investments in microfinance from existing microfinance investment funds (A3)					

As Of Date	Microfinance Portfolio		Fund Manager	Type of Fund/Structure	Shareholders	Financial products actually offered (in percentage)		
	USD Million	EUR Million				Equity	Loans, debt	Guarantees
31-Déc-03	13.5	10.7	Triodos International Fund Management B.V.	Microfinance Development Fund	NA	34	64	2
30-Sept-04	88.6	71.8	IMI AG	Commercially-oriented Microfinance Inv Fund	Social and commercial Inst. Investors	70	30	0
30-Juin-04	1.7	1.4	Incofin	Microfinance Development Fund	Social and commercial Institutional Investors and private individuals	53	47	1
30-Juin-04	1.5	1.2	I&P Etudes et Conseils	Commercially-oriented Microfinance Inv Fund	Mainly private individuals + 1 listed company	27	73	0
30-Sept-04	0.4	0.3	Kolibri Kapital ASA	Microfinance Development Fund	Private individuals & Church-related inst. Investors	100	0	0
30-Sept-04	0.5	0.4	Horus	Commercially-oriented Microfinance Inv Fund	Social Inst. Investors	100	0	0
31-Déc-03	15.8	12.5	Cyrano Management S.A., Panama	Commercially-oriented Microfinance Inv Fund	Social Inst. Investors	0	100	0
31-Juil-04	2.6	2.2	MicroVest Capital Management LLC	Commercial Microfinance Inv Fund	Social Institutional Investors and private individuals	24	76	0
30-Juin-04	66.7	54.9	Oikocredit	Microfinance Development Fund	Essentially church related organisations incl. local parishes	16	83	1
30-Juin-04	19.4	16.0	Opportunity International	Microfinance Development Fund	Opportunity International	98	2	0
22-Juil-04	0.3	0.23	Planet Finance	Microfinance Development Fund	Donors	0	100	0
31-Mars-04	14.8	12.1	Omrix S.A., Costa Rica	Commercially-oriented Microfinance Inv Fund	Mainly Social Institutional Investors	90	10	0
30-Juin-04	6.3	5.2	Credit Suisse MF Fund Mgt Cy (responsAbility Social Inv Ser. as Advisor)	Commercial Microfinance Inv Fund	Social Inst. Investors and private individuals	20	80	0
30-Sept-04	2.2	1.8	MEDA Investments, Inc.	Microfinance Development Fund	MEDA as shareholder and inst. and private ind. as lenders	32	68	0
31-Mars-04	1.5	1.2	ShoreCap Management Ltd	Commercially-oriented Microfinance Inv Fund	Mainly Social Institutional Investors + Financial Inst.	100	0	0
31-Déc-03	4.9	3.8	SIDI	Microfinance Development Fund	Social Inst. Investors and private individuals	62	38	0
30-Juin-04	3.4	2.8	Triodos International Fund Management B.V.	Commercial Microfinance Inv Fund	Social Inst. Investors and private individuals in Holland	7	93	0
31-Déc-03	22.4	17.8	Triodos International Fund Management B.V.	Microfinance Development Fund	Doen Foundation	29	69	2
				The term Social Institutional Investors refers to Development Agencies, Private Donors and other such institutional investors				
	415.1	337.7						
	20.0	16.2						
	395.1	321.5						

