



Grameen Foundation USA



## **Tapping Financial Markets for Microfinance**

Grameen Foundation USA Fostering This Emerging Trend

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## **Foreword**

For microfinance to deliver on its potential to reduce poverty, it will need to do three things simultaneously. First, in key markets like India, it will need to rapidly scale up home to high numbers of the world's poor. Second, in this process, clear priority is needed for philanthropic, quasi-commercial and commercial financing for the business plans of MFIs targeting the poorest segments of the population, especially women. Third, microfinance will need to realize its possibility as a broad platform and movement, more than simply an intervention and industry.

Grameen Foundation USA is involved in many ways in advancing this vision, and is tracking the progress of allies and peers. We closely monitor progress in Bangladesh, which assumed a leadership role in the micro-finance movement in the 1980s, and shows no signs of relinquishing it despite impressive progress in other nations. It is truly the Wall Street of microfinance. The pioneering and continued leadership of Grameen Bank, Grameen Trust and Grameen Family of Companies inspire and inform our work.

This paper focuses on the challenge of attracting the domestic and international commercial financial markets to support rapid scaling up of microfinance. In countries such as India, where the number of poorest families (earning less than US\$1 per day per capita) to be reached is an estimated 70 million, the amount of subsidized financing, long an important source of financing to MFIs, is now insufficient, falling far short of the need. The paper includes case studies within and outside of the network of organizations with historical linkages to Grameen Foundation USA. A conscious effort was made to discuss innovations, strategies and cases relevant to MFIs that actively and effectively target the poorest.

The paper was written for a broad audience, including investors, microfinance stakeholders, and managers, to introduce issues necessary to attracting commercial investment. It is less a technical piece, though it is hoped the paper will serve as a foundation for such needed works. It is our hope these ideas inform the movement, and also serve as a call to action to engage the mainstream financial community in creative ways that do not distort MFIs' missions, but rather help their missions be realized on an accelerated timetable. We acknowledge we are building on ideas and achievements of many individuals and institutions who have worked for years to ensure that the vast reservoirs of commercial capital become available for financing quality, poverty-focused MFIs. This vision, when realized, will accelerate scaling-up because achieving rapid growth is reduced to a management challenge. The financial barriers will have been removed for as long as MFI leadership rises to the challenge of ensuring that the growth is managed properly.

I would like to take this opportunity to thank Jennifer Meehan for agreeing to write this GF-USA paper, and for doing such a terrific job. She was assisted by many people within and outside GF-USA, most notably by Drew Tulchin and GF-USA's Capital Markets Committee, Chaired by Bob Eichfeld. We look forward to future papers by her, including ones further exploring issues introduced here, and have enjoyed her past papers commissioned by the Microcredit Summit Campaign, to which our movement owes so much, and also by CASHPOR, the Asian network of Grameen Bank adaptors.

**Alex Counts, President**  
**Grameen Foundation USA**  
[www.gfusa.org](http://www.gfusa.org)

### **Author's Biography**

Jennifer Meehan, formerly with The Chase Manhattan Bank (now JP Morgan Chase), is a microfinance and social investing consultant. Ms. Meehan will soon be joining Grameen Foundation USA as Director of Capital Markets. Over the last six years, she has worked extensively with a network of Grameen Bank replicators in Asia, on financial management, financial planning and modeling, and financing, as well as on assignments for Microcredit Summit Campaign, Calvert Social Investment Foundation, Japan Bank for International Cooperation and GF-USA. She is on the Investment Committee of the Aavishkaar India Micro Venture Capital Fund. She graduated with a B.A. in International Affairs from George Washington University.

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The views and opinions expressed in the paper are those of the author and do not necessarily reflect the official position of Grameen Foundation USA. The author is responsible for any remaining errors.

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## **Section 1. Executive Summary**

It is now widely acknowledged that microfinance for the poor – loans, savings and other financial services specially tailored to meet their needs – has enabled numerous families to lift themselves out of poverty.<sup>1</sup> Yet the promise of microfinance remains unrealized for most families. Market demand for microfinance services is estimated at more than US\$300 billion<sup>2</sup>, while market supply is just US\$4 billion.<sup>3</sup> Despite the important and catalytic role played by the international donor community<sup>4</sup> in promoting microfinance, it has invested only US\$1.2 billion in the sector and allocates an incremental US\$800 million to US\$1 billion per year in new financing.<sup>5</sup> Domestic financing represents the primary source of financing for microfinance. To date, neither international nor domestic financing has been sufficient to meet estimated demand.

If microfinance institutions are to close the significant supply-demand gap, vast external resources need to be tapped. In the long-term, only financial markets<sup>6</sup> have the available resources for optimal growth.

The microfinance industry is rapidly transforming. Professionally managed, profitable leaders are emerging from a fragmented marketplace of approximately 10,000 microfinance institutions. Evidence shows that among these leaders, poverty-focused microfinance institutions (MFIs),<sup>7</sup> those committed to serving customers below the poverty line, are among the most cost-efficient and have the highest portfolio quality in the sector. Further, and perhaps more importantly, the statistics show that the poverty level of an MFI's customers does not necessarily influence profitability; a track record exists of profitable MFIs working with the very poor.

The financial and operational track record of these leading MFIs has aroused some early financial market interest, primarily domestically. A number of pioneering transactions have closed: a US\$15 million bond issue by Compartamos in Mexico; a partnership between India's second largest bank, ICICI, and CASHPOR, operating in northern India; a US\$4.3 million securitization of India-based SHARE's loan portfolio, again with ICICI; and a US\$40 million bond issue by Blue Orchard Microfinance Securities I in the international capital markets. While these transactions have not yet been widely replicated, their promise of access to large injections of capital on favorable terms and conditions presents the industry with a significant opportunity. Seizing this opportunity requires leading MFIs to listen to concerns raised by investors about the sector and adopt strategies to overcome them.

Accessing the financial markets is not a short-term solution for overcoming the financing hurdle faced by MFIs (most of whom are not yet positioned to tap the financial markets), but it does represent a long-term opportunity to transform the sector. Over the next five to ten years, organizations like Grameen Foundation USA (GF-USA), a US-based nonprofit organization, should develop financial and other products to enable MFIs to better access financial markets and facilitate growth to serve more customers.

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<sup>1</sup> A strong summary of the impact of microfinance services on the poor is the Consultative Group to Assist the Poor's (CGAP) Focus Note No. 24, *Is Microfinance An Effective Strategy to Reach the Millennium Development Goals?*.  
<[http://www.cgap.org/docs/FocusNote\\_24.pdf](http://www.cgap.org/docs/FocusNote_24.pdf)>

<sup>2</sup> Throughout the paper, \$ is used to denote the United States Dollar

<sup>3</sup> Tulchin, p. 4. Please note, these figures are not limited to microfinance for the poor.

<sup>4</sup> The term "international donor community" refers to below market rate public and private financing from international sources. This includes bilateral and multilateral donors (such as the United States Agency for International Development and the World Bank, respectively), foundations, networks, MFI partner institutions (such as GF-USA), and other below market rate international funders.

<sup>5</sup> CGAP estimates.

<sup>6</sup> The term "financial markets" refers exclusively to commercially priced financing. This includes capital markets transactions and linkages with commercial banks.

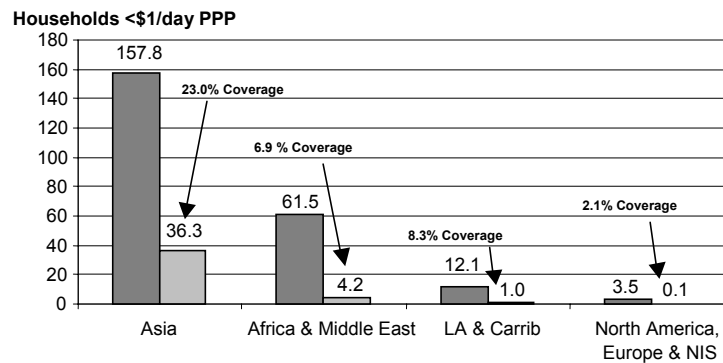
<sup>7</sup> The term "MFIs" refers to poverty-focused microfinance institutions, as defined above.

## Section 2. Microfinance for the Poor: Market Overview

### 2.1 Unmet Demand Offers Significant Growth Opportunity

Around the globe there are 2.8 billion people, approximately 560 million families, who are considered poor, living on less than US\$2 per day purchasing power parity (PPP). Of those, 1.2 billion people live in abject poverty; the “poorest” surviving on less than US\$1 per day PPP. Despite recognition of microfinance as a proven poverty reduction tool<sup>8</sup>, fewer than 18% of the world’s poorest households have access to financial services. This figure likely underestimates, perhaps significantly, demand for microfinance services as it assumes only one member per family would avail of such services. The gap between supply and demand varies dramatically by region, as illustrated in Table 2.1:<sup>9</sup>

**Figure 2.1: Regional Breakdown of Market Access by the Poorest**



Rapid growth in outreach to new poor customers has been successfully undertaken by leading MFIs when sufficient financing is available. From the end of 1983 to the end of 1996 the Grameen Bank grew from just over 58,000 to 2 million customers – averaging annual growth of 33.7% - and its portfolio grew exponentially. High portfolio quality was maintained.

A significant growth opportunity exists to meet demand among poor customers. However, there are two critical questions that must ultimately be answered, if this is to occur. First, who is best placed to meet the demand of poor customers? Secondly, where will the financial resources come from to provide the services required by the poor? The rest of this section will explore these two questions.

