Will Microfinance Continue to do Well?

BY P. SPARREBOOM, PROGRAM DIRECTOR, WORLD MICROFINANCE FORUM GENEVA

On the 23rd of June 2009, the World Microfinance Forum Geneva (WMFG) organized an event for pension funds and institutional asset managers, Will Microfinance Continue to do Well? With the event, WMFG sought to deepen the private sector’s understanding of some of the current issues surrounding investment in inclusive finance.

1 INTRODUCTION

The event started with an introduction by Xavier Reille, Lead Microfinance Specialist at CGAP, an independent think tank on microfinance housed at the World Bank. Mr Reille presented the overall trends, opportunities and threats for microfinance at this juncture.

This presentation was followed by a debate on the role of public funding in managing the risk of private investments in microfinance. The focus was on so-called Development Finance Institutions (DFIs): the private sector arms of government-owned bilateral and multilateral development agencies.

The panel consisted of the microfinance specialists of three leading DFIs, and the leader of a microfinance rating agency that is a long-term critic of DFIs. They were:

- Andre Laude, Chief Investment Officer, Global Financial Markets Department, International Finance Corporation (IFC).
- Roland Siller, Head, Global Competence Center for Financial Sector Development, and First Vice President, Europe and Caucasus, KfW
- Chikako Kuno, Director Small Business Finance, European Bank for Reconstruction and Development (EBRD)
- Damian von Stauffenberg, Founder and Chairman of the Board, MicroRate

The purpose of this report is to share the highly interesting insights shared during the event with people who could not attend the event, and who would like to learn more about the role of DFIs in investment in microfinance. It is also interesting for those among the audience who had little prior knowledge about microfinance, and who would like to better understand the issues debated.

World Microfinance Forum Geneva
WMFG is an independent think tank and learning platform that promotes sustainable investment in inclusive financial markets. Its work is based on the premise that the provision of financial services to the population at the bottom of the economic pyramid not only contributes to poverty reduction and development, but also offers interesting business and investment opportunities to the private sector.

Caveat
Please note that WMFG has taken the liberty to change the order in which facts and opinions were presented, and to paraphrase the statements made by the speakers. This has been done to clarify the arguments and enhance readability. Every effort has been made to maintain the original intention. Any omission or misinterpretation is entirely our responsibility.
2 MICROFINANCE INVESTMENTS TRENDS

Mr Reille explained that CGAP defines microfinance as the provision of financial services at the bottom of the pyramid. It is a responsible business with a double bottom line, which renders both financial and social returns. The microfinance business model is characterized by high net interest margins, strong asset quality and a high operating cost ratio. Institutions that provide microfinance services are very diverse, and include banks, non-bank financial institutions and non-governmental organizations (NGOs).

As can be seen in Figure 1, between 2000 and 2007 assets of microfinance institutions (MFIs) grew more than ten-fold.

Three types of investors dominate the landscape: public investors (49%), institutional investors (29%) and retail investors (22%). All invest both directly and through specialized microfinance investment vehicles, so-called MIVs. Approximately half of foreign capital investment in microfinance is managed by MIVs. This is illustrated in Figure 2.

More than three quarters of investment is in the form of debt and most of the remainder is in equity. Hard currencies make up almost three quarters of investment, but local funding is increasing.

Box 1. Definition of an MIV

An MIV is an investment entity with microfinance as a core investment objective and mandate. It is either self-managed or managed by an investment management firm or by a trustee. It receives money from investors through the issuance of shares, bonds, or other financial instruments. It provides debt, equity or guarantees to microfinance institutions and non-specialized intermediaries.


Over the past four years investment in microfinance has tripled. The return on fixed income funds has been steady, with the Euro Microfinance Index consistently above the Euribor 6 month rate. The private equity valuation P/BV has varied between 1.7 and 1.9.

Figure 1
Source: CGAP Research

Figure 2
Source: CGAP Research
2 WHAT HAS BEEN THE ROLE OF DFIs IN MICROFINANCE

Mr Reille started the panel discussion by reminding the audience that DFIs have played an important role in the early development of the microfinance market. They were also among the first to see the potential of commercial investments in the sector. The panelists then described how they have helped to build and develop the market, by:

a. Investing in greenfield undertakings
b. Investing in transformations
c. Helping commercial banks to downscale
d. Creating an enabling environment for a more inclusive financial sector
e. Leveraging private capital in microfinance

a Investing in greenfield undertakings

Most microfinance institutions (MFIs) started off as non-governmental organizations (NGOs). As long as these NGOs depended on donors they stayed small, because there was no pressure to be disciplined. When some pioneering NGOs started to show that a commercial approach to lending to the poor paid off in terms of efficiency and the number of people who could be reached, DFIs were quick to help establish new NGOs that applied best practices in microfinance. Nowadays, DFIs often make greenfield investments in microfinance institutions that are established as formal financial institutions.

b Investing in transformations

In the early nineties, some microfinance NGOs started to realize that there were important benefits to transforming themselves into a bank, regulated and supervised by the central bank. Not only would it allow them to offer additional much valued services to their clients -- such as deposits and insurance -- it also offered access to additional sources of funding much needed for growth (savings and well as loans from more conservative investors). DFIs played an important role in many transformations of microfinance NGOs into regulated banks or non-bank financial institutions.
c  Helping commercial banks to downscale

Commercial banks used to ignore micro- and small businesses, because they did not have the knowledge and technology to serve this market in a profitable manner. Thanks to many years of experiments by NGOs, such knowledge and technology have now been developed. Training and technology transfer have proven very effective in helping to convince commercial banks to enter this market. DFIs have led the way in helping commercial banks to ‘downscale’, i.e. to develop the capacity to serve a market segment with an average income below that of their original clientele.

