



## **IFIs: Crowding Out or Crowding In? An Online Debate March 28 – 30, 2007**

### **SUMMARY**

#### **Introduction**

From March 28 to 30, the Microfinance Gateway held an online discussion, "IFIs: Crowding Out or Crowding In?" to provide a space for debate following the controversial MicroRate paper on this topic. With opening comments from Damian von Stauffenberg of MicroRate and Xavier Reille of CGAP, the discussion featured substantial insights and commentary from 20 experts with various perspectives, including IFIs, private equity funds, donors and others, all attempting to address the question: *What are the best roles for IFIs (international financial institutions) in a rapidly changing microfinance environment?*

#### **Crowding out?**

While discussion focused primarily on the roles of IFIs, the premise of the MicroRate paper was also subjected to scrutiny throughout the debate. Some agreed with the premise – that IFIs are crowding out private investment in microfinance, while others questioned some of the paper's evidence or offered more nuanced approaches. A poll, which was available on the website for participants and public users to take, indicated that out of 50 responses, 50% agreed that IFIs are crowding out private investment, 36% disagreed, and 14% were undecided.

As one of the first participants to weigh in on the matter, Marc de Sousa-Shields of Enterprising Solutions agreed that donors are crowding out private investors, but also pointed out that "donors can help facilitate access to private capital and have been doing so for years, though unevenly and not in the coordinated way private capital markets like to work." David Satterthwaite of Prisma Microfinance also echoed the MicroRate paper's thesis "that government-owned financial institutions (IFIs) [should] reconsider their lending practices."

However, Stefan Harpe of Oikocredit argued that he has "not seen many real private investors being crowded out, particularly equity investors." Cyrille Arnould of European Investment Bank (EIB) was also unconvinced, stating that there was no "real evidence ... of a systematic crowding out by IFIs." Both participants questioned some of the statistics provided in the original paper.

Erik Geurts of Triple Jump offered additional anecdotal evidence of crowding out, mentioning that his company sees "many cases where these [more mature] MFIs are still doing business with IFIs that offer conditions that cannot be met by funds working in a private environment."

As debate continued, Stefan Harpe made a plea for balance and context, writing that "if the situation is misconstrued or over simplified, we risk losing some essential long term partners..." He also offered a reality check, reminding everyone that, while all the important roles suggested for IFIs sound reasonable, IFIs are still lending institutions with a bureaucratic imperative to make loans.

In addition, Alex Silva of Omatrix, Inc. and Calmeadow Foundation called for some introspection, asking the participants to “review the objectives stated in the charters/bylaws of our respective organizations” and then to “pause to reflect and ask ourselves if we are truly pursuing what is best in terms of achieving those objectives or, rather, we might be becoming increasingly more concerned with what is good for our own institution.”

Gert van Maanen, formerly of Oikocredit, agreed with the MicroRate paper’s premise about crowding out, but argued that the overall question should be re-framed from “Are public development institutions crowding out private investment in microfinance?” to ask instead “why development banks are not concentrating on the potentials amongst the non-regulated [MFIs], instead of on the winners.”

Others also critiqued the focus of the question itself. David Roodman of Center for Global Development called for more clarification to answer “Why is ‘crowding out’ bad? Why should I care?” while Mark de Sousa-Shields asked “Why worry about the interests of international funds at all if local capital is the objective?” Cyrille Arnould agreed, stating that the mobilization of local private capital should be the ultimate priority, not protecting socially responsible investors.

Though disagreements are likely to continue on the issue of crowding out, Marc de Sousa-Shields pointed out the usefulness of the MicroRate paper in bringing about this very debate and questioning of IFI roles, writing: “An inevitability of economic interventions by donors is that market equilibriums are found [and] learned through trial and error. For me Role Reversal identifies where the MFI capital access equilibrium may lie and where a new donor course may be charted.”

### **Key areas of debate**

Several other themes of debate came up repeatedly, pointing to a “need for more clarity and precision in specifying whether there is a problem and what it might be,” as Kate McKee of CGAP pointed out.

- 1) *Public vs. private capital.* Kate McKee wrote that “Private is not the same as commercial: The heart of the matter is whether social financing (whether its ownership and source of funds happens to be private or public or mixed) is displacing and crowding out commercial capital.” Acknowledging her point, Damian von Stauffenberg argued, “But let’s face it, there are hardly any purely commercial foreign funders in microfinance...yet. Our hopes are pinned on the MIVs because we see them as the forerunners of true commercial funding.”
- 2) *Debt vs. equity.* Several participants felt the need to clarify that the competition in funding is only for debt placements, but that an important new role for IFIs (and also possibly private investors) would be to provide equity.
- 3) *TA vs. financing.* Damian claimed that top-tier MFIs don’t need TA “by any stretch of the imagination,” yet are being offered TA by IFIs as a bribe. He asked if TA grants might be better de-linked from lending. Maria Teresa Zappia turned the discussion around by asking why private investors don’t provide TA, stating that TA is necessary to complement lending in early transition environments. Kate McKee argued that the “core product of both public and private investors is financing” and found it “unrealistic to

expect the IFIs to primarily concentrate on ...TA” or to de-link that TA from financing.

