FocusNote
NO. 30 AUGUST 2005

THE MARKET FOR FOREIGN INVESTMENT IN MICROFINANCE: OPPORTUNITIES AND CHALLENGES

CGAP

The authors of this Focus Note are Gautam Ivatury, microfinance analyst, CGAP; and Julie Abrams, consultant.

The authors thank Rich Rosenberg and Alexia Latortue, who made major contributions to this paper, and also Elizabeth Littlefield and Xavier Reille for their helpful comments.

CGAP, the Consultative Group to Assist the Poor, is a consortium of 31 development agencies that support microfinance. More information is available on the CGAP web site: www.cgap.org.

Introduction

Many microfinance institutions (MFIs) in developing and transition economies have received foreign funding, especially the larger MFIs. Most of that funding has consisted of grants or highly subsidized loans from donor agencies, including such bilateral donors as Agence Française de Développement or the US Agency for International Development, and multilateral agencies such as the United Nations Development Programme or the World Bank. In recent years, these bilateral and multilateral donors have provided approximately US $0.5–1.0 billion annually in grants and soft loans for microfinance by CGAP estimates.

However, since 2000 there has been a rapid growth in foreign investment by various agencies and funds that tend to be more commercially oriented, such as the Dexia Microcredit Fund and MicroVest. By mid-2004, this group of actors had invested a total of nearly US $1.2 billion in about 500 MFIs. The equity, loans, and guarantees that they offer to MFIs are typically less subsidized than grants and loans from traditional donors. These "foreign investors" and the demand for their services are the subject of this paper, which surveys the market and addresses some key questions:

- How much foreign investment in MFIs is really private?
  Less than a quarter.
- How much of this investment is really commercial?
  Very little.
- Where is the investment being placed, in terms of region, number, and type of MFIs?
  505 MFIs have received foreign investment, but it has been concentrated in large investments in a small number of licensed and regulated institutions in Latin America and Eastern Europe/Central Asia.
- Are investors competing for MFIs to invest in?
  It is surprisingly common to find a single investor funding an MFI both directly and indirectly, suggesting that the supply of funds from foreign investors may exceed the demand from low-risk MFIs.

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  It is surprisingly common to find a single investor funding an MFI both directly and indirectly, suggesting that the supply of funds from foreign investors may exceed the demand from low-risk MFIs.

- As MFIs continue to grow and absorb more funding, what is the likely role of foreign investment compared with domestic sources in the MFIs' own countries?

  Domestic sources seem likely to become more prevalent, particularly for regulated MFIs.

- Does foreign debt create inappropriate currency risk for MFIs?

  Many MFIs seem to be taking on hard-currency debt because the interest rates appear lower in nominal terms, without factoring in the significant foreign exchange risk they are thereby creating.

- What practical lessons emerge from the analysis?

  Foreign investors would add more value to the market if they were able to tolerate more risk, and thus work with less-well-established MFIs. Those funded with public money are best-positioned to take additional risk. Regulated MFIs should be helped to access more local funding. MFIs and investors need to be aware of the foreign exchange risk inherent in hard-currency loans.

The term "microfinance institution" as used in this paper includes NGOs, cooperatives, banks, and licensed non-bank institutions that focus on delivering financial services to microentrepreneurs and other low-income clients, generally using new lending techniques that have been developed during the last 25 years. There are other socially-oriented financial intermediaries—especially postal banks and other state-owned banks—that probably reach substantially more low-income clients than the MFIs reach. These latter institutions are not discussed here because they generally neither attract nor require foreign investment. Nevertheless, it is important to recognize the major role that their services and infrastructure play.[1]

Data Sources

Between July and September 2004, CGAP, the MIX (Microfinance Information eXchange), and ADA (Appui au Développement Autonome) surveyed 54 foreign microfinance investors to ascertain their legal structures, investment focus and history, availability of uncommitted funds, and financial performance. The survey yielded data on "direct" investments in 505 MFIs and "indirect" investments in 25 microfinance funds. For 33 of the 54 investors, survey responses were corroborated or supplemented with information from annual reports.

In July 2004, CGAP and the MIX issued an open invitation to MFIs and other financial institutions that serve the poor to complete a questionnaire on their capital structures and funding preferences.[2] Two hundred sixteen institutions from 60 countries responded.[3] These responses were supplemented by balance sheet and financial performance data provided by industry associations and service providers.[4]

Foreign Investors: Type, Number, and Scale

By mid-2004, there were about 60 foreign investors in microfinance, of which 54 participated in the CGAP-MIX-ADA survey (see annex 1). The participating funds can be classified in two groups:

- The investment arms of 9 bilateral and multilateral development agencies (international financial institutions or "IFIs"), such as the International Finance Corporation (IFC), Germany's Kreditanstalt für Wiederaufbau (KfW), and others. These agencies' funding

[1] Christen, Rosenberg, and Jayadeva, *Financial Institutions with a "Double Bottom Line": Implications for the Future of Microfinance,* 2004.

[2] The English version of the survey is accessible at www.surveymonkey.com/s.asp?u=33938560773.

[3] The assistance of the Microfinance Centre (MFC) in Poland, CAPAF in Senegal, and a number of microfinance foreign investors and MFI associations was invaluable in obtaining these responses.

[4] The authors thank Glenn Westley of the Inter-American Development Bank (IDB), Damien von Stauffenberg and Todd Farrington of MicroRate, and Isabelle Barrès of the MIX for their contributions in gathering these data.

comes from governments or from borrowing in capital markets where their public status secures low interest rates.

- Forty-five privately-run foreign investors and foundations ("private funds"). While their management is private, more than half of their capital comes from government sources.

Both private funds and IFIs generally take a near-commercial approach to investment analysis and monitoring. However, none of the IFIs and very few of the private funds are fully commercial: they take greater risks and accept lower returns than investors that purely maximize profit.[5]

Table 1 shows amounts of direct and indirect foreign investment as of mid-2004.[6] Direct investment of about US $1.2 billion is what actually reaches MFIs. Indirect investment of $611 million is investment in another fund, which will eventually reach the MFI in the form of a direct investment by that other fund. The majority of the direct investment ($648 million, or 56 percent) comes from the IFIs. In addition to their direct investment, these public investors have also invested another $484 million into privately-managed investment funds. Likewise, the private funds have made both direct investments in MFIs and indirect investments in other private funds.

Over and above the US $1.2 billion already directly invested in MFIs by mid-2004, how much more funding was available, or is likely to be available soon? It is not possible to quantify the further amounts that are available directly from the IFIs because their microfinance investments usually come from their general budget, rather than from some budget that is earmarked in advance for microfinance.

A rough estimate, however, can be made for the private funds. In addition to raising capital from the IFIs, the private funds attract funding from private socially-motivated investors and NGOs, as well as from bilateral donor agencies and government lottery programs. CGAP estimates the amount of this non-IFI contribution to the private funds was above US $460 million. IFI direct and indirect investment was $1.13 billion, for a total foreign investment allocated to microfinance of about $1.6 billion. If approximately $1.2 billion of this amount has already been invested in MFIs, the estimate of funds available and uncommitted in private funds would be over $400 million.

In addition to this US $400 million already available in mid-2004, the private investors expected to increase their capital by about $104 million in the near term. Five new private funds were expected to start operations in 2005 with assets of about $150 million. Thus, a total of about $654 million was expected to be available through private funds in the near term. Again, since this does not include future direct investment by IFIs, the total amount of near-term foreign investment for microfinance could be substantially more.

[5] The survey did not include international banks such as Société Générale, Citigroup, and others that have made cross-border investments in a few financial institutions that serve the poor.

[6] Data provided by investors as of December 31, 2003; March 31, 2004; or June 30, 2004.

Table 1 Foreign Investment in Microfinance, as of mid-2004 (US$ millions)

	IFIs	Private Funds	All Investors
Direct: Financing for retail microfinance providers	$648 56%	$511 44%	**$1,159** **100%**
Indirect: Financing to other investment funds, only part of which has already flowed through to direct investment	$484 79%	$126 21%	**$611** **100%**
Total Investments: Note that this line includes double counting since some of the direct investments by the private funds came from IFIs and other funds.	$1,132 64%	$637 36%	

Source: 2004 CGAP-MIX-ADA survey of microfinance foreign investors. Totals reflect the sum of three types of data: disbursed funds, committed but undisbursed funds, and in a few cases, portfolio outstanding. Investors surveyed did not provide consistent forms of data.

How Much of the Investment Is Private or Truly Commercial?

When investments in microfinance by IFIs and government programs are aggregated, the public sector, directly or indirectly (e.g., through investment in private funds), finances at least 75 percent of all foreign capital investment for microfinance. Of the US $1.6 billion in foreign investment for microfinance available or committed in mid-2004, the nine IFIs identified in this analysis contribute $1.13 billion, and government lottery programs fund about $63 million, mostly to a handful of private funds in Europe. Other public development agencies and development finance institutions, such as the Commonwealth Development Corporation (CDC) and the Central American Bank for Economic Integration (CABEI), fund an additional estimated $50 million. The total funding from these public sources, approximately $1.25 billion, represents over 75 percent of all foreign capital investment for microfinance.

In addition to the split between public and private funding, it is important to ask how much of the private funding comes from commercially-motivated (i.e., profit-maximizing) sources. Investors that view microfinance as a profitable investment are more likely to have an ongoing commitment to investing in microfinance.

Currently, the majority of private funding for foreign investment in microfinance comes from socially-motivated sources, such as religious organizations, NGOs, and socially-motivated, high net-worth individuals. Profit-maximizing commercial investors, such as the socially-responsible investment industry (which seeks market returns but screens out certain perceived undesirable investment sectors), have placed relatively little money into microfinance to date. In any case, funding from domestic sources—especially deposits and loans from commercial banks—is more likely to be truly commercial, and therefore more assured over the long-term, than most foreign investment that MFIs receive. That most local banks take a purely commercial approach is clear from the difficulty that many MFIs face in borrowing from them; unregulated institutions, in particular, must overcome high collateral requirements due to their legal status.

Where Is the Foreign Investment Going?