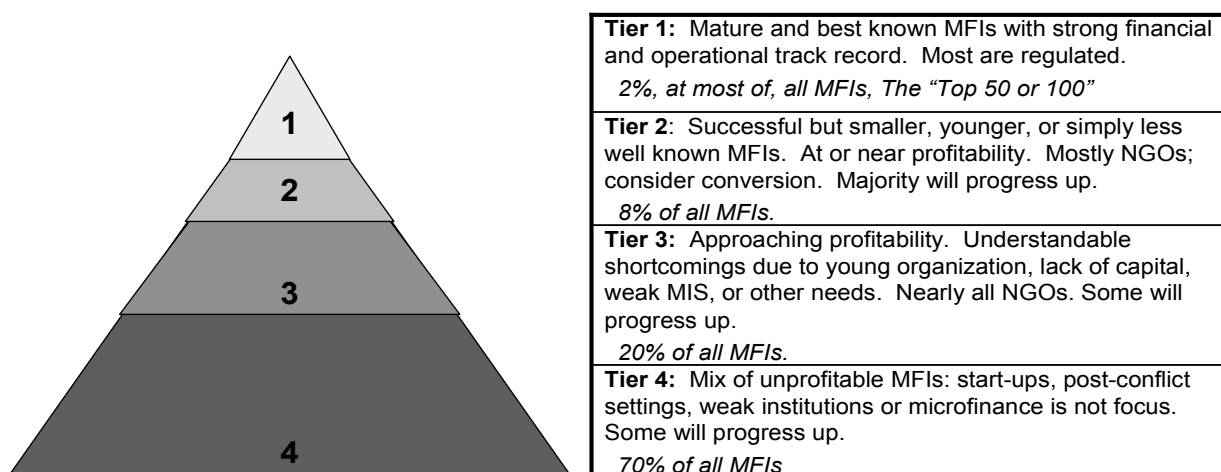
### 2.2 The Future of the Microfinance Industry

The microfinance industry is rapidly transforming, particularly among institutions serving poor customers. A growing divide is emerging between larger, more commercially-oriented specialized microfinance institutions, many of whom are, or intend to become, regulated financial intermediaries, and smaller, NGO-managed MFIs. Figure 2.2 illustrates the magnitude of the divide, segmenting the sector into four tiers. The pyramid only considers specialized microfinance institutions that focus exclusively on the microfinance sector.

<sup>8</sup> A strong summary of the impact of microfinance services on the poor is the CGAP Focus Note No. 24, *Is Microfinance An Effective Strategy to Reach the Millennium Development Goals?*. <[http://www.cgap.org/docs/FocusNote\\_24.pdf](http://www.cgap.org/docs/FocusNote_24.pdf)>

<sup>9</sup> Sources: Regional Poverty Statistics (<\$1/day PPP) – 1998 new Poverty Net, World Bank Group. Microfinance Outreach Statistics - State of the Microcredit Summit Campaign Report 2003, Microcredit Summit Campaign.

**Figure 2.2: Breakdown of Specialized MFIs**



Source: Adapted from Positive Fund

The financial success of Tier 1 institutions in particular, as measured by return on equity and return on assets, has attracted the interest of local commercial banks and global banks, as well as alternative financial institutions (AFIs) such as savings and credit cooperatives and postal banks<sup>10</sup> in certain markets, some of whom have entered the microfinance market.

The industry finds itself at a critical juncture. Attempting to pinpoint how the industry will trend over the next five years is invariably difficult. However, three potential trends, which may play out individually or collectively, are identified:

- **Industry Consolidation:** The industry will begin to consolidate around the top few 100 MFIs, those in Tiers 1 and 2 today. Tier 3 and Tier 4 institutions may continue to provide financial services on a limited basis, if they are able to attract financing, but the majority will not likely become strong financial performers or serve large shares of the market.<sup>11</sup>
- **Integration with Domestic Financial Sector:** Leading MFIs will mature both financially and operationally, in some cases transforming into banks, and integrate into the financial sector.
- **Increasing Downscaling by Commercial Banks & Other AFIs:** Commercial banks and other AFIs will enter the microfinance market directly, by “downstreaming”, and indirectly, through partnerships, bringing their own technology and productivity as well as offering a wider range of services such as insurance.

Each trend has important implications in meeting demand of poor customers in the future.

<sup>10</sup> CGAP recently took a survey of such AFIs available at <[www.cgap.org/docs/OccasionalPaper\\_8.pdf](http://www.cgap.org/docs/OccasionalPaper_8.pdf)> It has also reviewed 227 formal financial institutions undertaking some form of microfinance activity. Please see <[www.microfinancegateway.org/content/article/detail/18154](http://www.microfinancegateway.org/content/article/detail/18154)>

<sup>11</sup> A small number of Tier 3 and 4 MFIs, encouraged by the success of Tier 1 and 2 MFIs in reaching large numbers of the poor, can be expected to reach the top tiers. While primarily focusing on its high growth partners, GF-USA has recognized the long-term potential of certain Tier 3 and 4 MFIs and is providing a combination of financial and technical assistance, including technology inputs through the Grameen Technology Center, to selected seedbed partners.

Consolidation should be positive for microfinance for the poor. It will ensure emphasis of financial and human resources on the 10% of MFIs (Tiers 1 and 2) that have the vision, strategy, management capacity, and operational and financial expertise to reach large numbers of poor customers.<sup>12</sup> GF-USA and several other microfinance partner institutions have refined their long-term strategy to reflect this market reality by focusing the majority of their resources on a select number of high potential partners in markets with the highest incidence of poverty.<sup>13</sup>

Integration of leading MFIs into the financial sector should also be positive for microfinance for the poor as it will afford access to a wider range of financing options. Evidence today suggests many leading poverty-focused MFIs are financially and operationally on track to integrate. Statistics from the Microbanking Bulletin (MBB)<sup>14</sup> show that they are among the most efficient microfinance institutions when the effects of loan size are neutralized and have the lowest portfolio-at-risk > 30 days<sup>15</sup> among all MFIs, estimated at 2.3%.

Further, and perhaps more importantly, the statistics show that the poverty level<sup>16</sup> of an MFI's clients does not necessarily influence profitability. A track record exists of profitable MFIs working with the very poor. Prominent investors have remarked on the success of such MFIs. Vinod Khosla, a partner at Kleiner, Perkins, Caulfield & Byers (a leading US venture capital firm) and cofounder of the technology company Sun Microsystems, observed that the poverty-focused microfinance institutions he visited in India and Bangladesh in February 2004 "ran more efficiently than most Silicon Valley organizations..."<sup>17</sup> In an interview with *Businessworld India*, he added that "...most of these organizations are very exciting. They are driven by people who are very, very entrepreneurial. They are CEOs who really want to make this work and to make money."<sup>18</sup> Such leading MFIs offer great potential to close the supply-demand gap.

The potential of commercial banks and other AFIs to reach large numbers of the poor is more mixed. To date, the "downscaling" phenomenon has been most prominent in Latin America with mixed results.<sup>19</sup> Most bank and AFI activity has been in the small and medium enterprise (SME)<sup>20</sup> market.<sup>21</sup> This is recognized in a recent paper by the Consultative Group to Assist the Poor (CGAP), a consortium of 29 donors who support microfinance, which notes that the clients of specialized MFIs "tend to be poorer on

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<sup>12</sup> Consolidation is a natural part of an industry's evolution as it moves from an emerging, fragmented market to one where a few "winners" rise to the top. In the microfinance industry, this trend has been observed in developed microfinance markets in Bangladesh and Bolivia. A forthcoming paper, *Financing Microfinance Institutions: Transition to Private Capital*, for USAID explores this subject in detail.

<sup>13</sup> GF-USA has numerous mature microfinance partner institutions. Its most important markets include India, Pakistan and the Philippines in Asia; Nigeria and Morocco in Africa.

<sup>14</sup> One hundred twenty-four MFIs reported results to the MBB in the July 2003 edition of the Bulletin; 50 from Latin America, 22 from Asia, 22 from Eastern Europe/Central Asia, 21 from Africa, and 9 from Middle East/North Africa. They represent some of the strongest MFIs in the industry.

<sup>15</sup> Portfolio-at-risk > 30 days is defined as the remaining outstanding balance of loans with arrears older than 30 days divided by the gross loan portfolio outstanding.

<sup>16</sup> The MBB uses average outstanding loan size divided by GNP per capita to categorize the target market of MFIs. Low-end MFIs, a proxy for poverty focused, are defined as <20% of loan size to GNP or an average loan size of <US\$150.

<sup>17</sup> "Tiny Loans Have Big Impact on Poor: A Venture Capitalist Lends His Talents to Help Small Entrepreneurs." *New York Times*, April 2, 2004.

<sup>18</sup> See interview at <[www.businessworldindia.com/apr1204/indepth01.asp](http://www.businessworldindia.com/apr1204/indepth01.asp)>

<sup>19</sup> Damian von Stauffenberg, a principal of Microrate, was quoted by US Banker as saying "Quite a few (global banks) have tried and, in most cases we've seen, they've done badly."

<sup>20</sup> The SME department of the World Bank defines small enterprises as businesses with up to 50 employees and assets and sales of up to US\$3 million. Medium enterprises are defined as businesses with up to 300 employees and assets and sales of up to US\$15 million.

<sup>21</sup> Interestingly, Latin America is currently seeing some specialized MFIs that formerly moved "upmarket", like Bancosol in Bolivia, reversing their strategies and moving back down market.

average than the clients of other AFIs in the same country.”<sup>22</sup> This is not to dismiss the potential of AFIs in general, but raises important questions about the role they will, or not, play in the niche market of microfinance for the poor. More likely to impact large numbers of poor customers are partnerships between leading poverty-focused MFIs and commercial banks. Such relationships present a compelling opportunity that plays to each institution’s respective core competencies. A model will be elaborated upon in Section 3.