Fund Legal Name	Country of Incorporation	Legal status	Sponsor	Total Fund Assets	
				USD Million	EUR Million
- Additional microfinance portfolios from existing Microfinance Investment Funds					
- New Microfinance Investment Funds					
ACCION Investments in Microfinance (AIM)	Cayman Islands	Portfolio company	ACCION International	19.5	15.8
BlueOrchard Microfinance Securities II, LLC (potential new closing in Q1 04)	USA	Limited Liability Company	BlueOrchard Finance SA Gra-meen Foundation USA Dev World Markets	75.1	60.9
Deutsche Bank Start-up Fund (launch expected in Q1, 05)	-	Non-profit Fund	Deutsche Bank NY	0.5	0.4
Global Commercial Microfinance Consortium (launch expected in Q1, 05)	Cayman Islands	Limited Liability Company	Deutsche Bank NY	50.0	40.5
Global Microfinance Facility (inv of original commitments)	Cayman Islands	Limited Liability Company	IFC & Cyrano Management S.A.	30.1	24.4
Gray Ghost Microfinance Fund LLC (inv of original commitments + new investments)	USA	Limited Liability Company	Robert Patillo	40.0	32.4
Impulse (to be launched Q4 04 or Q1 05)	Belgium	Investment Company	Incofin	6.2	5.0
Investisseur et Partenaire pour le Développement (inv of original commitments)	Mauritius	Investment Company	NA	10.5	8.5
LaFayette Investissement (to be launched Q4 04 or Q 1 05)	Luxembourg	Investment Company	Horus Development Finance	16.8	13.6
MicroVest (inv of original commitments)	Delaware USA	Limited Partnership	MEDA, CARE & SEED	15.0	12.2
ShoreCap International (inv of original commitments)	Cayman Islands	For-profit Investment Company	Shorebank Corporation, Illinois	23.3	18.9
Solidus - Cyrano (to be launched Q1 05)	Panama	S.A.	Cyrano Management S.A.	22.0	17.8
Total for new or increased Microfinance Investment Funds				308.9	250.5
Total additional assets to A (B1)				157.1	126.3
Total current and expected Microfinance Investment Funds				1'026.7	826.8
Estimated duplications due to additional assets (B2)					
Total net investments in microfinance from existing and expected microfinance investment funds (B3)					

As Of Date	Microfinance Portfolio		Fund Manager	Type of Fund/Structure	Shareholders	Financial products actually offered (in percentage)		
	USD Million	EUR Million				Equity	Loans, debt	Guarantees
	16.7	13.5	ACCION Investment Management Company	Commercially-oriented Microfinance Inv Fund	Social Inst. Investors and private individuals - Min. \$ 250,000	100	0	0
	33.2	26.9	BlueOrchard Finance USA, Inc.	Commercial Microfinance Inv Fund	Social and commercial Institutional Investors and private individuals	0	100	0
	0.5	0.4	Deutsche Bank NY	Microfinance Development Fund	Social Institutional Investors	0	100	0
	50.0	40.5	Deutsche Bank NY	Commercially-oriented Microfinance Inv. Fund	Social and commercial Institutional Investors	0	100	0
	22.5	18.2	Cyrano Management S.A.	Commercial Microfinance Inv. Fund	Social and commercial Institutional Investors	0	100	0
	36.0	29.2	Gray Ghost	Commercial Microfinance Inv. Fund	Private Social Investors	-	-	-
	6.2	5.0	Incofin	Commercial Microfinance Inv. Fund	Institutional Investors	-	-	-
	9.0	7.3	I&P Etudes et Conseils	Commercially-oriented Microfinance Inv Fund	Private individuals	27	73	0
	16.8	13.6	Horus Development Finance	Commercially-oriented Microfinance Inv. Fund	Social Institutional Investors	-	-	-
	12.4	10.0	MicroVest Capital Management LLC	Commercial Microfinance Inv Fund	Social Institutional Investors and private individuals	24	76	0
	21.8	17.7	ShoreCap Management Ltd	Commercially-oriented Microfinance Inv. Fund	Mainly Social Institutional Investors + 2 Financial Inst.	-	-	-
	22.0	17.8	Cyrano Management S.A.	Commercially-oriented Microfinance Inv. Fund	Social Institutional Investors	0	100	0
	247.0	200.3						
	247.0	200.3						
	662.1	538.0						
	25.0	20.3						
	617.1	501.5						