Foreign investment in MFIs takes the form of:

- equity—the investor buys stock in the MFI, becomes a voting shareholder, and often controls a seat on the board of directors;
- debt—the investor makes a loan to the MFI, and occasionally is legally subordinated to the claims of other lenders/depositors, in which case it may function as quasi-equity for regulatory purposes; or
- guarantees—the investor guarantees MFI borrowings from local banks or capital markets.

The retail institutions that receive the investments can be broken into two groups. Banks and "nonbank financial institutions" (NBFIs) are licensed and regulated by national banking authorities; they can use equity, debt, and guarantees. NGOs and cooperatives (including credit unions) are not legally structured to receive equity investments, so they can use only debt and guarantees.[7] Of the 505 investee MFIs identified by the investor survey, 166 are regulated and 196 are NGOs and cooperatives. The legal status of the remaining 143 investee MFIs was not reported, although most if not all are likely to be unregulated. Thus, regulated MFIs comprise about one-third of the investee MFIs identified.

Foreign investment has been spread among the world's developing regions, and those with economies in transition, of the world. But there

[7] Foreign investors have made equity investments to assist the transformation of NGOs: the investor and the NGOs capitalize a new for-profit company to continue the NGO's microfinance operations, but as a regulated institution.

has been heavy concentration in certain regions, types of institutions, and individual MFIs.

Table 2 shows that 87 percent of foreign investment has gone to Latin America (mainly from private funds) and to Eastern Europe/Central Asia (mainly from IFIs). This is because most of the investment goes to regulated MFIs, which are concentrated in these regions (see figure 1). Most foreign investment took the form of debt (69 percent), 24 percent was placed in equity, and only 8 percent went to guarantees for local borrowing.

There are several possible explanations for the substantial concentration of investment in these two regions. In Asia, MFIs have been able to secure funding from governments and multilateral lenders at subsidized rates more easily than institutions in other regions. Many profitable MFIs in East and South Asia have secured funding from domestic sources, including deposits and bank loans. Some foreign investors report that in Africa, donor funds continue to flow to profitable institutions, reducing their demand for foreign investment. In West Africa, credit unions and cooperatives are dominant providers of microfinance, and are not structured for equity investment. These institutions typically use member savings to fund credit operations.[8]

There is a similar concentration by institutional type: 82 percent of the foreign investment has gone to MFIs that are licensed and regulated by banking authorities (see figure 1). This is not particularly surprising, since the regulated MFIs tend to be larger, more mature, and relatively less risky. The regulated investee MFIs are primarily Latin American institutions and ProCredit banks in Eastern Europe/Central Asia.

There is also a high concentration in a few individual MFIs. Just ten of the 505 MFIs captured 25 percent of all the direct investment, and the 148 MFIs that each received at least US $1 million in foreign debt, equity, or guarantees accounted for 89 percent of all foreign investment. The 18 ProCredit banks constitute 4 percent of the institutions receiving investments, but have received 34 percent of the total amount invested, including nearly 60 percent of all the equity provided by

[8] See Ivatury and Reille, *Foreign Investment in Microfinance: Debt and Equity from Quasi-Commercial Investors,* 2004.

Table 2 Foreign Investment Disbursed (in US$ millions and %) **and Number of Recipient MFIs, as of mid-2004**

Region	**Private Funds**			**IFIs**			**All Investors**	
	Equity	Debt	Guarantees	Equity	Debt	Guarantees	**Total Amount**	**Total Recipients**
Eastern Europe/ Central Asia (ECA)	$74 46%	$39 14%	$0 0%	$68 71%	$323 69%	$2 3%	**$506 46%**	**89 18%**
Latin America/ Caribbean (LAC)	$69 43%	$166 59%	$6 78%	$13 14%	$136 29%	$57 76%	**$447 41%**	**193 38%**
Sub-Saharan Africa (AFR)	$15 9%	$30 11%	$1 10%	$6 6%	$2 0%	$8 11%	**$62 6%**	**104 21%**
East Asia/Pacific (EAP)	$2 1%	$23 8%	$1 9%	$4 4%	$6 1%	$0 0%	**$36 3%**	**63 12%**
South Asia (SAR)	$1 1%	$23 8%	$0 3%	$5 5%	$0 0%	$1 1%	**$30 3%**	**48 10%**
Middle East/ North Africa (MENA)	$0 0%	$2 1%	$0 0%	$0 0%	$0 0%	$7 9%	**$9 1%**	**8 2%**
Total	$161 100%	$283 100%	$8 100%	$96 100%	$467 100%	$75 100%	**$1,090 100%**	**505 100%**

Source: 2004 CGAP-MIX-ADA survey of microfinance foreign investors. Recipients are regulated and unregulated retail microfinance providers only.

Figure 1 Volume of Foreign Investment in Microfinance, as of mid-2004

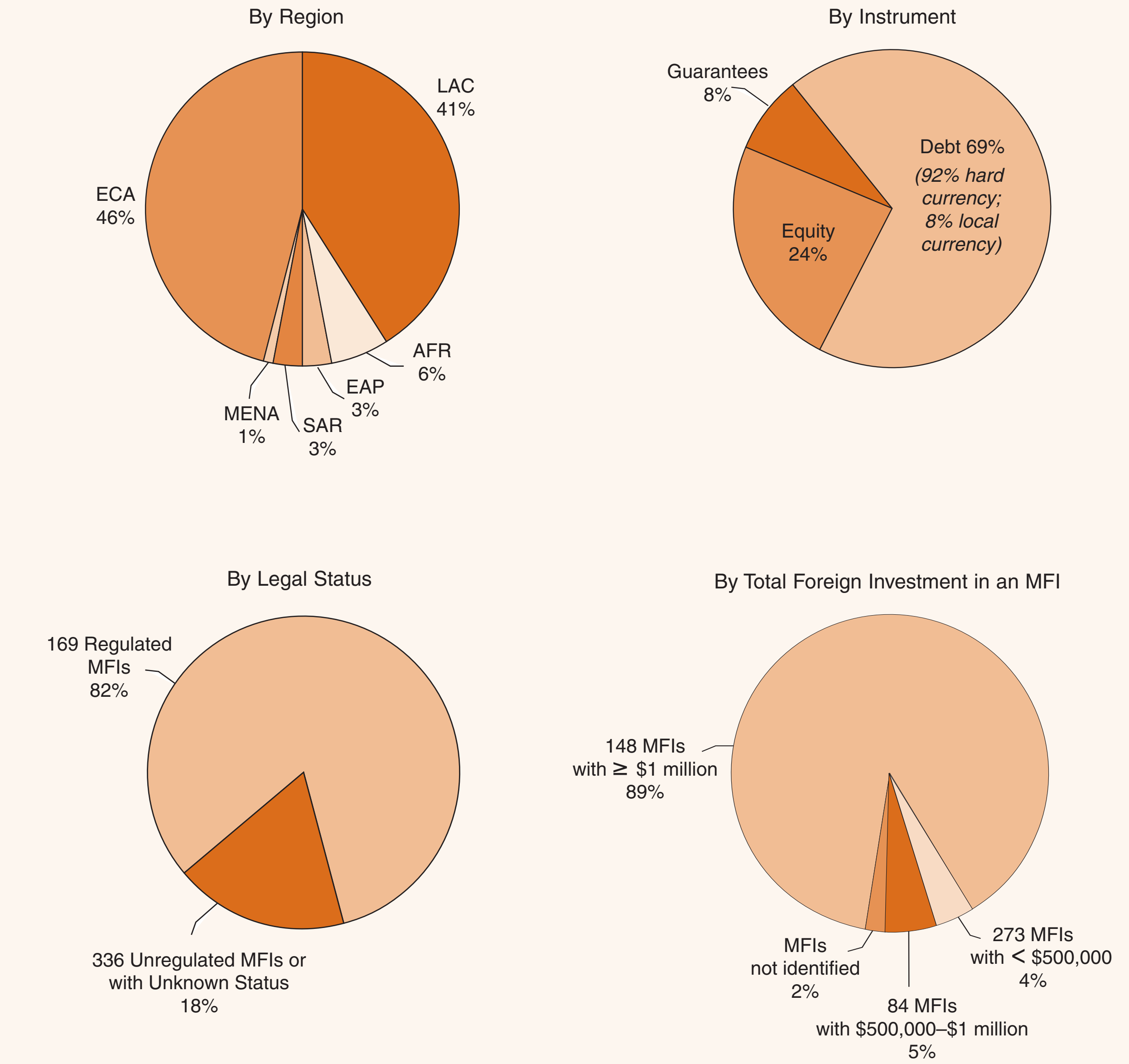

Table 3 Foreign Investment in ProCredit Institutions, as of mid-2004 (US$ millions and %)

	Private Funds			IFIs			Total	
	Equity	Debt	Guarantees	Equity	Debt	Guarantees	Total	Number of Recipients
18 ProCredit Banks	$92.7	$7.3	$0.0	$59.1	$210.9	$4.8	$374.7	18
% of Total	58%	3%	0%	61%	44%	6%	34%	4%

Source: 2004 CGAP-MIX-ADA survey of microfinance foreign investors.

private funds, and 45 percent of all debt provided by IFIs, as can be seen in table 3.[9]

Finally, there is considerable concentration in the suppliers of foreign investment. Nearly one-half of all investment is provided by just four of the IFIs—International Finance Corporation (IFC), European Bank for Reconstruction and Development (EBRD), Kreditanstalt für Wiederaufbau (KfW), and the United States Agency for International Development's (USAID) Development Credit Authority (DCA). If two private funds are added—ProCredit Holding (AG) and Oikocredit—the share rises to two-thirds of all the investment being delivered by just 6 of the 54 investors.

Thus far, the foreign investment picture has been dominated by a few large funds investing in a small number of low-risk MFIs, mainly regulated institutions in Latin America and Eastern Europe/Central Asia.

Are Foreign Investors Competing to Find MFIs to Invest In?

There are numerous anecdotal suggestions that investors are not finding it easy to place funds in MFIs that meet their standards. In a surprising number of cases in Latin America, where private funds invest most of their money, multiple investors are investing in a single MFI. Of the 54 foreign investors, 20 have funded Banco Solidario (Ecuador), 15 have funded Confianza (Peru), 11 have funded Fundación Nieberowski (Nicaragua), and 10 have funded Caja Los Andes (Bolivia) and SFE (Ecuador).