Taken together, these trends suggest a primary role for specialized MFIs in meeting the demand of poor customers; microfinance for the poor is a niche industry that requires special market and operational knowledge. Such leading MFIs are emerging and are well-placed to close the supply-demand gap. Yet, it is just such institutions – specialized MFIs - that struggle to mobilize the financing required to grow optimally. This begs the question: from where will MFIs find the financial resources necessary to reach large numbers of the poor?

### 2.3 The Financing Environment for MFIs

Overall, market demand for microfinance services is estimated at more than US\$300 billion, while market supply is just US\$4 billion.<sup>23</sup> A majority<sup>24</sup> of respondents to a survey conducted by the CGAP and the MIX Market, an internet-based information exchange for the microfinance industry, “perceive funding as the biggest constraint to growth.”<sup>25</sup> Fewer than half the respondents indicated they could raise an amount equal to 30% of their assets in the next year. Yet, sustained growth rates of 50% and even 100% have been achieved in the rare situations where financing is not a constraint.

The challenge for the industry has been its traditional approach to raising financing.<sup>26</sup> Most MFIs began, and many continue as, not-for-profit organizations. They have relied predominantly on grants and low-interest rate loans from the international donor community to meet their financing needs. The following table introduces the types of financing available to MFIs by stage of development, correlated to Tiers 1 through 4 introduced above, and legal status:

**Table 2.1: Financing by Stage of Development and Legal Status**

Type of Financing	Tier 4	Tier 3	Tier 2		Tier 1	
	Start-up	Break-Even	Profitable		Commercial Return	
	NGO	NGO	NGO	FI <sup>27</sup>	NGO	FI
<b>Public Financing (Donors, Apex, Foundations)</b>						
- Grants	X	X	X	X	X	X
- Below Market Loans	X	X	X	X	X	X
- Guarantees/Q-E		X	X	X	X	X

<sup>22</sup> CGAP, Occasional Paper No. 8, p. 2.

<sup>23</sup> Tulchin, p. 4. These figures are not limited to microfinance for the poor.

<sup>24</sup> According to the report, “respondents were asked to rank the following constraints to growth on a scale from 1 (lowest constraint) to 6 (highest constraint): lack of funds, lack of infrastructure, government regulations, weak systems, lack of staff, and lack of market. In every region except [Middle East North Africa], respondents ranked the lack of funds as the greatest constraint to growth.”

<sup>25</sup> CGAP “Study on MFI Demand for Funding”, p. 1. CGAP is currently working on a new funding survey.

<sup>26</sup> A forthcoming paper, *Financing Microfinance Institutions: Transition to Private Capital*, for USAID explores this subject in detail.

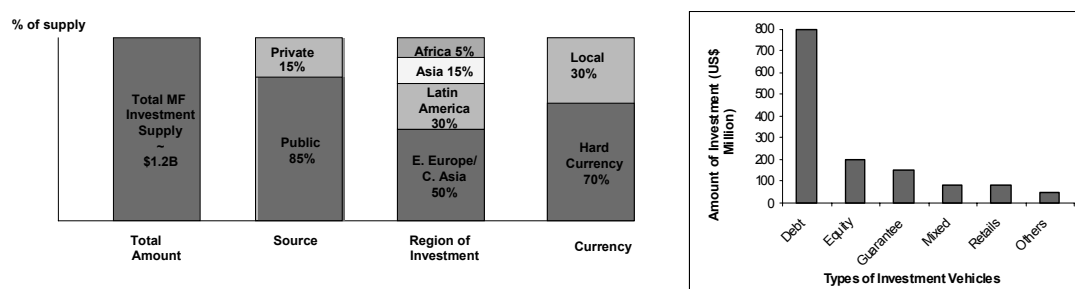
<sup>27</sup> FI stands for financial institution and refers to any kind of licensed or legally recognized structure.

**Table 2.1: Financing by Stage of Development and Legal Status cont'd**

Type of Financing	Tier 4	Tier 3	Tier 2		Tier 1	
	Start-up	Break-Even	Profitable		Commercial Return	
	NGO	NGO	NGO	FI <sup>28</sup>	NGO	FI
<b>Internal</b>						
- Compulsory Savings	X	X	X	X	X	X
- Voluntary Savings <sup>29</sup>				X		X
- Retained Earnings			X	X	X	X
<b>Private</b>						
- Debt						
> Commercial Loans			X	X	X	X
> Guarantee Funds			X	X	X	X
> Bonds				X		X
> Securitization				X		X
> Inter-bank Borrowings						X
- Quasi-Equity		X	X	X	X	X
- Equity						
> Socially Responsible Equity				X		X
> Commercial Equity				X		X

The international donor community has played an important and catalytic role in supporting the development of the microfinance industry through the provision of no cost – grants – and below market rate financing – debt, equity, and guarantees, among others. To date, it has invested only US\$1.2 billion in the sector and allocates an incremental US\$800 million to US\$1 billion per year in new financing.<sup>30</sup> It has not been sufficient to reach the majority of potential customers. Moreover, a closer look at these figures raises important concerns about the ability of the international donor community to provide financing to rapidly scale-up microfinance for the poor in the future.

**Figure 2.3: International Supply of Below Market Rate Investments in Microfinance**



First, allocated resources represent a fraction of the reported demand for microfinance services. Second, 80% of financing has been offered in Latin America and Eastern/Europe/Central Asia, while Asia and Africa, home to 93% of the world’s poorest families, have received a disproportionately small share. Finally, the majority of financing has been in hard – or foreign – currency with limited applicability in nondollarized economies, as those in Asia and Africa. While noncommercial social investors are a strong fit to provide financing, and a number of specialized funds have been established,<sup>31</sup> volumes to date have

<sup>28</sup> FI stands for financial institution and refers to any kind of licensed or legally recognized structure.

<sup>29</sup> Unregulated MFIs are often not legally able to collect savings. While some do collect savings, they are often not used as a source of financing for the MFI.

<sup>30</sup> CGAP estimates.

<sup>31</sup> See “International Investment Funds: Mobilizing Investors Towards Microfinance” by Appui au Développement Autonome. Available at <[www.microfinancegateway.org/content/article/detail/19424](http://www.microfinancegateway.org/content/article/detail/19424)>

been limited. Their role will likely be restricted to providing catalytic capital to enable MFIs to leverage additional resources.

Domestic financing has been, and will continue to play, an increasing role as the primary source of financing for the sector. Local currency financing is particularly critical to MFIs as their loan portfolios are generally denominated in local currency. A potential enormous source of domestic capital for many MFIs is savings, which tend to be low-cost in comparison to local bank financing. While it is estimated that 97% of US commercial bank liabilities are made up of demand and time deposits,<sup>32</sup> despite the potential of savings, it has not proven out for most MFIs.<sup>33</sup> For some, it is a management issue. “The experience in the field indicates that, where debt is concerned, it is easier to access debt through the issuance of paper than through the mobilization of savings.”<sup>34</sup> For many others, both regulated, nonbank MFIs and unregulated MFIs, it is illegal for the organization to collect savings. As savings is not the focus of this paper, its merits for MFIs and their customers will not be discussed in further detail.

Domestic borrowings from government, development and commercial banks, both below market and market rate, are available to leading MFIs in certain markets; access to commercial banks has often been made possible by partial or full guarantees from international organizations including GF-USA. While an important source of financing for many leading MFIs, the availability of these funds – particularly in terms of reliability and timeliness – tend to be uncertain and often overpriced.

#### **Box 2.1: Other Constraints to Growth**

While financing is the primary constraint to growth for leading MFIs, they will face two other constraints -- unfavorable regulatory regimes and challenges related to rapid growth. Of the two, the regulatory environment, which plays a major role in the ability of MFIs to grow and access capital, is the more significant. As regulatory regimes vary by country, MFIs will need to customize their operating and financing strategies to their local context.<sup>35</sup> In the meantime, MFIs and MFI partner organizations like GF-USA should work together to lobby government for more favorable regulatory regimes.

In terms of challenges arising with growth, MFIs “will face the same problems of any corporation in a state of enormous expansion. Management skills, performance accountability, sound information systems, clear definition of responsibilities, effective delegation of authority, implementation of controls and procedures, and the weeding out of underperforming staff, all become vital here as in any organization grown large, regardless of vision.”<sup>36</sup> These problems are widely recognized and MFIs can hire experts, as appropriate, to address specific concerns.

In order to close the gap in the demand for and supply of financial services for the poor, billions of dollars in new financing – both debt and equity – will be required over the next decade. The emergence of professionally-managed, profitable MFIs serving the poor that are best-positioned to tap the financial markets in a significant way, signals a unique opportunity for the industry. In recent years, a number of pioneering financial market transactions have closed, highlighting the promise of the financial markets for microfinance for the poor. Section 3 will explore four of these transactions in detail.

<sup>32</sup> Fehr, D. and G. Hishigsuren, p. 3.

<sup>33</sup> While the Grameen Bank finances itself with customer savings, other MFIs, like Kashf Foundation in Pakistan and CARD Bank in the Philippines have not been able to convert the potential of savings into a reality.

<sup>34</sup> Chu, p. 2.

<sup>35</sup> See for example, Grameen Foundation USA’s paper on microfinance regulation by Alex Counts and Sharmi Sobhan, available at <[www.gfusa.org](http://www.gfusa.org)>

<sup>36</sup> Chu, p. 4.

## Section 3. Learning Lessons from Pioneering Transactions

### 3.1 Ground-breaking Transactions, But Not Yet Widely Replicated

Over the last few years, a number of groundbreaking transactions that involve microfinance institutions and the financial markets have been closed. Poverty-focused MFIs are taking the lead in a number of markets: a US\$15 million bond issue by Compartamos in Mexico in 2002; a partnership between India's second largest bank, ICICI, and CASHPOR, operating in northern India in 2003; a US\$4.3 million securitization of India-based SHARE's loan portfolio, again with ICICI in early 2004; and a US\$40 million bond issue by Blue Orchard Microfinance Securities I in the international capital markets in July 2004.