- 4) *Competing on price vs. other terms.* IFIs and private investors do not compete only on price. It is necessary to view the entire package of what a funder offers to an MFI, since as several participants pointed out, there are many other advantages which IFIs hold over private investors (mentioned below).
- 5) *Interests of small/individual taxpayer vs. small/individual investor.* An undercurrent of discussion questioned whether public institutions really should take more risk than private.

### **What should IFIs do?**

As it moved beyond the MicroRate paper’s question on crowding out, the debate was productive in getting at the heart of the matter and its primary purpose: addressing the roles IFIs should play in this quickly changing microfinance environment.

All participants agreed that IFIs have made important contributions to the development of the microfinance industry. In looking at the comparative advantages which IFIs offer over private investors, key amongst them was the importance of long-term support. Cyrille Arnould pointed out that “Private investors still have to convince managers that they will stick with them during good and bad times and that the Last In will not be the First Out.” In addition, Klaus Maurer of the European Fund for Southeast Europe brought in the MFI perspective, writing that MFIs want IFIs as funders not because of lower pricing, but all the other advantages they offer, including large volumes of funding, reputation, and access to policymakers.

Taking into account these comparative advantages, discussion began with Damian von Stauffenberg’s list of 10 possible roles for IFIs, including greenfielding and taking higher risk structured finance positions. This list stimulated debate and led to many suggestions for IFI roles in microfinance. Marc de Sousa-Shields helped to provide focus by categorizing Damian’s list into 3 broad areas of support: assets, liabilities and infrastructure.

#### Assets: *Building strong MFIs*

- *Equity investment.* Xavier Reille mentioned that “IFIs have the experience, local knowledge and instruments to invest in equity and strengthen the MFI governance.” Several participants agreed that this was a very important role for IFIs to develop.
- IFI financing, whether debt or equity, should focus on:
  - *Greenfielding:* Seed the next generation of MFIs
  - *MFIs with limited access to local markets*
- Help MFIs expand their product offerings (savings, insurance, housing loans) and link up with the domestic market
- Help MFIs to expand beyond their national boundaries, such as ACLEDA Cambodia’s plan to expand in East Asia
- Promote new distribution channels for microfinance (such as bank downscaling)

#### Liabilities: *Leveraging domestic and private capital*

- Create foreign exchange risk mitigation mechanisms
- Take higher risk positions in structured finance transactions (first loss positions, guarantees, etc.). Risk-sharing products such as securitizations can help prepare the ground for private investors and create “crowding in.”

- Provide guarantee funds: As a risk-sharing product, several participants suggested this role in particular for IFIs, though Erik Geurts warned that IFIs should be careful with issuing guarantees as it could lead to moral hazard
- Help MFIs leverage local capital: Stefan Harpe suggested evaluating IFI involvement in MFI sector by measuring the extent of local capital mobilization, including
  - Accessing domestic capital – equity, bank loans, bond emissions, domestic securitization such as BRAC and Procredit Bulgaria
  - Increasing deposit mobilization

Infrastructure: *Developing the microfinance industry*

- Assist in setting up credit bureaus, rating agencies and standards
- Support auditing and regulatory standards
- Promote conducive policy environments
- Support sector wide approach by building investment support facilities in frontier markets like MISFA in Afghanistan and MITAF in Sierra Leone

Some of these suggested roles have already been accepted by IFIs, and participants mentioned a few initiatives which demonstrate their new, emerging roles. Brigit Helms of the IFC talked about IFC’s new microfinance strategy (under consideration) in which IFC will no longer support individual MFIs but rather focus on other industry support, namely collective investment vehicles, supporting networks, and strategic partnerships with other IFIs for more risky deals. Alex Silva mentioned that FMO is about to launch a facility to mitigate FX risk, and Cyrille Arnould pointed out that several IFIs are starting to invest in equity in addition to debt.

**Industry-wide recommendations**

Finally, discussion also addressed the broader issues within microfinance investment, providing suggestions for ways in which public and private investors should move forward:

- 1) Transparency
  - Greater disclosure on loan terms, portfolios and practices
  - Code of conduct committing IFIs to transparency, additionality and market pricing
- 2) Consolidation: is there a need for 19 IFI & 74 funds?
- 3) Dialogue – better communication between MIVs and IFIs
  - This responsibility lies on the shoulders of both IFIs and MIVs. Damian recognized that “MIVs can’t roundly condemn IFIs in private but keep their heads down in public (‘you never know when you might need them’).”

**Conclusion**

The debate revealed that the issue of IFI roles in microfinance investment is complex, but it also made a few things clear. First of all, as Xavier Reille pointed out, “the postings made clear that IFIs, MIVs, and MFIs have different perspectives (and self interest) on the subject.” However, “both sides – and this discussion reminds us of that – are pursuing the same objective,” Damian concluded. The question is, as he put it, “Now what?” There is much work to be done, but many agreed that the industry-wide recommendations for transparency and greater dialogue between players are a good place to start.