Are MFIs securing funding from a large number of investors because each fund invests only a small amount? This may be true for MFIs with a modest number of investors. However, the degree of multiple investments shown in table 4

[9] ProCredit Holding AG is the successor to IMI (Internationale Micro Investitionen AG).

Table 4 MFIs with Eight or More Foreign Investors, as of mid-2004 (US$ millions)

Institution	45 Private Funds		9 IFIs		54 Total Investors	
	Number	Amount Invested	Number	Amount Invested	Number	Amount Invested
Banco Solidario (Ecuador)	15	$21.7	5	$19.1	**20**	**$40.9**
Confianza (Peru)	14	$5.8	1	$0.3	**15**	**$6.1**
Fundación Nieberowski (Nicaragua)	11	$3.7	0	$0	**11**	**$3.7**
Caja Los Andes (Bolivia)	5	$9.5	5	$24.7	**10**	**$34.2**
SFE (Ecuador)	5	$11.6	5	$9.5	**10**	**$21.1**
WWB Cali (Colombia)	6	$4.8	3	$10.1	**9**	**$14.8**
FFP FIE (Bolivia)	7	$8.1	2	$5.9	**9**	**$14.0**
Banco Sol (Bolivia)	5	$8.1	3	$11.0	**8**	**$19.1**
Findesa (Nicaragua)	7	$5.8	1	$1.5	**8**	**$7.3**
Prestanic (Nicaragua)	8	$1.5	0	$0	**8**	**$1.5**

Source: 2004 CGAP-MIX-ADA survey of microfinance foreign investors.

would seem to suggest that the supply of foreign investment exceeds the demand from suitable MFIs—i.e., MFIs that meet the investors' quality and risk profile.

In some instances, a single investor is funding the same institution through several indirect channels. For example, BIO, an IFI funded by the government of Belgium, owns about 15 percent of Caja Los Andes in Bolivia, in addition to providing debt to the MFI. BIO also owns equity in ProCredit Holding AG, which in turn owns the majority of Caja Los Andes. In addition, BIO owns equity in Alterfin, which owns equity in SIDI, which owns equity in ProFund, which invests in Caja Los Andes. BIO has additional exposure to Caja Los Andes through SIDI's investment in LA-CIF. BIO's direct and indirect ownership of the MFI is approximately 20 percent.

Other IFIs, such as KfW and IFC, have similar overlapping investments. The 10 investors in Caja Los Andes and the 21 investors in Banco Solidario do not share risk according to the relative amounts of their direct investments. For instance, in addition to IFC's direct exposure to both institutions, it has indirect participation through two private funds, ACCIÓN Investments in Microfinance (AIM) and ProFund.

Given this complex overlapping picture, some eventual consolidation among the investors would seem to make sense.

Relative Demand: Local vs. Foreign Funding

As figure 1 shows, most of the foreign investment in debt is going to licensed MFIs that are regulated by banking authorities. The CGAP-MIX survey of funding needs found regulated MFIs wanting a large increase in local deposits as a percentage of their liabilities: according to the 37 regulated respondents to the survey, their ideal ratio of deposits to total liabilities averaged 1.5 times higher than their present level. This does not necessarily mean that these MFIs want the absolute amount of their foreign borrowings to decline, but it does suggest that in the future the regulated MFIs that have absorbed most of the foreign debt may need less of it as a proportion of total liabilities.

MFIs that are new to managing deposits have often underestimated the complexity and cost of this funding source. For some of these MFIs, foreign technical support in product design and information systems might be more helpful than foreign loans.

The ProCredit microfinance banks in Eastern Europe have received one-third of all foreign debt and equity investment, as of mid-2004. Yet, a recent rating report on ProCredit Holding AG indicates that "retail deposits are regarded as the main source of future growth and it is hoped that the recent adoption of a unified ProCredit brand and group logo, and the confidence inspired by the 'foreign' elements of the ProCredit network (e.g., western managers, Frankfurt-based head office) will facilitate the attraction of retail deposits by the individual banks."[10] ProCredit's microfinance banks are also attempting to tap domestic capital markets where possible: in June 2004, ProCredit Bank (Ukraine) sold US $6.5 million in 3-year, local currency-denominated bonds mainly to local investors, taking advantage of a liberalized domestic capital market.

In Peru and other countries, increasing competition, including the entry of profit-maximizing commercial banks into the microfinance sector, may be encouraging regulated MFIs to increase domestic financing of their liabilities.[11] As of June 2004, seven Peruvian commercial banks held 39 percent of the microlending market. Banco de Crédito del Peru, the country's largest commercial bank, began a microenterprise lending program in 2001 that now has 14 percent of the market,

[10] Fitch Ratings report on IMI AG, September 28, 2004.

[11] Chowdri and Silva, eds., *Downscaling Institutions and Competitive Microfinance Markets: Reflections and Case Studies from Latin America*, 2004.

compared to 8 percent for Mibanco, the largest MFI.[12] The portfolio yield on 11 MFIs' loan portfolios fell from 46 percent to 37 percent (a drop of 20 percent) between 1997 and 2003, partly as a result of competition. The declining yields have probably contributed to the MFIs' shift toward deposit funding, which is seen as less expensive than debt. A desire to avoid hard-currency-denominated borrowings may also have contributed to this shift. The MFIs' deposits grew from 40 percent of total capital in 1997 to 62 percent in 2003.[13]

Peruvian MFIs have borrowed more capital from private microfinance funds than MFIs in any other country; Peru ranks third in the total volume of foreign investment in debt, equity, and guarantees in microfinance. The shift in the funding preferences of Peruvian MFIs towards domestic deposits probably means that foreign investors will provide a smaller slice of the funding pie in that country.

Nevertheless, the CGAP-MIX survey of funding needs found that both regulated and unregulated MFIs continue to seek foreign debt for a variety of reasons, as shown in table 5.

Yet MFIs seeking foreign debt are not a captive market: foreign lenders report that MFIs are increasingly price-shopping for the lowest possible interest rates.

Uncertain Demand for Equity

Regulated MFIs will continue to seek more debt than equity from foreign sources. These institutions often have high levels of equity capital, and therefore have greater interest in increasing liabilities rather than raising new equity. Although most countries allow such institutions to maintain debt-to-equity ratios of between 5.0x to 8.0x, most regulated MFIs have lower levels of leverage. NBFIs reporting to the *MicroBanking Bulletin* have a 2.9x (2.9-to-1) average debt-to-equity ratio and specialised microfinance banks maintain a 5.6x average ratio.[14]

A recent report of the Council of Microfinance Equity Funds (CMEF) revealed that of the

12 Izquierdo, Fitch Ratings Perú, Apoyo & Asociados, "El Fondeo de las Instituciones de Microfinanzas: Oportunidades y Desafios," presentation at IADB Forum, Cartagena, Colombia, September 2004.

13 Analysis of 1997–2003 MicroRate data.

14 *MicroBanking Bulletin 9* (2003)

Table 5 Why MFIs and Cooperative Institutions Seek Foreign Investment

Motivating factor for seeking foreign investment	Percent of respondents rating this factor as "extremely important" or "very important"	
	36 Regulated MFIs	112 Unregulated MFIs and Cooperatives
Lower interest rate	86%	78%
Easier or lower amount of collateral	69%	72%
Investor's willingness to negotiate	69%	66%
Tenor (length of loan)	61%	66%
Speed of disbursement	56%	65%
Ability to attract other lenders and investors	56%	60%
Better range of products	44%	56%
Technical assistance provided with foreign capital	32%	54%
Prestige	31%	40%

Source: 2004 CGAP-MIX survey of MFI funding needs.

thousands of MFIs in operation, only 115 would be candidates for foreign equity investment, given their legal status, profitability and size.[15] Many of these institutions are likely to have limited demand for such investment: the 26 MFIs with foreign equity that participated in the CGAP-MIX survey of funding needs indicated that, on average, they would like foreign investors to hold 48 percent of their shares relative to the 45 percent these investors own now, only a small increase. The CMEF also interviewed eight general managers of leading regulated MFIs, seven of whom reported having no need for additional equity capital over a three-to-five-year period. These managers indicated a preference for using deposits or profits to finance growth.[16] Investors that offer MFIs debt and equity, such as IFC, confirm this preference.[17]

Unregulated MFIs are more numerous than regulated MFIs, but are considerably smaller in terms of assets. They are not structured to take equity investment and therefore are more likely to seek foreign debt than their regulated peer institutions, which can more easily borrow from domestic banks. These NGOs are funded primarily through grants and are generally prohibited from taking public savings. Their legal structure does not include owners that banks can hold accountable in case of default. Hence, few domestic banks lend to these institutions beyond a 1.0x (or 1-to-1) debt-to-equity ratio, and most require a mortgage on property as collateral for loans.[18] Foreign lenders will be attractive to these institutions if they are willing to lever these MFIs beyond a 1.0x debt-to-equity level and accept less burdensome collateral than local banks.

In general, unregulated MFI and cooperative institutions may have a relatively greater interest in foreign debt investment than the 166 regulated MFIs that have received the bulk of foreign debt investment from IFIs and private funds to date. The results of CGAP's survey and other research suggest that these regulated MFIs are increasingly seeking domestic deposits to fund their liabilities, leaving only a limited role for foreign debt investment. Furthermore, as the risks of borrowing in foreign currency become more widely understood, more of these MFIs are likely to think carefully before assuming additional hard currency borrowings.

Foreign Debt and Currency Risk

Most of an MFI's loans and other assets tend to be denominated in local currency. If the MFI funds such assets with a foreign currency loan, it is creating a foreign exchange risk. Suppose, for example, that an MFI borrows euros and uses them to fund local currency microloans at a given exchange rate. If the local currency later depreciates against the euro, collecting the microloans will not yield enough to pay off the hard currency loan. On its face, a foreign loan with a lower nominal interest rate than a local currency loan may seem to be less expensive, even though in real terms it is more costly. MFIs need to balance the purported lower interest rate against the potential losses of adverse foreign exchange rate movements.[19]

Local currency in many developing countries is more likely to devalue than to appreciate. A recent study of 23 countries with active microfinance markets on five continents found an 8.8 percent average compound annual decline of the local currency's value against the US dollar. In 22 of the 23 countries, the currency depreciated for at least three, and as many as all five, of the years analyzed.[20]

15 Kadderas and Rhyne, Characteristics of Equity Investment in Microfinance, 2004.

16 Kadderas and Rhyne, p. 25.

17 Interview with S. Aftab Ahmed, senior manager, microfinance, International Finance Corporation.

18 2004 CGAP-MIX survey of funding needs.