These transactions move far beyond the traditional sources of financing detailed in Section 2.3. In receiving large amounts of financing at one time, normally at lower rates and for longer terms, the MFIs were better able to achieve rapid growth. If the small, yet growing, and capable universe of leading poverty-focused MFIs can tap into the financial markets, going beyond the achievements described above, these breakthroughs could indeed lead to a revolution in the financing of microfinance. The ultimate benefactors, of course, are the poor.

### 3.2 Commercial Bank Linkages

In 2003, CASHPOR, an MFI working in the poorest region of India, and ICICI Bank, India's second largest bank (and largest private bank) with over US\$20 billion in assets, entered into a mutually beneficial strategic partnership agreement to provide microfinance services to the poor. CASHPOR, with its market knowledge of poor customers, originates and services loans, while ICICI, with its strong balance sheet and vast financial resources, provides capital, including working capital, for CASHPOR to carry out its work. Underpinning this agreement is CASHPOR's approval of loan proposals. A closer look at the specific division of labor appears below:

**Table 3.1: Division of Responsibility in Strategic Partnership Model**

CASHPOR	ICICI Bank
<ul style="list-style-type: none"> <li>• Cost-effective identification of poor women</li> <li>• Training of women</li> <li>• Approval and grouping of loan proposals for ICICI Bank</li> <li>• Receipt of funds from ICICI &amp; disbursement to clients</li> <li>• Physical check on first loan utilization</li> <li>• Supervision of employees</li> <li>• Monthly bulk repayment to ICICI</li> <li>• Delinquency management &amp; provision of first loss default guarantee</li> <li>• Monthly and quarterly monitoring &amp; variance analysis</li> <li>• Internal audit</li> <li>• Semi-annual external audit</li> </ul>	<ul style="list-style-type: none"> <li>• Provision of cash credit facility until profitability achieved</li> <li>• Provision of Documentation Officer at CASHPOR headquarters to provide loan documentation</li> <li>• Transfer of requested bulk amounts</li> <li>• Receipt bulk repayments of interest &amp; principal from CASHPOR monthly</li> <li>• Monitoring of CASHPOR repayment performance</li> <li>• Monthly reconciliation</li> <li>• Management of relationship with servicing banks</li> </ul>

Early evidence is positive. David Gibbons, chairman of CASHPOR, notes that “In the first year, the strategic partnership achieved market penetration and business volume performances not attained by other Grameen-type MFIs, nor even earlier by a sister CASHPOR company.” In the first year, it recruited almost 6,000 new customers and disbursed approximately Rs. 3 crore (US\$650,000) to them. Portfolio-at-risk >30 days was .02%.

From CASHPOR’s perspective, the partnership has allowed the MFI to overcome two primary hurdles to reaching large numbers of poor customers: a lack of capital and legal/regulatory constraints. With access to needed financial resources, it is able to penetrate the market at an accelerated growth rate and also move towards its mission of maximizing poverty reduction profitably. Additionally, CASHPOR is able to overcome a regulatory hurdle many MFIs interested in conversion often face; high minimum net owned funds requirement. In the partnership model, CASHPOR does not operate as a regulated financial intermediary and thus is not subject to minimum capital requirements.<sup>37</sup>

For ICICI, its initial interest in microfinance was to meet the Reserve Bank of India’s requirement that private sector banks allocate at least 18% of their net credit to the agricultural sector (nearly half of the 40% direct lending requirement to priority sectors), including microfinance. Yet once involved, it saw a business opportunity, not an opportunity for charity. Over the next five years, ICICI plans to commit the equivalent of US\$1 billion to the sector.<sup>38</sup> As it does not have the branch infrastructure in rural India or market knowledge of poor customers, it is seeking to work with MFIs to tap this segment. It has now adopted the partnership model with additional MFIs and offers “on tap” securitizations (see the SHARE securitization, Section 3.3.1).

The strategic partnership model is viewed as one of the most promising breakthroughs in terms of expanding access of financial services to the poor; GF-USA is motivated to replicate this model outside India. While the model is promising, there are conditions unique to India, in particular the priority sector lending requirements detailed above that have implications concerning its wider replicability. The feasibility of replicating the approach in other countries requires deeper exploration and support.

### **3.3 Accessing the Domestic Debt Capital Markets<sup>39</sup>**

#### **3.3.1 SHARE Microfin Limited (SHARE) Microfinance Securitization<sup>40</sup>**

In the largest individual microfinance securitization to date, ICICI paid US\$4.3 million for 25% of SHARE’s (a leading, poverty-focused MFI based in Andhra Pradesh state) loan portfolio. SHARE’s cost of funds was approximately 8.75%, below the 12 to 13% it has traditionally paid borrowing from commercial banks, including ICICI.

This deal is particularly exciting in that it recognizes, and adapts for, microfinance as an asset class. There was not an attempt to force a cookie-cutter securitization formula on the transaction. Two unique aspects should be highlighted. First, the securitization is not “asset-backed”, as many securitizations in the housing, credit card, and car markets usually are; ICICI will not have recourse to the assets the poor

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<sup>37</sup> CASHPOR operates as a Section 25 company. According to the Reserve Bank of India, such companies engaged in microfinance but not taking public deposits or disbursing loans of more than Rupees 50,000 (approximately US\$1,000) to any individual client are exempted from registering as a Non-Banking Finance Company. They are not allowed to collect savings.

<sup>38</sup> See “ICICI Bank’s Microfinance Strategy: A Big Bank thinks Small” from September 2003 for more detail on ICICI’s strategy. See <[www.microfinancegateway.org/content/article/detail/13446](http://www.microfinancegateway.org/content/article/detail/13446)>

<sup>39</sup> The term “capital markets” refers to private and public sources for obtaining capital, or financing, including both debt and equity. Also, the place (market) where buying and selling of financing instruments occurs (Source: GF-USA Capital Market Glossary).

<sup>40</sup> The term “securitization” refers to the process of pooling a group of assets, such as loans or mortgages and selling securities either backed or not by these same assets (from GF-USA Capital Markets Research).

purchased with the proceeds of the loans they originally received from SHARE. Instead, ICICI has cash collateral in the form of a “first loss guarantee” equal to 8% of the securitization value, of which GF-USA provided US\$325,000. Second, SHARE will act as the servicer in the transaction, collecting repayments from the underlying borrowers. While the servicer role is often outsourced to third parties in securitizations, appointing SHARE in the role recognizes that lending to the poor is a niche market.

ICICI undertook this transaction despite the lack of secondary markets for such paper. Part of the reason goes back to the lending targets the Reserve Bank of India imposes on private banks (see Section 3.1). ICICI could have placed SHARE’s assets on its books to meet the requirement. Instead, ICICI sold the entire portfolio to another bank just prior to fiscal year end, likely because the other bank needed to meet its priority sector lending requirements. ICICI sold the assets at a premium, netting over 400 basis points on approximately US\$4million.

From SHARE's perspective, this transaction was important not only because it resulted in an injection of a large amount of capital at lower cost. An asset securitization provides a unique “capital sparing”<sup>41</sup> opportunity. As will be discussed in Section 4.4, lack of equity capital is a severe problem among Indian MFIs, even leaders. By moving these assets off-balance sheet, SHARE was able to raise new debt without having to increase its capital base. And going forward, future loans originated in the 26 branches from which SHARE sold its portfolio will be financed using the Strategic Partnership Model pioneered by ICICI and CASHPOR (see 3.1 for more detail). In terms of achieving its mission, the deal allowed SHARE and its Founder and Managing Director Udaia Kumar to “...meet his aim of increasing his number of borrowers from under 300,000 now to one million, a target that will, he reckons, require US\$62.5 million in new funds.”<sup>42</sup>

Since the SHARE securitization, a number of such transactions have been carried out in India providing important financing to leading MFIs. This investment product, given its short-term nature and lack of exposure to business risk, would likely be replicable in many markets and should be pursued.

### **3.3.2 Compartamos Bond<sup>43</sup> Issue**

In 2002, Compartamos – a regulated Mexican microfinance institution - issued a 100 million MXP (approximately US\$10 million), 3-year, 13.1% coupon bond;<sup>44</sup> this was the first tranche of a US\$15 million bond. The bond was rated mxA+ with no credit enhancement. The initial US\$10 million bond was privately placed by Grupo Financiero Banamex, a local Citibank affiliate, to institutional investors (20%) and individuals (80%). In the second tranche, institutional investors purchased 50%, while the remainder was taken by individuals.

Key financial covenants include: maintenance of debt to tangible net worth of no more than five to one; maintenances of reserves  $\geq$  the larger of 2% of loans outstanding or 60% of past due loans (>30 days); current assets to total assets of no less than 5%; cash and cash equivalents, free of liens, no less than 3% of total assets; and maintain tangible net worth of at least US\$4,000,000.

As proof there is investor interest in such transactions, the Compartamos transaction was oversubscribed, even without external support or guarantee. There were more investors (institutional investors like pension funds and individuals) seeking to purchase the bonds than there were bonds available.

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<sup>41</sup> This term was suggested by Mr. Harmohan Ahluwalia, designated CEO of the future Grameen Capital India Private Ltd.

<sup>42</sup> Economist article, p.67

<sup>43</sup> A bond is a debt instrument. The terms of the bond issue oblige the issuer to meet certain requirements. Generally, these are the repayment of the amount borrowed and the payment of a fixed rate (from GF-USA Capital Markets Research).

<sup>44</sup> The coupon was based on CETES, Mexican Treasury Notes, plus 2.5%.

Compartamos management believes that the bond issue was successful primarily due to strong financial and operational performance, which led to a solid rating.