Fund Legal Name	Country of Incorporation	Legal status	Sponsor	Total Fund Assets	
				USD Million	EUR Million
Development Agencies, Foundations and NGOs acting as investors in microfinance					
BIO	Belgium	SA	NA	NM	NM
Cordaid	Netherlands	Foundation	NA	275.6	218.2
Corporacion Andina de Fomento (CAF)	Venezuela	Multilateral Financial Institution	NA	NM	NM
Doen Foundation	Netherlands	Foundation	Dutch Post Code Lottery	60.4	47.8
European Bank for Reconstruction and Development (EBRD)	UK	-	NA	NM	NM
Finnfund	Finland	Limited Liability company	NA	NM	NM
FMO	Netherlands	Development Bank	NA	NM	NM
ICCO (Inter Church Organization for Development Co-operation)	Netherlands	Foundation	NA	4.8	3.8
International Finance Corporation (IFC)	USA	-	Part of the World Bank Group	NM	NM
KFW/DEG	Germany	Development Bank - Corporation under public law	NA	NM	NM
Multilateral Investment Fund (MIF/IADB)	USA	Part of the IADB	Inter-American Development Bank	NM	NM
NOVIB	Netherlands	Foundation	NA	12.1	9.6
Partners for the Common Good	USA	Non-profit organisation	NA	7.1	5.8
Rabobank foundation	Netherlands	Foundation	Rabobank	12.2	10.0
Unitus	USA	Non-profit 501(c) 3 corporation	NA	6.3	5.2
USAID	USA	-	NA	NM	NM
				NM: Not meaningful	
Total for existing Development Agencies (C1)				NM	NM
Total estimated duplications between A/B & C (C2)					
Net investments of Dev Agencies, Foundations and NGOs in microfinance (exclud. above MFIFs) (C3)					
Total net current and expected investments for Microfinance Investment Funds and Development Agencies (B3 + C3)					

As Of Date	Microfinance Portfolio		Fund Manager	Type of Fund/Structure	Shareholders	Financial products actually offered (in percentage)		
	USD Million	EUR Million				Equity	Loans, debt	Guarantees
30-Juin-04	19.8	16.3	BIO	Development Financial Institution	Directly and indirectly owned by the Belgian state	62	38	0
31-Déc-03	38.5	30.5	Cordaid	Foundation	NA	2	97	1
30-Oct-04	42.2	33.0	CAF	Development Finance Institution	NA	10	83	7
31-Déc-03	54.5	43.1	Doen Doudation	Foundation	NA	97	3	0.1
31-Déc-03	201.5	159.5	EBRD	Development Finance Institution	NA	16	84	0.0
30-Sept-04	8.0	6.5	FinnFund	Development Finance Institution	Directly and indirectly owned by the Finnish state	62	38	0
31-Déc-03	28.5	22.6	FMO	Development Finance Institution	Dutch State (51%), large Dutch Banks (42 %) and various Dutch investors	68	32	0
31-Déc-03	3.1	2.5	ICCO	Foundation	NA	7	26	68
30-Sept-04	225.0	182.5	IFC	Development Finance Institution	NA	27	65	8
5-Oct-04	477.3	388.4	KfW	Development Finance Institution	Federal Republic of Germany & German Federal states	8	92	0
31-Déc-03	63.0	49.8	IADB	Development Agency	NA	24	76	0
31-Déc-03	12.1	9.6	NOVIB - FSU	Microfinance Development Fund	NA	2	77	21
30-Sept-04	0.3	0.2	Partners for the Common Good	Non-profit Organisation	Social Inst. Investors	0	100	0
30-Juin-04	9.5	7.8	Rabobank Foundation	Microfinance Development Fund	NA	2	94	4
31-Août-04	7.1	5.9	Unitus	Microfinance Development Fund	NA	5	92	3
30-Sept-04	63.6	51.6	USAID	Development Agency	NA	0	0	100
	1'253.8	1'009.6						
	155.0	125.7						
	1'098.8	883.9						
	1'715.9	1'385.5						

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