19 Any currency mismatch creates foreign currency risk. For example, a euro-denominated loan to an MFI in Bolivia (a dollarized economy) does entail foreign exchange risk even though both the dollar and euro are considered hard currency.

20 Cavazos, Abrams, and Miles, Foreign Exchange Risk Management in Microfinance, 2004.

Ninety-two percent of debt issued to MFIs is in hard currency.[21] Are MFIs recognizing and managing the exchange risk when they borrow in foreign currency? After all, significant devaluations, such as the Dominican peso's 40 percent drop against the US dollar in 2003, are not rare. Anecdotal evidence suggests that some MFIs are not alert to this issue. The results of the MFI survey seem to fit with this impression. MFIs that take on foreign debt are heavily focused on the apparent interest rate advantage (see table 5). Of the 105 MFIs in the survey that reported foreign debt, only 25 fully hedged their currency risk. Those that did not fully hedge the risk reported that they had "never [given] it much thought," or that it was not available or was too expensive. In most developing countries, adequate hedging mechanisms are not available or are too expensive, which should further strengthen MFIs incentive to borrow locally rather than abroad.

Foreign currency liabilities do not always need to be hedged on a currency market. They can be offset by assets—for instance, liquid investments denominated in a hard currency. A certain level of currency exposure may be tolerable if it is small in relation to the MFI's equity. Banking regulations often permit banks to maintain a limited foreign exchange gap, and some guidelines for MFIs recommend similar watchfulness.[22]

Conclusion: Practical Lessons

The findings of the CGAP surveys raise some questions for the future. The sheer number of foreign investors, as well as the concentration and overlap of their investments, suggests that there may now be more of them than is justified by the needs of qualified MFI investees, or considerations of efficiency. To some extent, this crowding is related to the relatively low risk tolerance of most of the investors. The less risk the investor is able to take, the fewer MFIs are viable targets for investment. Three practical recommendations would seem to emerge from the data reported above.

1. Foreign investors would add more value to the market if they were able to tolerate more risk, and thus work with less-well-established MFIs.

The intent of this paper is not to criticize the conservatism of most of the foreign investors. Their mission and funding sources require that they take less risk than traditional donor agencies. They need to focus on overall investment returns. They can depart only so far from commercial risk/return criteria. They need to keep pre-investment research costs down, and the average size of investments up. But the more constrained an investment fund is, with respect to these variables, the more likely it is to concentrate its investments in precisely those MFIs that are best able to obtain funds from other sources. When that happens, the foreign investor may be displacing other financing, especially local financing that creates no foreign exchange risk, and in particular local deposits, which can be not only a source of funds but a valued service to the MFIs' poor clients.

To the extent that an investor's charter, funding sources, and investment strategy permit it to finance less-well-established (including not-yet-licensed) MFIs, accept higher risk, spend greater amounts on pre-investment research, and deliver funding in smaller packages, that investor is better positioned to add value in the market and to work with MFIs where investment funding is the true bottleneck to growth. Private funds financed by profit-maximizing investors will generally take less risk and expect higher returns than IFIs or funds financed with public money. Therefore, IFIs and private funds with socially-motivated capital are best placed to invest in higher-risk MFIs.

[21] 2004 CGAP-MIX-ADA survey of microfinance foreign investors.

[22] The recommended ratio of foreign currency assets to liabilities is a range from 0.9 to 1.1. See Cavazos, Abrams, and Miles, p. 14; and Schneider-Moretto, Tool for Developing a Financial Risk Management Policy, 2005, p. 21; Also see Featherston, Littlefield, and Mwangi, Foreign Currency Exchange Risk in Microfinance, forthcoming 2005.

A handful of private funds have successfully focused on unregulated MFIs and cooperative institutions. Oikocredit, through a network based in 11 regional offices, has financed 140 retail microfinance providers, virtually all of which are unregulated MFIs or cooperatives.[23] Rabobank Foundation has made loans to 84 institutions at an average deal size of just over US $100,000, far below the average size ($1.6 million) of the loans that all microfinance foreign investors reported making to microfinance providers.

2. Regulated MFIs should be helped to access more local funding.

Regulated MFIs are increasingly focusing on local financial sources. Local funding has at least two important advantages. First, it usually does not create foreign exchange risk for the MFI. Second and more important, local deposit, debt, and equity funding is more likely to come from commercially-motivated sources. This means that it is likely to be available in larger amounts, and on a more permanent basis, than external socially-motivated funding.

Foreign investors sometimes displace local funding, but they can also help the MFI access local capital in several ways. First and most obviously, the foreign investor can issue a guarantee in favor of local banks or bond buyers that reduces their risk and thus makes them more willing to lend to an MFI. Note that as of mid-2004, guarantees accounted for only 8 percent of foreign investment. Guarantees have the potential advantage of strengthening the relationship between the MFI and the local lender, which may continue even when foreign guarantees are no longer needed or available. A drawback of such guarantees is that they usually entail some duplication of pre-investment appraisal costs, as both the local lender and the foreign guarantor have to assess the risk of a guaranteed loan.

Second, the participation of a foreign investor can sometimes improve an MFI's credibility with local funding sources. About one-third of the MFIs that responded to the CGAP-MIX survey of funding needs cited "prestige" as an important advantage of foreign investment.

Third, foreign equity investment can help the MFI leverage more debt in local markets. An MFI's debt-to-equity ratio is a key indicator of risk. For unregulated MFIs, local banks are seldom willing to lend into a balance sheet where debt exceeds equity; if the debt-equity ratio is one-to-one, then the MFI can lose half of its assets and still have enough to repay its lenders. Regulated MFIs also face legal limits on how much debt they can leverage, usually ranging from 4-to-1 up to 20-to-1. If (and only if) an MFI is approaching the limit of how much local debt it can raise in relation to its equity, then a foreign equity investment will enable the MFI to raise more local debt.

Finally, foreign technical assistance can sometimes play a role in helping an MFI learn how to manage deposit funding or structure and sell a bond issue. (This kind of assistance does not require that the foreign provider also make an investment in the MFI.)

3. MFIs and investors need to be alert to the foreign exchange risk entailed by hard-currency loans.

Foreign borrowing denominated in hard currency may be a more serious issue for unregulated MFIs than for the regulated ones, since the latter may be governed by legal limits on their foreign exchange exposure. But all MFIs, and the investors that fund them, need to be aware of this risk and manage it carefully, rather than focusing exclusively on the apparent price advantage of the hard-currency loan.

[23] The CGAP studies did not include any substantial analysis of individual investment deals. In general, however, external investment in savings and loan cooperatives needs to be approached very cautiously. The experience with donor support to such cooperatives suggests that external funding tends to undermine good governance by making the cooperative less depositor-oriented and more borrower-dominated. Savers are more likely than borrowers to care about the financial health of the cooperative. The policy of the World Council of Credit Unions is to discourage such external funding.

Foreign investors have played an important and useful role in the development of microfinance. They have often bridged a crucial gap for MFIs that are moving beyond grants and highly subsidized loans from donors, but are not yet able to attract deposits, debt, or especially equity from local sources. These investors have started or supported a number of "greenfield" microfinance banks that now thrive. The foreign investors' contribution is not limited to finance: in some cases they have brought important skills and discipline to the governance and transparency of the MFIs in which they have invested. By helping MFIs access more local funding, and by working with less well-established MFIs, these investors can continue to make substantial contributions to building a permanent supply of financial services for the poor.

Annexes

Annex 1
Foreign Investors that Participated in the CGAP-MIX-ADA Survey

International Financial Institutions (IFIs)

BIO (Belgische Investeringsmaatschappij voor Ontwikkelingslanden N.V.)

Corporación Andina de Fomento (CAF)

European Bank for Reconstruction and Development (EBRD)

FinnFund

FMO Nederlandse Financierings-Maatchappij voor Ontwikkelingslanden NV (FMO)

International Finance Corporation (IFC)

Kreditanstalt für Wiederaufbau (KfW)

Multilateral Investment Fund (MIF) of the Inter-American Development Bank (IDB)

United States Agency for International Development (USAID) Development Credit Authority (DCA)

Privately-Managed Microfinance Investment Funds

ACCIÓN AIM

ACCIÓN Gateway Fund

ACCIÓN Latin American Bridge Fund

AfriCap Microfinance Fund

Alterfin

ASN/Novib Fund (ANF)

AWF Development Debt

BlueOrchard Securities

Calvert Social Investment Foundation

Cordaid

CreSud SpA

Deutsche Bank Microcredit Development Fund (DBMDF)

Developpement International Desjardins (Fonidi Fund)

Developpement International Desjardins (Guarantee Fund)

Developpement International Desjardins (Partnership Fund)

Dexia Microcredit Fund

DOEN Foundation

Etimos

Fonds International de Garantie (FIG)

Global Microfinance Facility
GrayGhost

Hivos-Triodos Fund (HTF)

Inter Church Organization for Development Co-Operation (ICCO)
Incofin
Internationale Micro Investitionen Aktiengesellschaft (IMI AG)
Investisseur et Partenaire pour le Développement (IPD)

Kolibri Kapital ASA

La Fayette Participations, Horus Banque et Finance (LFP)
Latin American Challenge Investment Fund, S.A. (LA-CIF)
LUXMINT

MicroVest

NOVIB

Oikocredit
Opportunity International-Opportunity Micro-credit Fund

Partners for the Common Good
PlaNet MicroFund
ProFund International, S.A.