Particularly critical and unique to this deal was Compartamos's strong and longstanding relationship with Banamex through its shareholders and board of directors. The Compartamos issue was small, even by local standards. The participation of Banamex, and affiliate Acciones y Valores who underwrote the issue, in a deal of this size is a reflection of the strength of the underlying relationship between the institutions.

The small size of the deal ensured that it would not offer secondary market liquidity to investors. This had significant implications for selling the issue. The two primary investor groups for such issues are institutional investors and individual investors. Institutional investors, such as pension funds, insurance companies and mutual funds, tend to look for liquidity, while individual investors (retail investors or private bank clients) tend to have longer investment horizons and thus may require less liquidity. In the case of the Compartamos issue, more than 80% of the paper was sold to individual investors. This reflected Banamex's strong retail market network as well as Compartamos's strong reputation. The relationship with Banamex was critical in getting this deal completed.

**Box. 3.1: Compartamos Builds Upon Success of Ground-Breaking Bond**

Following the success of its first bond in August 2004, Compartamos, again supported by Banamex and Acciones y Valores de Mexico, issued the first MXN 190 million tranche (US\$16.8 million) of a larger MXN 500 million (US\$44 million) bond issue targeting local institutional investors. As institutional investors have been exclusively targeted, this bond offers a 34% guarantee from the International Finance Corporation (IFC), enabling the deal to be rated AA by the local affiliates of Standard & Poor's and Fitch Ratings. This new issue has helped "...Compartamos diversify funding sources as [it] focuses on achieving its growth plans, which include growing its customer base to one million clients by 2008."<sup>45</sup> From an industry perspective, this second and larger issue illustrates the promise of the financial markets for MFIs in reaching their goal of expanding outreach to the poor.

The potential for leading MFIs to issue bonds in local markets looks positive, assuming a capital market exists. Encouraged by the success of Compartamos, a number of poverty-focused MFIs are exploring this option. In order to replicate Compartamos's success, pioneering transactions – either first-time issues or larger deals – may need some form of guarantee or support, though this support should be limited to the greatest extent possible. This is a potentially key role for the international donor community.

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<sup>45</sup> Citigroup Inc. Press Release, August 2, 2004.

### **3.4 Accessing the International Debt Capital Markets**

In July 2004, Blue Orchard Securities I, a special purpose company, issued a US\$40 million bond to support MFIs in nine developing countries. The largest transaction in the US capital markets to fund microfinance, this seven-year deal has four tranches, one senior and three subordinated. The senior note is secured by a US\$30 million guarantee from the Overseas Private Investment Corporation, effectively resulting in a Treasury Note rating. JP Morgan Securities will service the bond. Details of each tranche appear below:

- Tranche 1 – US\$30 million senior notes guaranteed by OPIC at US Treasury + .25-.5%
- Tranche 2 – US\$3-4 million subordinated A notes at US Treasury + 1%
- Tranche 3 – US\$3-4 million subordinated B notes at US Treasury + 2%
- Tranche 4 – US\$3-3.5 million subordinated C notes at US Treasury + 4%

There were 66 total investors: 12 foundations, 15 MFI practitioners/investors, 11 Social Responsible Investment (SRI) Asset Managers, 3 SRI Funds, 22 private investors and 3 institutional investors. Critical to completing the deal was bringing together different investors through multiple tranches to appeal to different risk-return appetites. Equity investors in Blue Orchard Securities I include Blue Orchard Finance and Developing World Markets, sponsors and co-structuring agents on the bond issue, and GF-USA, Omidyar Network, and Skoll Foundation. A second closing is scheduled for early 2005.

This transaction allowed nine MFIs - seven in Latin America, one in Cambodia and one in Russia – to tap the US capital markets for lower cost and longer term financing, ultimately providing approximately 40,000 new loans to micro-entrepreneurs. While pioneering in its tapping of the US capital markets, the transaction raises some questions regarding replicability. First and most significantly, it was a US dollar issue and only MFIs in dollarized economies participated. Whether a US capital markets issue can provide financing for many Asian and African MFIs without covering the foreign exchange risk, which does not currently exist, seems unlikely. Secondly, the amount raised per MFI was small, averaging under US\$5 million. Presumably subsequent issues will be larger.

### **3.5 Replicating Success**

These pioneering transactions represent a starting point for leading MFIs seeking to tap the financial markets; important ground has been broken that will serve as a foundation for future transactions in existing and new markets. While local capital market and regulatory conditions will be primary considerations in determining how quickly or widely these deals will be replicated, a more fundamental issue must be addressed. Why have investors shown such little interest in microfinance to date? Section 4 explores concerns investors have raised about the microfinance industry as a viable investment opportunity and proposes a number of strategies for overcoming those concerns. While a seeming departure from the content of the paper thus far, such practical steps offer a blueprint to MFIs, industry stakeholders, and ultimately investors, for moving forward.

The financial markets, particularly the domestic markets, represent a long-term opportunity for the microfinance sector. In the short to medium-term, there is an important facilitating role that the international donor community and MFI partner organizations such as GF-USA can play in providing catalytic capital to leading MFIs, e.g., the kind GF-USA offered in the SHARE securitization and in the Blue Orchard-Developing World Markets bond issue. Donors can play a leading role in analyzing the pros and cons of financial market strategies in key markets, providing financial support to cover financing costs, including but not limited to internationally-recognized ratings and legal counsel.

## Section 4. Turning Financing Exceptions into the Rule

### 4.1 Commercial Investors Do Not Yet Understand the Industry

While the pioneering transactions highlighted in Section 3 have not yet been widely replicated, their promise of access to large injections of capital on favorable terms and conditions in local currency presents the industry with a significant opportunity that must be seized. Yet, accessing the financial markets is not a short-term solution nor is it a solution for all but the leading MFIs. While many of the Tier 1, and even a sizeable number of Tier 2 MFIs, have been “donor darlings”, most have not been subjected to the analytical rigors of commercial capital. Pursuing such opportunities – whether it is the capital markets or linkages with commercial banks – requires MFIs to address concerns raised by investors about the sector.

The pioneering transactions offer preliminary evidence that commercial investors – whether purely for-profit or socially responsible investors “screening” investments but seeking a commercial return - are beginning to see microfinance for the poor as an investment opportunity capable of yielding substantial financial as well as social returns. To become more widespread, the industry needs to do more. This section offers concrete recommendations for doing so.

The challenges the industry faces are outlined by John Wilson, director of Socially Responsible Investing at Christian Brothers Investment Services Inc. At a recent conference, Mr. Wilson offered the top ten reasons he believes commercial investors should not invest in microfinance. Although Mr Wilson is a US-based investor, many of the concerns he raised are universal to international and domestic investors. They are detailed in the table below:<sup>46</sup>

**Table 4.1: Top 10 Reasons Commercial Investors Should Not Invest in Microfinance<sup>47</sup>**

Top 10 List	Description
<b>#10 Social Justice? Who cares?</b>	At the end of the day, financial returns matter as much as social returns. For broad access to social investment markets, financial performance has to be competitive with investment opportunities of similar risk and return profiles. MFIs need to understand the investor rationale. (See also point 3 below.)
<b>#9 We can't trade the securities.</b>	MFI shares are not typically tradable in a liquid market.
<b>#8 We can't price them.</b>	Nontradable securities do not have efficient pricing mechanisms and, therefore there is no way to report the net asset value of investments regularly (daily or even monthly) as required by institutional investors.
<b>#7 We can't legally own them.</b>	The Investment Act of 1940 allows fiduciaries to invest in a range of investments that could include MFIs, given certain restrictions for different asset classes. Money market funds, for example, would be exempt. Bond and equity funds would be acceptable, though current practice and other restrictions (e.g. daily valuations) limit the potential.
<b>#6 They're not entirely useful.</b>	MFI investments do not fit traditional investment strategies. For example, MFIs will never represent more than a very small fraction of an asset manager's portfolio (which typically range from hundreds of millions, to billions, of dollars), and thus do not help diversify portfolios. Managers need another reason to include MFIs in a portfolio (e.g., this asset class is uncorrelated with other markets). Also, since MFI investments do not match floating benchmarks, an asset strategy cannot be implemented in any case since their prices do not fluctuate.

<sup>46</sup> It should be noted that the speaker also applied his comments to US-based Community Development Financial Institutions (CDFIs).

<sup>47</sup> The comments are excerpted from “Financing Microfinance: ‘Transitions to Private Capital’ Workshop Proceedings, May 14, 2004”, led by Enterprising Solutions Global Consulting.

**Table 4.1: Top 10 Reasons Commercial Investors Should Not Invest in Microfinance cont'd**

<b>Top 10 List</b>	<b>Description</b>
<b>#5 They're too risky.</b>	The level of financial disclosure is not as formalized as in other types of investments, and therefore it is much harder for an asset manager to understand MFI investment risk. This leads to an exaggerated perception of MFI default risk. This combines with already high perceptions of country risk, currency risk, and various other risks plaguing developing country investments.
<b>#4 Their "guarantees" don't guarantee enough.</b>	There are different types of risk and the guarantees typically provided do not sufficiently hedge against all the risk seen as inherent in MFI investments.
<b>#3 We are fiduciaries.</b>	Fiduciaries have legal responsibility to maximize performance. Socially responsible fiduciaries are possible and legal because their investment decisions are based on financial returns that are not sacrificed for social return.
<b>#2 We don't have the expertise.</b>	Investors don't have in-house expertise. They either need to build in-house expertise or outsource this function. At a minimum, asset managers need information to gauge MFI investment performance relative to appropriate benchmarks. Any information supplier must have good credentials and proven analytical techniques. Professionals from the CDFI/MFI sector could serve this function well since they can answer the kinds of questions typically posed by fund managers.
<b>#1 The great divide.</b>	<p>In most investment companies, there is an organizational and cultural separation between those who manage assets and those who apply social investment criteria. This is to avoid conflicts of interest between those screening investments and those managing assets. Investment managers are not compensated on social return, and hence have little incentive to incorporate these strategies without an investment perspective.</p> <p>Most asset managers have an investment background and, coming from that perspective, believe in efficient markets. They assume that if MFI investments are not already desired by asset managers they are not valuable assets. The MFI professionals do not typically speak the language of asset managers, leading to confusion and difficulty working together and, ultimately, difficulty establishing the value of MFI investments. The key is to learn to speak the language of asset management and to devise products that fit an investment strategy as well as a social mission.</p>

The list, though daunting, succinctly pinpoints areas of concern; in this case, from an institutional investor's perspective (see Section 4.2.7 which explores varying investors' concerns). The positive news is that there are not underlying weaknesses in the essentials of the microfinance industry. Rather, most items can be overcome through better communication of the market's fundamentals and changes in the way the microfinance industry presents itself to investors.