Rabobank Foundation
ResponsAbility Global Microfinance Fund

Sarona Global Investment Fund, Inc (SGIF)
ShoreCap International
Societe d'Investissement et de Developpement International (SIDI)

Triodos Fair Share Fund (TFSF)
Triodos-Doen Foundation

Unitus

Annex 2
Foreign Investor Telephone Interviews Conducted by CGAP-MIX-ADA

S. Aftab Ahmed, *International Finance Corporation*
Bessam Ben Ali, *PlaNet MicroFund*
Gil Crawford, *MicroVest Capital Management*
Loic de Canniere, *Incofin*
Michael de Groot, *Rabobank Foundation*
Jean-Philippede Schrevel, *BlueOrchard Finance*
Axel de Ville, *ADA*
Emile Groot, *FMO*
Stefan Harpe, *AfriCap Microfinance Fund*
Stavely Lord, *US Agency for International Development*, *Development Credit Authority*
Daniela Luppi, *Etimos*
P. Gerhard Ries, *Sarona Global Investment Fund*
Guillermo Salcedo, *Oikocredit*
Alejandro Silva, *ProFund International, S.A.*
Mark van Doesburgh, *ANF and NOVIB*
Marilou van Golstein Brouwers, *Triodos Fair Share Fund, Hivos-Triodos Fund, Triodos-DOEN Foundation*
Rik Vyverman, *BIO*
Cor Wattel, *ICCO*
Jacob Winter, *Cordaid*

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No. 30

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- As MFIs continue to grow and absorb more funding, what is the likely role of foreign investment compared with domestic sources in the MFIs' own countries?

  Domestic sources seem likely to become more prevalent, particularly for regulated MFIs.

- Does foreign debt create inappropriate currency risk for MFIs?

  Many MFIs seem to be taking on hard-currency debt because the interest rates appear lower in nominal terms, without factoring in the significant foreign exchange risk they are thereby creating.

- What practical lessons emerge from the analysis?

  Foreign investors would add more value to the market if they were able to tolerate more risk, and thus work with less-well-established MFIs. Those funded with public money are best-positioned to take additional risk. Regulated MFIs should be helped to access more local funding. MFIs and investors need to be aware of the foreign exchange risk inherent in hard-currency loans.

The term "microfinance institution" as used in this paper includes NGOs, cooperatives, banks, and licensed non-bank institutions that focus on delivering financial services to microentrepreneurs and other low-income clients, generally using new lending techniques that have been developed during the last 25 years. There are other socially-oriented financial intermediaries—especially postal banks and other state-owned banks—that probably reach substantially more low-income clients than the MFIs reach. These latter institutions are not discussed here because they generally neither attract nor require foreign investment. Nevertheless, it is important to recognize the major role that their services and infrastructure play.[1]

Data Sources

Between July and September 2004, CGAP, the MIX (Microfinance Information eXchange), and ADA (Appui au Développement Autonome) surveyed 54 foreign microfinance investors to ascertain their legal structures, investment focus and history, availability of uncommitted funds, and financial performance. The survey yielded data on "direct" investments in 505 MFIs and "indirect" investments in 25 microfinance funds. For 33 of the 54 investors, survey responses were corroborated or supplemented with information from annual reports.

In July 2004, CGAP and the MIX issued an open invitation to MFIs and other financial institutions that serve the poor to complete a questionnaire on their capital structures and funding preferences.[2] Two hundred sixteen institutions from 60 countries responded.[3] These responses were supplemented by balance sheet and financial performance data provided by industry associations and service providers.[4]

Foreign Investors: Type, Number, and Scale

By mid-2004, there were about 60 foreign investors in microfinance, of which 54 participated in the CGAP-MIX-ADA survey (see annex 1). The participating funds can be classified in two groups:

- The investment arms of 9 bilateral and multilateral development agencies (international financial institutions or "IFIs"), such as the International Finance Corporation (IFC), Germany's Kreditanstalt für Wiederaufbau (KfW), and others. These agencies' funding

1 Christen, Rosenberg, and Jayadeva, *Financial Institutions with a "Double Bottom Line": Implications for the Future of Microfinance*, 2004.

2 The English version of the survey is accessible at www.surveymonkey.com/s.asp?u=33938560773.

3 The assistance of the Microfinance Centre (MFC) in Poland, CAPAF in Senegal, and a number of microfinance foreign investors and MFI associations was invaluable in obtaining these responses.

4 The authors thank Glenn Westley of the Inter-American Development Bank (IDB), Damien von Stauffenberg and Todd Farrington of Micro-Rate, and Isabelle Barrès of the MIX for their contributions in gathering these data.

comes from governments or from borrowing in capital markets where their public status secures low interest rates.

- Forty-five privately-run foreign investors and foundations ("private funds"). While their management is private, more than half of their capital comes from government sources.

Both private funds and IFIs generally take a near-commercial approach to investment analysis and monitoring. However, none of the IFIs and very few of the private funds are fully commercial: they take greater risks and accept lower returns than investors that purely maximize profit.[5]

Table 1 shows amounts of direct and indirect foreign investment as of mid-2004.[6] Direct investment of about US $1.2 billion is what actually reaches MFIs. Indirect investment of $611 million is investment in another fund, which will eventually reach the MFI in the form of a direct investment by that other fund. The majority of the direct investment ($648 million, or 56 percent) comes from the IFIs. In addition to their direct investment, these public investors have also invested another $484 million into privately-managed investment funds. Likewise, the private funds have made both direct investments in MFIs and indirect investments in other private funds.

Over and above the US $1.2 billion already directly invested in MFIs by mid-2004, how much more funding was available, or is likely to be available soon? It is not possible to quantify the further amounts that are available directly from the IFIs because their microfinance investments usually come from their general budget, rather than from some budget that is earmarked in advance for microfinance.

A rough estimate, however, can be made for the private funds. In addition to raising capital from the IFIs, the private funds attract funding from private socially-motivated investors and NGOs, as well as from bilateral donor agencies and government lottery programs. CGAP estimates the amount of this non-IFI contribution to the private funds was above US $460 million. IFI direct and indirect investment was $1.13 billion, for a total foreign investment allocated to microfinance of about $1.6 billion. If approximately $1.2 billion of this amount has already been invested in MFIs, the estimate of funds available and uncommitted in private funds would be over $400 million.

In addition to this US $400 million already available in mid-2004, the private investors expected to increase their capital by about $104 million in the near term. Five new private funds were expected to start operations in 2005 with assets of about $150 million. Thus, a total of about $654 million was expected to be available through private funds in the near term. Again, since this does not include future direct investment by IFIs, the total amount of near-term foreign investment for microfinance could be substantially more.

[5] The survey did not include international banks such as Société Générale, Citigroup, and others that have made cross-border investments in a few financial institutions that serve the poor.

[6] Data provided by investors as of December 31, 2003; March 31, 2004; or June 30, 2004.

Table 1 Foreign Investment in Microfinance, as of mid-2004 (US$ millions)

	IFIs	Private Funds	All Investors
Direct: Financing for retail microfinance providers	$648 56%	$511 44%	**$1,159** **100%**
Indirect: Financing to other investment funds, only part of which has already flowed through to direct investment	$484 79%	$126 21%	**$611** **100%**
Total Investments: Note that this line includes double counting since some of the direct investments by the private funds came from IFIs and other funds.	$1,132 64%	$637 36%	

Source: 2004 CGAP-MIX-ADA survey of microfinance foreign investors. Totals reflect the sum of three types of data: disbursed funds, committed but undisbursed funds, and in a few cases, portfolio outstanding. Investors surveyed did not provide consistent forms of data.

How Much of the Investment Is Private or Truly Commercial?

When investments in microfinance by IFIs and government programs are aggregated, the public sector, directly or indirectly (e.g., through investment in private funds), finances at least 75 percent of all foreign capital investment for microfinance. Of the US $1.6 billion in foreign investment for microfinance available or committed in mid-2004, the nine IFIs identified in this analysis contribute $1.13 billion, and government lottery programs fund about $63 million, mostly to a handful of private funds in Europe. Other public development agencies and development finance institutions, such as the Commonwealth Development Corporation (CDC) and the Central American Bank for Economic Integration (CABEI), fund an additional estimated $50 million. The total funding from these public sources, approximately $1.25 billion, represents over 75 percent of all foreign capital investment for microfinance.

In addition to the split between public and private funding, it is important to ask how much of the private funding comes from commercially-motivated (i.e., profit-maximizing) sources. Investors that view microfinance as a profitable investment are more likely to have an ongoing commitment to investing in microfinance.

Currently, the majority of private funding for foreign investment in microfinance comes from socially-motivated sources, such as religious organizations, NGOs, and socially-motivated, high net-worth individuals. Profit-maximizing commercial investors, such as the socially-responsible investment industry (which seeks market returns but screens out certain perceived undesirable investment sectors), have placed relatively little money into microfinance to date. In any case, funding from domestic sources—especially deposits and loans from commercial banks—is more likely to be truly commercial, and therefore more assured over the long-term, than most foreign investment that MFIs receive. That most local banks take a purely commercial approach is clear from the difficulty that many MFIs face in borrowing from them; unregulated institutions, in particular, must overcome high collateral requirements due to their legal status.

Where Is the Foreign Investment Going?

Foreign investment in MFIs takes the form of:

- equity—the investor buys stock in the MFI, becomes a voting shareholder, and often controls a seat on the board of directors;
- debt—the investor makes a loan to the MFI, and occasionally is legally subordinated to the claims of other lenders/depositors, in which case it may function as quasi-equity for regulatory purposes; or
- guarantees—the investor guarantees MFI borrowings from local banks or capital markets.

The retail institutions that receive the investments can be broken into two groups. Banks and "nonbank financial institutions" (NBFIs) are licensed and regulated by national banking authorities; they can use equity, debt, and guarantees. NGOs and cooperatives (including credit unions) are not legally structured to receive equity investments, so they can use only debt and guarantees.[7] Of the 505 investee MFIs identified by the investor survey, 166 are regulated and 196 are NGOs and cooperatives. The legal status of the remaining 143 investee MFIs was not reported, although most if not all are likely to be unregulated. Thus, regulated MFIs comprise about one-third of the investee MFIs identified.

Foreign investment has been spread among the world's developing regions, and those with economies in transition, of the world. But there

[7] Foreign investors have made equity investments to assist the transformation of NGOs: the investor and the NGOs capitalize a new for-profit company to continue the NGO's microfinance operations, but as a regulated institution.

has been heavy concentration in certain regions, types of institutions, and individual MFIs.

Table 2 shows that 87 percent of foreign investment has gone to Latin America (mainly from private funds) and to Eastern Europe/Central Asia (mainly from IFIs). This is because most of the investment goes to regulated MFIs, which are concentrated in these regions (see figure 1). Most foreign investment took the form of debt (69 percent), 24 percent was placed in equity, and only 8 percent went to guarantees for local borrowing.

There are several possible explanations for the substantial concentration of investment in these two regions. In Asia, MFIs have been able to secure funding from governments and multilateral lenders at subsidized rates more easily than institutions in other regions. Many profitable MFIs in East and South Asia have secured funding from domestic sources, including deposits and bank loans. Some foreign investors report that in Africa, donor funds continue to flow to profitable institutions, reducing their demand for foreign investment. In West Africa, credit unions and cooperatives are dominant providers of microfinance, and are not structured for equity investment. These institutions typically use member savings to fund credit operations.[8]

There is a similar concentration by institutional type: 82 percent of the foreign investment has gone to MFIs that are licensed and regulated by banking authorities (see figure 1). This is not particularly surprising, since the regulated MFIs tend to be larger, more mature, and relatively less risky. The regulated investee MFIs are primarily Latin American institutions and ProCredit banks in Eastern Europe/Central Asia.

There is also a high concentration in a few individual MFIs. Just ten of the 505 MFIs captured 25 percent of all the direct investment, and the 148 MFIs that each received at least US $1 million in foreign debt, equity, or guarantees accounted for 89 percent of all foreign investment. The 18 ProCredit banks constitute 4 percent of the institutions receiving investments, but have received 34 percent of the total amount invested, including nearly 60 percent of all the equity provided by

[8] See Ivatury and Reille, *Foreign Investment in Microfinance: Debt and Equity from Quasi-Commercial Investors,* 2004.

Table 2 Foreign Investment Disbursed (in US$ millions and %)
and Number of Recipient MFIs, as of mid-2004

Region	Private Funds			IFIs			All Investors	
	Equity	Debt	Guarantees	Equity	Debt	Guarantees	**Total Amount**	**Total Recipients**
Eastern Europe/ Central Asia (ECA)	$74 46%	$39 14%	$0 0%	$68 71%	$323 69%	$2 3%	**$506 46%**	**89 18%**
Latin America/ Caribbean (LAC)	$69 43%	$166 59%	$6 78%	$13 14%	$136 29%	$57 76%	**$447 41%**	**193 38%**
Sub-Saharan Africa (AFR)	$15 9%	$30 11%	$1 10%	$6 6%	$2 0%	$8 11%	**$62 6%**	**104 21%**
East Asia/Pacific (EAP)	$2 1%	$23 8%	$1 9%	$4 4%	$6 1%	$0 0%	**$36 3%**	**63 12%**
South Asia (SAR)	$1 1%	$23 8%	$0 3%	$5 5%	$0 0%	$1 1%	**$30 3%**	**48 10%**
Middle East/ North Africa (MENA)	$0 0%	$2 1%	$0 0%	$0 0%	$0 0%	$7 9%	**$9 1%**	**8 2%**
Total	$161 100%	$283 100%	$8 100%	$96 100%	$467 100%	$75 100%	**$1,090 100%**	**505 100%**

Source: 2004 CGAP-MIX-ADA survey of microfinance foreign investors. Recipients are regulated and unregulated retail microfinance providers only.

Figure 1 Volume of Foreign Investment in Microfinance, as of mid-2004

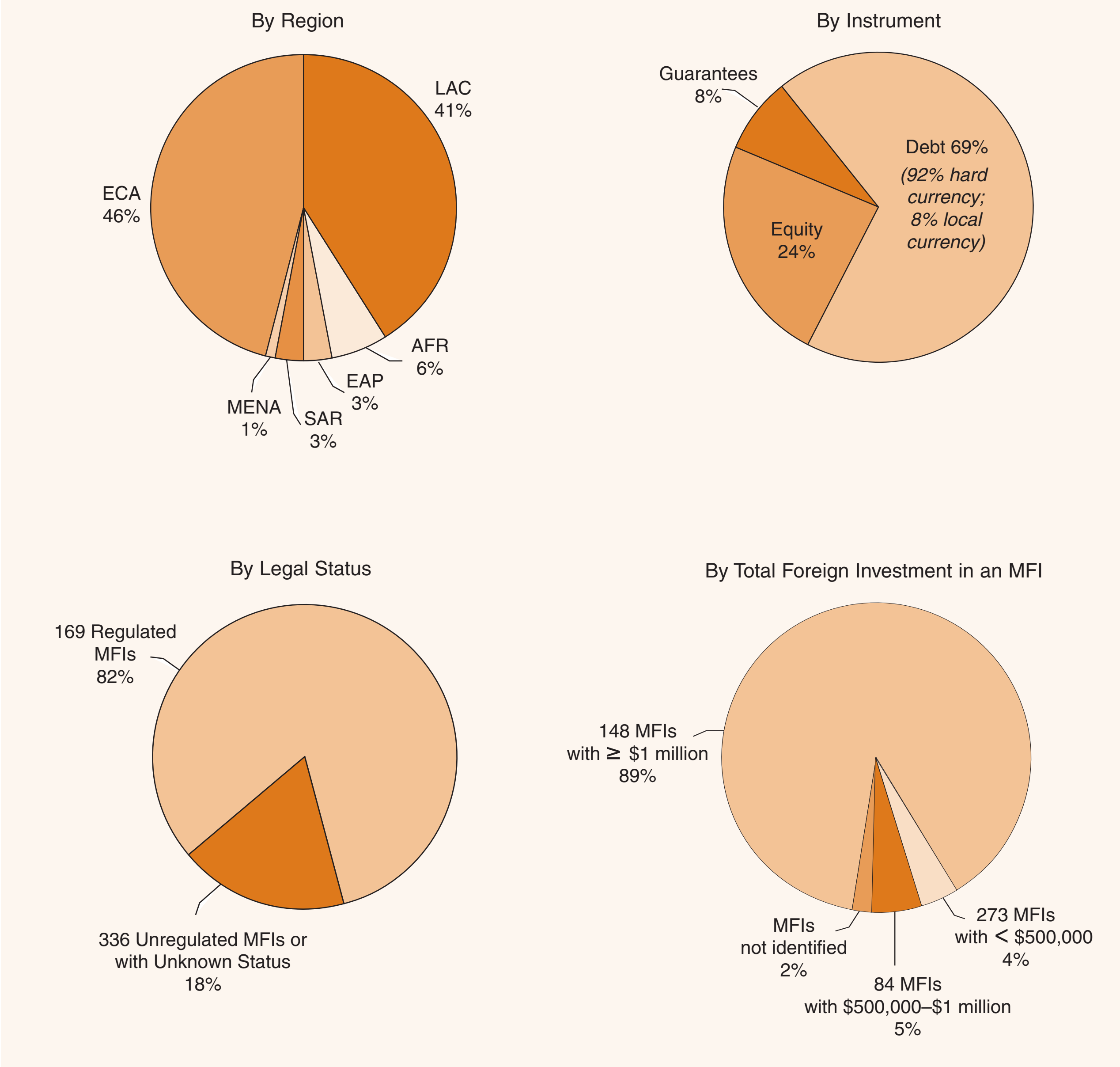

Table 3 Foreign Investment in ProCredit Institutions, as of mid-2004 (US$ millions and %)

	Private Funds			IFIs			Total	
	Equity	Debt	Guarantees	Equity	Debt	Guarantees	Total	Number of Recipients
18 ProCredit Banks	$92.7	$7.3	$0.0	$59.1	$210.9	$4.8	$374.7	18
% of Total	58%	3%	0%	61%	44%	6%	34%	4%

Source: 2004 CGAP-MIX-ADA survey of microfinance foreign investors.

private funds, and 45 percent of all debt provided by IFIs, as can be seen in table 3.[9]

Finally, there is considerable concentration in the suppliers of foreign investment. Nearly one-half of all investment is provided by just four of the IFIs—International Finance Corporation (IFC), European Bank for Reconstruction and Development (EBRD), Kreditanstalt für Wiederaufbau (KfW), and the United States Agency for International Development's (USAID) Development Credit Authority (DCA). If two private funds are added—ProCredit Holding (AG) and Oikocredit—the share rises to two-thirds of all the investment being delivered by just 6 of the 54 investors.

Thus far, the foreign investment picture has been dominated by a few large funds investing in a small number of low-risk MFIs, mainly regulated institutions in Latin America and Eastern Europe/Central Asia.

Are Foreign Investors Competing to Find MFIs to Invest In?

There are numerous anecdotal suggestions that investors are not finding it easy to place funds in MFIs that meet their standards. In a surprising number of cases in Latin America, where private funds invest most of their money, multiple investors are investing in a single MFI. Of the 54 foreign investors, 20 have funded Banco Solidario (Ecuador), 15 have funded Confianza (Peru), 11 have funded Fundación Nieberowski (Nicaragua), and 10 have funded Caja Los Andes (Bolivia) and SFE (Ecuador).

Are MFIs securing funding from a large number of investors because each fund invests only a small amount? This may be true for MFIs with a modest number of investors. However, the degree of multiple investments shown in table 4

[9] ProCredit Holding AG is the successor to IMI (Internationale Micro Investitionen AG).

Table 4 MFIs with Eight or More Foreign Investors, as of mid-2004 (US$ millions)

Institution	45 Private Funds		9 IFIs		54 Total Investors	
	Number	Amount Invested	Number	Amount Invested	Number	Amount Invested
Banco Solidario (Ecuador)	15	$21.7	5	$19.1	**20**	**$40.9**
Confianza (Peru)	14	$5.8	1	$0.3	**15**	**$6.1**
Fundación Nieberowski (Nicaragua)	11	$3.7	0	$0	**11**	**$3.7**
Caja Los Andes (Bolivia)	5	$9.5	5	$24.7	**10**	**$34.2**
SFE (Ecuador)	5	$11.6	5	$9.5	**10**	**$21.1**
WWB Cali (Colombia)	6	$4.8	3	$10.1	**9**	**$14.8**
FFP FIE (Bolivia)	7	$8.1	2	$5.9	**9**	**$14.0**
Banco Sol (Bolivia)	5	$8.1	3	$11.0	**8**	**$19.1**
Findesa (Nicaragua)	7	$5.8	1	$1.5	**8**	**$7.3**
Prestanic (Nicaragua)	8	$1.5	0	$0	**8**	**$1.5**

Source: 2004 CGAP-MIX-ADA survey of microfinance foreign investors.

would seem to suggest that the supply of foreign investment exceeds the demand from suitable MFIs—i.e., MFIs that meet the investors' quality and risk profile.