## **4.2 Recommendations for Attracting the Financial Markets**

This paper offers a brief list of recommendations for attracting financial markets to microfinance. While not all-inclusive and only an introduction to the concepts identified, the list is a preliminary strategy for MFIs and other industry stakeholders seeking to raise capital from the financial markets. It also offers investors a perspective on what to expect from the industry.

#### 4.2.1 Characterizing Microfinance as an Investment Opportunity

To overcome concerns about the ability of microfinance to offer financial returns and fit traditional investment strategies (see points #1, #3, #6, and #10 in Table 4.1), MFIs need to characterize microfinance as a commercial investment opportunity. To date, microfinance has not been systematically categorized by investor category or industry, nor has it been benchmarked against domestic and international financial institutions.<sup>48</sup> While presenting benchmarks is outside the scope of this paper, a brief qualitative characterization of microfinance as a business opportunity appears below:

- **Investor Category:** Microfinance is primarily an emerging market opportunity. Within the emerging markets, it represents a subsector of small-sized financial institutions.
- **Industry Profile:** Microfinance for the poor is a high-growth, niche industry with tremendous opportunity for future growth and product innovation. Competition is currently limited or nonexistent in most markets, particularly in Asia and Africa, creating a unique short-term growth opportunity for microfinance service providers to capitalize on the industry's attractive returns. The industry has a more than 15-year documented track record of strong asset quality globally, better than other financial asset classes, with poverty-focused institutions performing strongly. Over the last five years, "winners" have begun to emerge from the industry's fragmented marketplace, setting standards for best practice.
- **Attractive Risk-Return Profile:** "Microfinance debt offers a better return than monetary instruments (an estimated additional 150 to 200 basis points)."<sup>49</sup> Systematic or market risk is mitigated by lower volatility than traditional emerging market equities or bonds and weak correlation to political, economic<sup>50</sup> or climatic events. Specific or company risk is mitigated by high solvency, backed by high quality portfolios with strong diversity.<sup>51</sup>
- **Double Bottom Line:** Microfinance not only offers an attractive financial risk-return profile, it also offers a significant social return. Microfinance is widely recognized as one of the most effective poverty reduction tools. While this may not be a primary consideration for all commercial investors, it will remain important for SRIs.

While the above classification alone is not sufficient to convince investors of the opportunity microfinance presents, it provides a common starting point. Investors can then evaluate individual MFIs on key criteria, including strategy, management talent, market position, portfolio quality, and financial and operational performance, among others.

#### 4.2.2 Detailing the Microfinance Cash Flow Model

The market potential of microfinance for the poor, given the significant gap between supply and demand, combined with the attractive returns<sup>52</sup> of leading MFIs present investors a unique investment opportunity. Investors have not widely acknowledged this (see #1, #3 and #10 in Table 4.1). Part of the reason is a lack of understanding of the nature of microfinance cash flows.

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<sup>48</sup> Enterprising Solutions Global Consulting is currently working on benchmarking microfinance against other asset classes.

<sup>49</sup> From the Blue Orchard website, <[www.blueorchard.ch](http://www.blueorchard.ch)>

<sup>50</sup> In the wake of the Asian financial crisis, Bank Rakyat Indonesia (BRI) was forced to write off 100% of its corporate portfolio and 50% of its middle market loans. On time repayment in its microfinance portfolio of four million borrowers, however, slid only one percent to 97.5%.

<sup>51</sup> This section borrows heavily, including quoting, the section "Microfinance as an Asset Class" presented by BlueOrchard Finance s.a., a manager of and adviser to specialized microfinance investment funds, on their website <[www.blueorchard.ch](http://www.blueorchard.ch)>

<sup>52</sup> In 2001, Citigroup's return on equity was 19.7%, while 12 leading MFIs in Latin America reported ROEs ranging from 20.2% to 42.9%. US Banker, August 2003.

Microfinance institutions traditionally expand on a branch-by-branch basis, adding single or multiple branches when financing is available. During periods of high growth, upfront investments in staff training, travel and marketing, as well as some limited infrastructure investments, at new branches (branches are normally started with a full roster of staff) are significant enough to materially and negatively impact consolidated profits, especially if the company is doubling in size or more on an annual basis. Yet, individual branches turn profit very quickly – in one to two years – as costs remain flat and revenues grow rapidly, generating significant cash flow and offering attractive returns on investment. As growth decelerates, this same trend occurs on a consolidated basis. CARD Bank in the Philippines, a GF-USA high growth partner that has only marginally increased market share in recent years due to regulatory limits on expansion, recently paid an 8% dividend. SHARE has calibrated growth to allow for profits annually, yet is able to pay a 10% dividend to its investors. These examples demonstrate that compared to average dividends of 1 to 2% in the US markets, microfinance can present an attractive opportunity, particularly for domestic investors, who do not need to adjust for foreign exchange.

There are, of course, important external risks related to MFI cash flows. These include: i) competition, which is increasing in certain markets; ii) restrictive legal and regulatory environments, such as the one CARD faces as a Rural Bank in the Philippines; iii) political pressure, either indirectly or through legislation, to forgive loans and/or reduce rates so that they are more closely aligned to the formal financial sector.<sup>53</sup> These will need to be assessed by investors on a market-by-market basis and stress tests undertaken in order to provide comfort.

### **4.2.3 Increasing Transparency in Reporting and Measuring Risk**

The financial markets evaluate and price risk. “Investors are interested in performance and how it relates to their investment...They care about the financial implications of information and management’s analysis as it pertains to investment risk.”<sup>54</sup> If investors lack the information they require, they most likely forgo opportunities, particularly opportunities in new industries.

#### **Loan Portfolio Quality**

For microfinance, loan portfolio quality is the primary risk investors wish to evaluate as it is the basis for the institution’s cash flow – and source of repayment and return. The repayment track record among leading MFIs has been widely heralded. Commercial investors, however, want hard, detailed data. MFIs must be able to readily and quickly provide comprehensive information on clients and loans. Information must be consistent and reports clear. (See #1, #2, and #5 in Table 4.1.)

Reporting on loan portfolio quality is improving among leading MFIs, most of whom have computerized management information systems (MIS) providing timely and reliable information. This is critical given microfinance’s decentralized risk management structure and “sophisticated credit algorithms.”<sup>55</sup> Yet providing repayment rates and portfolio-at-risk figures will not be sufficient for investors. By stripping the portfolio by different criteria such as number of times the customer has borrowed, by loan product, by use of loan, by season, by region, etc., investors will get a clearer picture of the portfolio’s creditworthiness<sup>56</sup> and will be better able to assess where risk lies. Moreover, it will be essential for MFIs

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<sup>53</sup> One reviewer of the paper commented that this is what happened to the consumer finance industry in Japan.

<sup>54</sup> Tulchin, p. 9.

<sup>55</sup> This observation was made by Vinod Khosla, partner at Kleiner Perkins, Caulfield & Buyers, a leading VC firm and cofounder of Sun Microsystems. He specifically identified the following: “Does a woman own a buffalo? Some chickens? Does she have a toilet in her home? What kind of roofing material does her home have? Does she bring a shawl to the village meeting?”

<sup>56</sup> The author would like to thank James Dailey for conversations on this subject, which have greatly strengthened this section. A technical project manager at the Grameen Technology Center, he has raised a technical limitation to MFIs ability to undertake such analysis. Microfinance institutions tend to use balance-based MIS rather than transaction-based MIS used by the financial

to provide data on individual borrower repayment, even if the liability is “guaranteed” by a group of members. In the SHARE securitization, ICICI Bank was able to get comfortable with SHARE’s reported portfolio quality as it could show individual loan performance for all clients for the previous two years.

The introduction of domestic credit bureaus would be a very positive development in increasing investor confidence in MFI asset quality. In Latin America, “growing competition and the desire to avoid crises of overindebtedness, such as that in Bolivia in 1999 have led to a serious interest in client information sharing”<sup>57</sup> through credit bureaus. In theory, by sharing the credit histories of their clients, credit risk (either real or perceived) across the industry will decrease. For investors, it will provide another “check” on asset quality.

### **Financial Performance**

Investors must also have confidence in financial performance figures, “...so far...impaired by a lack of recognized accounting standards, risk assessments, and commonly accepted minimum disclosure standards.”<sup>58</sup> While these concerns are part and parcel of emerging market investing in general, a lack of familiarity with microfinance exacerbates the concern. External audit by internationally-recognized auditors will be essential for building investor confidence.