In some instances, a single investor is funding the same institution through several indirect channels. For example, BIO, an IFI funded by the government of Belgium, owns about 15 percent of Caja Los Andes in Bolivia, in addition to providing debt to the MFI. BIO also owns equity in ProCredit Holding AG, which in turn owns the majority of Caja Los Andes. In addition, BIO owns equity in Alterfin, which owns equity in SIDI, which owns equity in ProFund, which invests in Caja Los Andes. BIO has additional exposure to Caja Los Andes through SIDI's investment in LA-CIF. BIO's direct and indirect ownership of the MFI is approximately 20 percent.

Other IFIs, such as KfW and IFC, have similar overlapping investments. The 10 investors in Caja Los Andes and the 21 investors in Banco Solidario do not share risk according to the relative amounts of their direct investments. For instance, in addition to IFC's direct exposure to both institutions, it has indirect participation through two private funds, ACCIÓN Investments in Microfinance (AIM) and ProFund.

Given this complex overlapping picture, some eventual consolidation among the investors would seem to make sense.

Relative Demand: Local vs. Foreign Funding

As figure 1 shows, most of the foreign investment in debt is going to licensed MFIs that are regulated by banking authorities. The CGAP-MIX survey of funding needs found regulated MFIs wanting a large increase in local deposits as a percentage of their liabilities: according to the 37 regulated respondents to the survey, their ideal ratio of deposits to total liabilities averaged 1.5 times higher than their present level. This does not necessarily mean that these MFIs want the absolute amount of their foreign borrowings to decline, but it does suggest that in the future the regulated MFIs that have absorbed most of the foreign debt may need less of it as a proportion of total liabilities.

MFIs that are new to managing deposits have often underestimated the complexity and cost of this funding source. For some of these MFIs, foreign technical support in product design and information systems might be more helpful than foreign loans.

The ProCredit microfinance banks in Eastern Europe have received one-third of all foreign debt and equity investment, as of mid-2004. Yet, a recent rating report on ProCredit Holding AG indicates that "retail deposits are regarded as the main source of future growth and it is hoped that the recent adoption of a unified ProCredit brand and group logo, and the confidence inspired by the 'foreign' elements of the ProCredit network (e.g., western managers, Frankfurt-based head office) will facilitate the attraction of retail deposits by the individual banks."[10] ProCredit's microfinance banks are also attempting to tap domestic capital markets where possible: in June 2004, ProCredit Bank (Ukraine) sold US $6.5 million in 3-year, local currency-denominated bonds mainly to local investors, taking advantage of a liberalized domestic capital market.

In Peru and other countries, increasing competition, including the entry of profit-maximizing commercial banks into the microfinance sector, may be encouraging regulated MFIs to increase domestic financing of their liabilities.[11] As of June 2004, seven Peruvian commercial banks held 39 percent of the microlending market. Banco de Crédito del Peru, the country's largest commercial bank, began a microenterprise lending program in 2001 that now has 14 percent of the market,

[10] Fitch Ratings report on IMI AG, September 28, 2004.

[11] Chowdri and Silva, eds., *Downscaling Institutions and Competitive Microfinance Markets: Reflections and Case Studies from Latin America*, 2004.

compared to 8 percent for Mibanco, the largest MFI.[12] The portfolio yield on 11 MFIs' loan portfolios fell from 46 percent to 37 percent (a drop of 20 percent) between 1997 and 2003, partly as a result of competition. The declining yields have probably contributed to the MFIs' shift toward deposit funding, which is seen as less expensive than debt. A desire to avoid hard-currency-denominated borrowings may also have contributed to this shift. The MFIs' deposits grew from 40 percent of total capital in 1997 to 62 percent in 2003.[13]

Peruvian MFIs have borrowed more capital from private microfinance funds than MFIs in any other country; Peru ranks third in the total volume of foreign investment in debt, equity, and guarantees in microfinance. The shift in the funding preferences of Peruvian MFIs towards domestic deposits probably means that foreign investors will provide a smaller slice of the funding pie in that country.

Nevertheless, the CGAP-MIX survey of funding needs found that both regulated and unregulated MFIs continue to seek foreign debt for a variety of reasons, as shown in table 5.

Yet MFIs seeking foreign debt are not a captive market: foreign lenders report that MFIs are increasingly price-shopping for the lowest possible interest rates.

Uncertain Demand for Equity

Regulated MFIs will continue to seek more debt than equity from foreign sources. These institutions often have high levels of equity capital, and therefore have greater interest in increasing liabilities rather than raising new equity. Although most countries allow such institutions to maintain debt-to-equity ratios of between 5.0x to 8.0x, most regulated MFIs have lower levels of leverage. NBFIs reporting to the *MicroBanking Bulletin* have a 2.9x (2.9-to-1) average debt-to-equity ratio and specialised microfinance banks maintain a 5.6x average ratio.[14]

A recent report of the Council of Microfinance Equity Funds (CMEF) revealed that of the

12 Izquierdo, Fitch Ratings Perú, Apoyo & Asociados, "El Fondeo de las Instituciones de Microfinanzas: Oportunidades y Desafios," presentation at IADB Forum, Cartagena, Colombia, September 2004.

13 Analysis of 1997–2003 MicroRate data.

14 *MicroBanking Bulletin 9* (2003)

Table 5 Why MFIs and Cooperative Institutions Seek Foreign Investment

Motivating factor for seeking foreign investment	Percent of respondents rating this factor as "extremely important" or "very important"	
	36 Regulated MFIs	112 Unregulated MFIs and Cooperatives
Lower interest rate	86%	78%
Easier or lower amount of collateral	69%	72%
Investor's willingness to negotiate	69%	66%
Tenor (length of loan)	61%	66%
Speed of disbursement	56%	65%
Ability to attract other lenders and investors	56%	60%
Better range of products	44%	56%
Technical assistance provided with foreign capital	32%	54%
Prestige	31%	40%

Source: 2004 CGAP-MIX survey of MFI funding needs.

thousands of MFIs in operation, only 115 would be candidates for foreign equity investment, given their legal status, profitability and size.[15] Many of these institutions are likely to have limited demand for such investment: the 26 MFIs with foreign equity that participated in the CGAP-MIX survey of funding needs indicated that, on average, they would like foreign investors to hold 48 percent of their shares relative to the 45 percent these investors own now, only a small increase. The CMEF also interviewed eight general managers of leading regulated MFIs, seven of whom reported having no need for additional equity capital over a three-to-five-year period. These managers indicated a preference for using deposits or profits to finance growth.[16] Investors that offer MFIs debt and equity, such as IFC, confirm this preference.[17]

Unregulated MFIs are more numerous than regulated MFIs, but are considerably smaller in terms of assets. They are not structured to take equity investment and therefore are more likely to seek foreign debt than their regulated peer institutions, which can more easily borrow from domestic banks. These NGOs are funded primarily through grants and are generally prohibited from taking public savings. Their legal structure does not include owners that banks can hold accountable in case of default. Hence, few domestic banks lend to these institutions beyond a 1.0x (or 1-to-1) debt-to-equity ratio, and most require a mortgage on property as collateral for loans.[18] Foreign lenders will be attractive to these institutions if they are willing to lever these MFIs beyond a 1.0x debt-to-equity level and accept less burdensome collateral than local banks.

In general, unregulated MFI and cooperative institutions may have a relatively greater interest in foreign debt investment than the 166 regulated MFIs that have received the bulk of foreign debt investment from IFIs and private funds to date. The results of CGAP's survey and other research suggest that these regulated MFIs are increasingly seeking domestic deposits to fund their liabilities, leaving only a limited role for foreign debt investment. Furthermore, as the risks of borrowing in foreign currency become more widely understood, more of these MFIs are likely to think carefully before assuming additional hard currency borrowings.

Foreign Debt and Currency Risk

Most of an MFI's loans and other assets tend to be denominated in local currency. If the MFI funds such assets with a foreign currency loan, it is creating a foreign exchange risk. Suppose, for example, that an MFI borrows euros and uses them to fund local currency microloans at a given exchange rate. If the local currency later depreciates against the euro, collecting the microloans will not yield enough to pay off the hard currency loan. On its face, a foreign loan with a lower nominal interest rate than a local currency loan may seem to be less expensive, even though in real terms it is more costly. MFIs need to balance the purported lower interest rate against the potential losses of adverse foreign exchange rate movements.[19]

Local currency in many developing countries is more likely to devalue than to appreciate. A recent study of 23 countries with active microfinance markets on five continents found an 8.8 percent average compound annual decline of the local currency's value against the US dollar. In 22 of the 23 countries, the currency depreciated for at least three, and as many as all five, of the years analyzed.[20]

15 Kadderas and Rhyne, Characteristics of Equity Investment in Microfinance, 2004.

16 Kadderas and Rhyne, p. 25.

17 Interview with S. Aftab Ahmed, senior manager, microfinance, International Finance Corporation.

18 2004 CGAP-MIX survey of funding needs.

19 Any currency mismatch creates foreign currency risk. For example, a euro-denominated loan to an MFI in Bolivia (a dollarized economy) does entail foreign exchange risk even though both the dollar and euro are considered hard currency.