Third-party risk assessment or ratings will also be required. Recognizing the importance of ratings in the business world, the microfinance industry has created specialized ratings. While useful to industry insiders, a financial manager interviewed as part of a separate paper pointed out “microfinance rating systems were only marginally helpful as they did not set up the investment option as an asset class.”<sup>59</sup> The microfinance ratings are so specialized to the industry that they cannot be used as a uniform standard for comparing investment options. To access the financial markets, internationally-recognized ratings that investors understand need to be undertaken. This implies obtaining an S&P or Moody’s rating or adopting the CAMEL evaluations<sup>60</sup> that are used by regulators domestically and internationally to classify banks and credit unions. Compartamos received an S&P rating for its bond issue, essential in reinforcing the strong performance data offered by Compartamos.<sup>61</sup>

### **4.2.4 Adopting a Legal Status Investors Understand**

While many leading MFIs are regulated financial intermediaries, a number continue to operate as not-for-profit entities. Microfinance institutions that seek to approach the financial markets must have a legal structure that can be clearly explained and understood by investors (See #1 and #5 in Table 4.1). Damian von Stauffenberg, principal of a rating agency for MFIs, notes that “Banks and supervised financial institutions are considered more stable and, therefore, more creditworthy, since they’re governed by transparent, well-known rules.”<sup>62</sup> Most true commercial investors will be reluctant to provide debt financing and incapable of providing equity to a not-for-profit entity, which by definition does not have owners or recourse and operate in uncertain legal environments.

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services industry. Going forward, Dailey recommends microfinance MIS move towards the transaction-based systems. It should be noted, however, that most leading MFIs do have MIS and that even with a balance-based system, the information can be extracted by creating an overlay system.

<sup>57</sup> Drake, Deborah and Elisabeth Rhyne, p. 269.

<sup>58</sup> Jansson, From Village to Wall Street, p. 16.

<sup>59</sup> Tulchin, p. 7.

<sup>60</sup> C = Quality and quantity of capital. A = Quality of Assets (testing for delinquency & write-offs). M = Quality of Management (e.g. policy and procedures, training). E = Earnings. L = Liquidity.

<sup>61</sup> Organizations like GF-USA are seeking to “rate” poverty targeting and social impact to ensure MFIs adhere to their social missions while maximizing financial performance. While not all investors will find such social ratings relevant, they would likely be material to social investors.

<sup>62</sup> US Banker, August 2003.

Such a reality can present significant challenges to poverty-focused MFIs, not least of which are corporate culture issues that conversion to a regulated entity entails. Moreover, possibly excluding Latin America, most countries have not developed regulatory regimes that are appropriate for microfinance institutions. In such cases, regulation limits growth, the Philippines being an example from an operating perspective and India from a financing perspective.<sup>63</sup>

#### **4.2.5 Focusing on Governance**

Governance is “the process by which a board of directors, through management, guides an institution in the fulfillment of its corporate mission and protects the institution’s assets over the course of time.”<sup>64</sup> Its importance to microfinance is increasingly recognized. Michael Chu, former president of ACCION and now a partner in Pegasus Investments, observes “...the fundamental factor that determines the sustainability of access to capital markets over time is the institution’s credibility as perceived by investors, whether as lenders or shareholders. If microfinance is to truly link with capital markets, the field must provide clear and solid answers to the critical issues of governance.” For governance to be effective, the Board must play a role in defining strategic priorities and ensuring that management carries out those priorities. In microfinance, this role is particularly important as “the top concern cited by general managers [is] attaining the right balance between social and financial goals.”<sup>65</sup> Some basic components of good governance include outside investors on the board, transparency and an established legal structure; it does not necessarily preclude the inclusion of customers on the board of directors.

#### **4.2.6 Applying Principles of Corporate Finance**

Most successful MFIs were started by innovative social entrepreneurs. Only a minority had prior experience in banking or finance. Most senior staff have similar “social” backgrounds and have risen through the ranks. Therefore, most senior managers, though certainly not all, lack experience in applying traditional corporate finance tools.

Corporate finance, which “covers every decision a firm makes that may affect its finances”, can be divided into five components:<sup>66</sup>

- **Objective function:** Define what exactly the objective in decision-making should be.
- **Investment decision:** Look at how a business should allocate resources across competing uses.
- **Financing decision:** Examine the sources of financing and whether there is an optimal mix of financing.
- **Dividend decision:** Determine how much a business should reinvest back into operations and how much should be returned to the owners.
- **Valuation:** All of the decisions made by a firm are traced through to a final value.

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<sup>63</sup> In the Philippines, rural banks, the most obvious alternative to NGO for MFIs, are not allowed to establish new branches in towns where an existing rural bank branch exists, even if the existing branch is not serving the poor. In India, minimum capital requirements of nearly US\$400,000 have inhibited MFIs from converting in the first place.

<sup>64</sup> Otero, p. 1.

<sup>65</sup> Kaddaras, James with Elisabeth Rhyne, p. 6.

<sup>66</sup> The below is excerpted from Professor A. Damodaran’s New York University, Stern Business School website. See <[http://pages.stern.nyu.edu/~adamodar/New\\_Home\\_Page/CFin/CF.htm](http://pages.stern.nyu.edu/~adamodar/New_Home_Page/CFin/CF.htm)>

A detailed discussion outlining corporate finance strategies is outside the scope of this paper. However, a few critical areas should be highlighted. First, MFIs must present investors with financing strategies that systematically analyze current and future capital structure – how MFIs finance themselves – and minimize weighted average cost of capital (WACC), the average cost of funds across all sources. Capital structure will vary by MFI depending on legal status, particularly whether the institution is deposit-taking or not.<sup>67</sup> Financial institutions, in general, are normally highly leveraged as they are very liquid; their assets can be easily converted into cash.

Second, if MFIs seek to grow rapidly, internally-generated funds will not be sufficient to drive growth. MFIs will need to focus on the balance sheet, using it to show that if an MFI is efficient, it can lead to higher profitability and, in theory, more attractive returns. Dr. Kendall Mau, COO & CFO of Prisma Microfinance, has used this approach to attract commercial investors into Prisma.

Finally, understanding the value of a business is a fundamental question asked by investors, especially equity investors. MFIs must be prepared to discuss valuation with investors. Two microfinance equity investments funds, Microvest and Shorecap, use a multiple of book value as their standard approach to valuing MFIs. The rule of thumb used by these organizations is 1x book value, though a strong MFI with superior returns might command a premium of up to 1.5x book value. While this will be a useful starting point for MFIs as they approach investors, they will need to be able to explain why this rule of thumb has been adopted. They will also need to discuss, based on projections, their dividend strategy.

#### 4.2.7 Better Understanding Investors' Perspective

Understanding investors is a critical component of “The Great Divide” described by Mr. Wilson in Table 4.1. This paper refers to the financial markets as a single, amorphous group. Yet, in reality, there are many different investors with different risk-return appetites and priorities; these characteristics serve as the foundation of the financial markets. MFI managers need to understand different investors' motivations and concerns when analyzing MFIs. A tailored sales pitch is then more effective.

In a survey of 34 US-based SRI professionals,<sup>68</sup> all seeking commercial returns on investment, a number of barriers to microfinance and small enterprise investment in emerging markets were identified:<sup>69</sup>

**Table 4.2: Assessment of Key Risks by Investor Type**

	All	Institutional Investors	Financial Planners	Brokers
Lack of Country Intelligence	3.0	3.1	.5	2.8
Lack of Experience in Emerging Market Investments	2.8	3.5	2.0	3.0
Insufficient Social Impact Measurement	2.7	3.3	2.0	4.0
Inadequate Risk/Return Profile	2.3	2.2	1.9	2.6
Lack of Appropriate Vehicle	2.0	1.8	2.0	2.5

Note: On a scale from 1-5 (with 5 representing the highest level of concern).

<sup>67</sup> Regulated financial intermediaries are normally required to maintain minimum capital requirements and capital adequacy – total equity divided by risk-adjusted assets. Deposit-taking institutions may have other reserve requirements.

<sup>68</sup> Of the 34, 17 were institutional investors, nine financial planners, seven brokers and one other.

<sup>69</sup> Survey undertaken by Marc de Sousa-Shields, Enterprising Solutions Global Consulting

As the table illustrates, even among a specialized sector, US-based SRIs' concerns and focus areas vary. Country intelligence was a key concern of institutional investors, yet financial planners, who were knowledgeable about the countries being discussed, were not concerned.

Brokers, those trying to sell the investments, were most concerned about insufficient social impact measurement, where financial planners were much less concerned.

What is important in this example is not how each of these groups necessarily assess the investment opportunity, but rather that differences exist. As MFIs move beyond traditional sources of financing, they will need to understand these individuals' concerns and be prepared to address them when approaching investors.

#### **4.2.8 Other Considerations**

A number of other considerations will be important as MFIs seek to attract financial market investment and investors assess the microfinance market. These include small deal size, lack of secondary market liquidity and foreign exchange risk.

An important barrier to microfinance success in financial markets is small deal size. Transaction costs, such as due diligence, legal expenses and custodial arrangements, reduce investor return. Bundling MFI portfolios, as in the Blue Orchard bond issue, is one approach to circumventing this issue. Another is to consider how microfinance is being positioned in the market. Looking at the deals that have been done in microfinance for the poor, the Compartamos deal is only US\$10 million. While smaller deal size will likely be tolerated in developing markets, deal size is still an important consideration. In looking at the US markets, it seems that microfinance institutions should position themselves as middle market issuers. In 2003, the average bond deal done for middle market companies was US\$11.3 million, only slightly larger than the Compartamos deal. The middle markets may present an interesting opportunity for smaller MFIs seeking to issue US-based securities.

Lack of liquidity or the ability to convert an investment to cash immediately (thereby reducing risk), was identified specifically by Mr. Wilson above. A lack of secondary markets for microfinance investments limits the ability of certain investors to take a position in microfinance. As the market matures, however, this factor is likely to change. As noted in Section 3, ICICI Bank's sale of SHARE's portfolio to another bank could signal the start of a secondary market in microfinance securities.

Foreign exchange risk will be a critical concern for MFIs seeking to attract international investors. While this paper advocates that domestic investors will and should play a primary role in financing microfinance in the long-term, the reality is that international investors too will participate. Currently, neither the MFIs nor investors are willing to bear this risk. "For investors, local currency loans make the risk/return calculation much harder; for microfinance institutions, hard currency loans complicate asset-liability management since they typically lend in local currency."<sup>70</sup> Establishing hedging mechanisms for MFIs has been discussed, but little progress has been made. Without such insurance, the role of international investors in nondollarized economies will be limited.

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<sup>70</sup> Jansson, p. 19.

### 4.3 Practical Steps in Approaching the Financial Markets

While MFIs will need to adopt the suggestions above to position themselves for the financial markets, there are a number of practical steps they might pursue, either individually or together, as they contemplate approaching the financial markets. These suggestions include:

- **Hire an Experienced Chief Financial Officer.** In small companies the focus is on operations. Finance staff are primarily responsible for internal matters, such as accounting and budgeting, while fundraising is carried out by senior management. Yet as the company grows and seeks to tap more sophisticated sources of financing, including the financial markets, companies need to hire astute financial professionals. These professionals can understand and apply sophisticated corporate finance principles and can comfortably communicate with investment banks and investors. Many leading MFIs have followed this trend. Others would likely benefit from doing so. Such professionals, while not necessarily experts in microfinance, are experts in financing. As has been shown in other industries, they add significant value to the company and its investors.
- **Hire an Advisor:** Sophisticated companies hire investment banks to play the role of “intermediary”, learning the industry and firm, communicating their strengths to investors, and structuring the best deal possible for the company that can also be sold in the markets. In pioneering transactions, investment banks have played critical intermediary roles in the Compartamos and Blue Orchard bond issues. Other potential intermediaries in the microfinance field include MFI partner organizations, such as Women’s World Banking and GF-USA.
- **Prepare a Business Plan:** The standard document for communicating with investors is a business plan. A business plan “seeks to capture the vision, current status, expected needs, defined markets, and projected results of the business.”<sup>71</sup> MFIs can either prepare these documents or hire an advisor to do so.
- **Train in Corporate Finance:** As deemed appropriate by senior management, MFIs may wish to send more junior and mid-level finance staff, particularly those without bachelor’s degrees in finance, for further training. Alternatively, the firm may wish to hire a corporate finance professional or academic to lead training at the institution.

These suggestions are intended only to identify next steps. A more detailed exploration of each step should be undertaken by industry stakeholders.

### 4.4 The Big Unknown – Equity

The pioneering transactions described above suggest financial market interest in microfinance. To date, however, the emphasis has been on debt financing. Commercial interest in equity has been negligible. The quantum of equity financing required to grow microfinance pales next to debt financing. But crucially, debt does not come without the equity. Not only is equity critical for a growing organization, but it also becomes a key consideration for those microfinance institutions that are regulated, and thus often required to meet minimum capital requirements and capital adequacy standards.<sup>72</sup>

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<sup>71</sup> See <[www.mplans.com/gm/index.cfm?a=s1&stern=Business%20Plan](http://www.mplans.com/gm/index.cfm?a=s1&stern=Business%20Plan)>

<sup>72</sup> International capital adequacy standards, which influence local regulation, are expected to be revised to better align capital requirements to risk. It is possible that microfinance with its small, uncollateralized loans, will be required to offer a capital

Part of the problem in attracting equity capital has been the approach. In a paper titled, “Positioning Microfinance Institutions for the Capital Markets”, GF-USA Capital Market Specialist Drew Tulchin correctly notes that “patient equity capital for a decade with little return and no defined exit prospects is more like charity than investment.”<sup>73</sup> A 2004 study by the Council of Microfinance Equity Funds recognizes that “as yet, purely private commercial capital still plays a relatively minor role in overall equity funding for MFIs.” This suggests MFIs are unsure how to move forward in attracting private commercial capital. Two key questions persist: can MFIs offer attractive equity returns and can investors exit these investments?

To date, the thinking on equity return has not been very creative. The lore of traditional venture capital is for every 10 investments, 2 at best will be homeruns (returns in the 100%’s), two to three will survive (with modest returns or their money back) and the rest will fail. Venture capital has averaged annual returns of 20% over the last generation.<sup>74</sup> High returns on some investments are necessary to overcome high failure rate. In the case of microfinance, it is possible to argue that business risk is much lower than in traditional venture capital investments. As such, the success rate of investments should be much higher – not in terms of return, but in terms of fewer failures. It is possible to envision a scenario where all of 10 MFI investments offer returns comparable to the venture capital industry average, or slightly higher. Given that shareholder’s equity should represent a small percentage of overall MFI financing, no more than 10% to 15% (and arguably much less if the MFI is not taking deposits), and recognizing the nature of MFI cash flows, such returns should be possible. There is no evidence to support this assertion, however, as there are no purely commercial equity investors in poverty-focused microfinance. Yet, a clear case, based on historical financial performance, could be made to investors.

The issue of exiting an investment is critical to equity investors. The Council of Microfinance Equity Funds paper identifies the following as possible exit opportunities for investors in microfinance: trade sale to a local or international commercial bank; trade sale to another MFI; a private placement to a group of eligible shareholders; a public listing or flotation of shares; or a public listing of the shares of the private equity funds that hold MFI shares. With the exception of sale to a strategic buyer as the industry consolidates, and that will only be relevant in more developed markets, none of these options are truly realistic for most MFIs in the short to medium-term.<sup>75</sup> At least, that is what experience to date tells us. It will be necessary for MFIs and investors alike to think anew about this issue.

Aavishkaar India Micro Venture Capital Fund (Aavishkaar) is a commercial venture capital fund promoting sustainable development in rural India by investing equity in SMEs that are socially relevant, environmentally friendly, commercially viable, and have little to no access to other sources of financing<sup>76</sup>. In the last two years, it has invested US\$200,000 in four SMEs. All along it has acknowledged that traditional exit options are unlikely. Recognizing that profits exist in its investee companies to offer attractive returns as well as return of the principal investment, as in microfinance, Aavishkaar is focusing on promoter buyback as its primary with a dividend-based return. Such innovative thinking needs to be presented to commercial equity investors in microfinance.

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premium. In essence, it will have to raise 50% more equity capital than it would have previously to meet the minimum capital adequacy target. See Tor Jansson, “Microfinance: From Village to Wall Street” for a more extended discussion of the topic.

<sup>73</sup> Tulchin, p. 14

<sup>74</sup> Satterthwaite, Brief on Capital Market Creation.

<sup>75</sup> Two notable exceptions are Bancosol in Bolivia and Bank Rakyat Indonesia in Indonesia.

<sup>76</sup> For more information, please see <[www.aavishkaar.org](http://www.aavishkaar.org)>

## **Section 5. Conclusion**

The pioneering financings completed by leading, poverty-focused MFIs have shown the industry what is possible – large amounts of financing that allows for rapid expansion of financial services to new poor customers. The MFIs offer a model to others that are interested in tapping the financial markets, not only in terms of lessons learned in executing these transactions, but in terms of business fundamentals – operating and financial performance, internal systems, governance, and strategic vision, among others. They have broken new ground, making a reality of the vision of linking commercial investors to the poor. Completing these first transactions and establishing a track record is a critical first step.

Leading, poverty-focused MFIs, expected to play the primary role in meeting the demand of poor customers for financial services over the next five to 10 years, will need to build upon the success of CASHPOR, SHARE and Compartamos if they are to raise the billions of dollars required to close the supply-demand gap. This paper has offered a number of suggestions for addressing domestic and international investor concerns. If leading MFIs continue on their present course and adopt some or all of the suggestions offered, financial market interest, or more specifically, debt capital market interest, in leading, poverty-focused MFIs is expected to grow. The same is true for interest on the part of commercial banks and other AFIs in the strategic partnership model. This represents a critical breakthrough. However, commercial equity financing for microfinance remains the big unknown and if not addressed in the short-term will ultimately become the primary hurdle to market expansion.

In five to 10 years, leading, poverty-focused MFIs should be financing themselves exclusively with commercial sources of financing, the majority, if not all, from domestic sources. In the short to medium-term, however, there is an important role of the international donor community and MFI partner organizations such as GF-USA to play in facilitating MFI access to the financial markets. This includes the provision of catalytic capital – of the kind GF-USA offered in the SHARE securitization and the Blue Orchard bond issue – as well as financial support to cover the necessary costs of accessing the financial markets, such as internationally recognized ratings and legal advice. There is also an important role to play in championing this innovation not only to the MFIs, but also to the wider microfinance industry and perhaps most critically, investors. By doing so, overcoming the gap between demand for and supply of financial services to the poor may indeed become a reality.

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## About Grameen Foundation USA

**Grameen Foundation-USA** is a young, dynamic, global organization that applies a powerful tool, *microfinance*, to empower the world's poorest people to escape poverty. In just seven years, GF-USA has established a global network of 46 partners in 20 countries and has impacted more than four million poor people in Asia, Africa, the Americas and the Middle East. The organization's mission is to empower the world's poorest people to lift themselves out of poverty with dignity through access to financial services and to information.

Our *Grameen Technology Center* is harnessing the power of technology to eliminate poverty and to leverage the power of micro finance. It opens an unparalleled opportunity to improve the lives of the world's poorest people. With this doorway into the information age, people in the world's poorest villages are able to generate economic opportunity and better address the needs in their communities.

Developing innovative ways to capture financial resources for microfinance is critical. Through our *Capital Markets Program*, GF-USA is introducing traditional, private sector financial markets to investment opportunities that support the microfinance movement. Early results suggest that capital markets and social investors will become major contributors to the growth and success of the microfinance industry.

The *Grameen Bank Replication Program* (GBRP), established in 1999, supports microfinance institutions and social entrepreneurs who seek to replicate the Grameen Bank approach, or scale up existing programs to provide financial services to the poor. GBRP provides financial, technical, technological, and human resource support.



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