20 Cavazos, Abrams, and Miles, Foreign Exchange Risk Management in Microfinance, 2004.

Ninety-two percent of debt issued to MFIs is in hard currency.[21] Are MFIs recognizing and managing the exchange risk when they borrow in foreign currency? After all, significant devaluations, such as the Dominican peso's 40 percent drop against the US dollar in 2003, are not rare. Anecdotal evidence suggests that some MFIs are not alert to this issue. The results of the MFI survey seem to fit with this impression. MFIs that take on foreign debt are heavily focused on the apparent interest rate advantage (see table 5). Of the 105 MFIs in the survey that reported foreign debt, only 25 fully hedged their currency risk. Those that did not fully hedge the risk reported that they had "never [given] it much thought," or that it was not available or was too expensive. In most developing countries, adequate hedging mechanisms are not available or are too expensive, which should further strengthen MFIs incentive to borrow locally rather than abroad.

Foreign currency liabilities do not always need to be hedged on a currency market. They can be offset by assets—for instance, liquid investments denominated in a hard currency. A certain level of currency exposure may be tolerable if it is small in relation to the MFI's equity. Banking regulations often permit banks to maintain a limited foreign exchange gap, and some guidelines for MFIs recommend similar watchfulness.[22]

Conclusion: Practical Lessons

The findings of the CGAP surveys raise some questions for the future. The sheer number of foreign investors, as well as the concentration and overlap of their investments, suggests that there may now be more of them than is justified by the needs of qualified MFI investees, or considerations of efficiency. To some extent, this crowding is related to the relatively low risk tolerance of most of the investors. The less risk the investor is able to take, the fewer MFIs are viable targets for investment. Three practical recommendations would seem to emerge from the data reported above.

1. Foreign investors would add more value to the market if they were able to tolerate more risk, and thus work with less-well-established MFIs.

The intent of this paper is not to criticize the conservatism of most of the foreign investors. Their mission and funding sources require that they take less risk than traditional donor agencies. They need to focus on overall investment returns. They can depart only so far from commercial risk/return criteria. They need to keep pre-investment research costs down, and the average size of investments up. But the more constrained an investment fund is, with respect to these variables, the more likely it is to concentrate its investments in precisely those MFIs that are best able to obtain funds from other sources. When that happens, the foreign investor may be displacing other financing, especially local financing that creates no foreign exchange risk, and in particular local deposits, which can be not only a source of funds but a valued service to the MFIs' poor clients.

To the extent that an investor's charter, funding sources, and investment strategy permit it to finance less-well-established (including not-yet-licensed) MFIs, accept higher risk, spend greater amounts on pre-investment research, and deliver funding in smaller packages, that investor is better positioned to add value in the market and to work with MFIs where investment funding is the true bottleneck to growth. Private funds financed by profit-maximizing investors will generally take less risk and expect higher returns than IFIs or funds financed with public money. Therefore, IFIs and private funds with socially-motivated capital are best placed to invest in higher-risk MFIs.

21 2004 CGAP-MIX-ADA survey of microfinance foreign investors.

22 The recommended ratio of foreign currency assets to liabilities is a range from 0.9 to 1.1. See Cavazos, Abrams, and Miles, p. 14; and Schneider-Moretto, Tool for Developing a Financial Risk Management Policy, 2005, p. 21; Also see Featherston, Littlefield, and Mwangi, Foreign Currency Exchange Risk in Microfinance, forthcoming 2005.

A handful of private funds have successfully focused on unregulated MFIs and cooperative institutions. Oikocredit, through a network based in 11 regional offices, has financed 140 retail microfinance providers, virtually all of which are unregulated MFIs or cooperatives.[23] Rabobank Foundation has made loans to 84 institutions at an average deal size of just over US $100,000, far below the average size ($1.6 million) of the loans that all microfinance foreign investors reported making to microfinance providers.

2. Regulated MFIs should be helped to access more local funding.

Regulated MFIs are increasingly focusing on local financial sources. Local funding has at least two important advantages. First, it usually does not create foreign exchange risk for the MFI. Second and more important, local deposit, debt, and equity funding is more likely to come from commercially-motivated sources. This means that it is likely to be available in larger amounts, and on a more permanent basis, than external socially-motivated funding.

Foreign investors sometimes displace local funding, but they can also help the MFI access local capital in several ways. First and most obviously, the foreign investor can issue a guarantee in favor of local banks or bond buyers that reduces their risk and thus makes them more willing to lend to an MFI. Note that as of mid-2004, guarantees accounted for only 8 percent of foreign investment. Guarantees have the potential advantage of strengthening the relationship between the MFI and the local lender, which may continue even when foreign guarantees are no longer needed or available. A drawback of such guarantees is that they usually entail some duplication of pre-investment appraisal costs, as both the local lender and the foreign guarantor have to assess the risk of a guaranteed loan.

Second, the participation of a foreign investor can sometimes improve an MFI's credibility with local funding sources. About one-third of the MFIs that responded to the CGAP-MIX survey of funding needs cited "prestige" as an important advantage of foreign investment.

Third, foreign equity investment can help the MFI leverage more debt in local markets. An MFI's debt-to-equity ratio is a key indicator of risk. For unregulated MFIs, local banks are seldom willing to lend into a balance sheet where debt exceeds equity; if the debt-equity ratio is one-to-one, then the MFI can lose half of its assets and still have enough to repay its lenders. Regulated MFIs also face legal limits on how much debt they can leverage, usually ranging from 4-to-1 up to 20-to-1. If (and only if) an MFI is approaching the limit of how much local debt it can raise in relation to its equity, then a foreign equity investment will enable the MFI to raise more local debt.

Finally, foreign technical assistance can sometimes play a role in helping an MFI learn how to manage deposit funding or structure and sell a bond issue. (This kind of assistance does not require that the foreign provider also make an investment in the MFI.)

3. MFIs and investors need to be alert to the foreign exchange risk entailed by hard-currency loans.

Foreign borrowing denominated in hard currency may be a more serious issue for unregulated MFIs than for the regulated ones, since the latter may be governed by legal limits on their foreign exchange exposure. But all MFIs, and the investors that fund them, need to be aware of this risk and manage it carefully, rather than focusing exclusively on the apparent price advantage of the hard-currency loan.

[23] The CGAP studies did not include any substantial analysis of individual investment deals. In general, however, external investment in savings and loan cooperatives needs to be approached very cautiously. The experience with donor support to such cooperatives suggests that external funding tends to undermine good governance by making the cooperative less depositor-oriented and more borrower-dominated. Savers are more likely than borrowers to care about the financial health of the cooperative. The policy of the World Council of Credit Unions is to discourage such external funding.

Foreign investors have played an important and useful role in the development of microfinance. They have often bridged a crucial gap for MFIs that are moving beyond grants and highly subsidized loans from donors, but are not yet able to attract deposits, debt, or especially equity from local sources. These investors have started or supported a number of "greenfield" microfinance banks that now thrive. The foreign investors' contribution is not limited to finance: in some cases they have brought important skills and discipline to the governance and transparency of the MFIs in which they have invested. By helping MFIs access more local funding, and by working with less well-established MFIs, these investors can continue to make substantial contributions to building a permanent supply of financial services for the poor.

Annexes

Annex 1
Foreign Investors that Participated in the CGAP-MIX-ADA Survey

International Financial Institutions (IFIs)

BIO (Belgische Investeringsmaatschappij voor Ontwikkelingslanden N.V.)

Corporación Andina de Fomento (CAF)

European Bank for Reconstruction and Development (EBRD)

FinnFund

FMO Nederlandse Financierings-Maatchappij voor Ontwikkelingslanden NV (FMO)

International Finance Corporation (IFC)

Kreditanstalt für Wiederaufbau (KfW)

Multilateral Investment Fund (MIF) of the Inter-American Development Bank (IDB)

United States Agency for International Development (USAID) Development Credit Authority (DCA)

Privately-Managed Microfinance Investment Funds

ACCIÓN AIM

ACCIÓN Gateway Fund

ACCIÓN Latin American Bridge Fund

AfriCap Microfinance Fund

Alterfin

ASN/Novib Fund (ANF)

AWF Development Debt

BlueOrchard Securities

Calvert Social Investment Foundation

Cordaid

CreSud SpA

Deutsche Bank Microcredit Development Fund (DBMDF)

Developpement International Desjardins (Fonidi Fund)

Developpement International Desjardins (Guarantee Fund)

Developpement International Desjardins (Partnership Fund)

Dexia Microcredit Fund

DOEN Foundation

Etimos

Fonds International de Garantie (FIG)

Global Microfinance Facility
GrayGhost

Hivos-Triodos Fund (HTF)

Inter Church Organization for Development Co-Operation (ICCO)
Incofin
Internationale Micro Investitionen Aktiengesellschaft (IMI AG)
Investisseur et Partenaire pour le Développement (IPD)

Kolibri Kapital ASA

La Fayette Participations, Horus Banque et Finance (LFP)
Latin American Challenge Investment Fund, S.A. (LA-CIF)
LUXMINT

MicroVest

NOVIB

Oikocredit
Opportunity International-Opportunity Micro-credit Fund

Partners for the Common Good
PlaNet MicroFund
ProFund International, S.A.

Rabobank Foundation
ResponsAbility Global Microfinance Fund

Sarona Global Investment Fund, Inc (SGIF)
ShoreCap International
Societe d'Investissement et de Developpement International (SIDI)

Triodos Fair Share Fund (TFSF)
Triodos-Doen Foundation

Unitus

Annex 2
Foreign Investor Telephone Interviews Conducted by CGAP-MIX-ADA

S. Aftab Ahmed, *International Finance Corporation*
Bessam Ben Ali, *PlaNet MicroFund*
Gil Crawford, *MicroVest Capital Management*
Loic de Canniere, *Incofin*
Michael de Groot, *Rabobank Foundation*
Jean-Philippede Schrevel, *BlueOrchard Finance*
Axel de Ville, *ADA*
Emile Groot, *FMO*
Stefan Harpe, *AfriCap Microfinance Fund*
Stavely Lord, *US Agency for International Development*, *Development Credit Authority*
Daniela Luppi, *Etimos*
P. Gerhard Ries, *Sarona Global Investment Fund*
Guillermo Salcedo, *Oikocredit*
Alejandro Silva, *ProFund International, S.A.*
Mark van Doesburgh, *ANF and NOVIB*
Marilou van Golstein Brouwers, *Triodos Fair Share Fund, Hivos-Triodos Fund, Triodos-DOEN Foundation*
Rik Vyverman, *BIO*
Cor Wattel, *ICCO*
Jacob Winter, *Cordaid*

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