Box 4. Example of downscaling

Chikako Kuno explained that EBRD works predominantly in Central and Eastern Europe, the Caucasus and Central Asia. Unlike other DFIs, it started off with a focus on commercial banks, because it entered the region when a private sector financial market was being established. EBRD has been predominantly involved in so-called downscaling of commercial banks.

d  Creating an enabling environment

MFIs require a supportive environment to operate. DFIs have therefore invested a lot of resources into discussions with stakeholders. They have taken an active role in the development of appropriate legislation and regulation, and the development of specialized supervisory capacity. Support has also been given for the development of the necessary financial infrastructure.

Box 5. Example of the creation of an enabling environment

Roland Siller described KfW’s Financial Sector Approach. KfW has a long-standing dialogue with central banks, ministries of finance and governments in the countries where it supports MFIs. It supports the development of the sector through financing for credit bureaus, rating agencies and deposit insurance schemes.

e  Leveraging private capital

DFIs realized over time that just like public grant funding, public commercial funding would not be enough to satisfy the funding needs of microfinance. They gradually started to see the importance of private capital to reach the poor, and became aware of their potential role in leveraging this capital.
4 HOW DO DFIs CATALYZE PRIVATE INVESTMENT IN MICROFINANCE?

At this point, Xavier Reille opened the debate. Damian von Stauffenberg was asked to challenge DFIs with some critical comments and questions.

Damian von Stauffenberg’s first point was that microfinance is overwhelmingly financed by local capital markets, and especially savings deposits. In fact, about 80% of MFI funding is local; foreign funding only makes up about 20%, broken down neatly into about 10% public and 10% private. In other words, DFIs and foreign private funders are relatively insignificant.

Roland Siller confirmed these numbers. He added that KfW and other DFIs are in fact increasingly encouraging MFIs to find local and private funding.

He also said, however, that the importance of DFIs often goes beyond the size of their investments, because they help to:

- Build a nascent industry
- Ensure that MFIs meet their social mission
- Reduce the risks for investors

Below we will summarize the lively discussion that ensued.

a Do DFIs help to build a nascent industry?

Xavier Reille brought into the discussion a paper co-authored by Damian von Stauffenberg in 2007, entitled ‘Role Reversal’, which questioned the role of public investors in building the microfinance market. Its main message was that DFIs were crowding out private investors, by focusing on the strongest (so-called first tier) MFIs, and offering more attractive conditions than private investors could offer. The paper recommended that public funders stop distorting the market and focus more on helping to make second and third tier MFIs ready for private investment.

Chikako Kuno felt that EBRD is not crowding out private investors. To begin with, it only supports 108 out of the 7,200 MFIs that CGAP counted in its region of operation, so there are plenty of options for other investors. It does of course try to select the best MFIs, because it has to operate on commercial criteria. EBRD also stays with the MFIs it selects through difficult times, because it feels that as a public investor it has a role in protecting them.

Roland Siller said that if KfW would have followed Damian’s recommendations in 2007, it would have abandoned the largest MFIs. It is very glad it did not, because by staying with them, it has been able to protect some of these MFIs and their many clients from the worst effects of the crisis.

He admitted that DFIs should not provide cheap money to MFIs, since this distorts the market. However, he felt quite certain that DFIs do not do that now.

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Box 6. Role Reversal

The rapid growth of foreign private lending to MFIs in the last several years has led to a surprising reversal of roles between government-owned development institutions and private lenders. Development institutions are concentrating their loans in the strongest MFIs, leaving private lenders to look for opportunities among smaller, riskier borrowers. In this way, they are ‘crowding’ private lenders out of the best MFIs.

Source: Julie Abrams and Damian von Stauffenberg, ‘Role Reversal’, MicroRate MFInsights February 2007

Roland Siller emphasized its work on creating Public Private Partnerships with well informed investors.

Chikako Kuno said that it makes a point of ‘crowding in’ private investors into the MFIs it supports. Roland Siller emphasized its work on creating Public Private Partnerships with well informed investors.
The DFIs described three different ways in which they try to crowd in private investors.

MICROFINANCE INVESTMENT VEHICLES

DFIs have been supporting the establishment of specialized private Microfinance Investment Vehicles (MIVs) by making seed investments, and by channeling some of their investments via the managers of these funds.

Box 7. Example of MIVs

According to CGAP, at the end of 2008 the largest microfinance funds after the ProCredit holding and EFSE structured finance vehicle (see below) are Oikocredit (632 million USD), BlueOrchard’s Dexia Microcredit Fund (429 million USD) and responsibility’s Global Microfinance Fund (378 million USD).

HOLDINGS

DFIs have been trying to accelerate the development of microfinance by encouraging specialized consulting companies and networks to form holdings of microfinance institutions. By requiring the founding consulting firms or networks to take a financial stake in these holdings, they ensured reasonably priced and high quality technical services to the MFIs that formed part of the holding. By encouraging the creation of holdings, DFIs have stimulated the transformation of member MFIs into regulated institutions, with better access to sustainable sources of funding.

“\text{We asked IPC to go around their family, talk to their grandmothers and mothers in law, to scratch the bottom of drawers and empty piggy banks and what have you, to be able to come with a sufficient stake. We allowed them to reinvest part of the proceeds of their technical assistance over time to increase their stake. And that model proved very successful, because right now they are the biggest shareholder.}”

Andre Laude

Holding companies are important vehicles to create new MFIs in frontier markets such as Sierra Leone, Liberia and the Democratic Republic of Congo. Holdings also allow for larger microfinance investments with a diversified country risk, and can be an attractive vehicle for private investment.

Box 8. Examples of holdings

Andre Laude explained how IFC and KfW encouraged IPC, a consulting firm that was providing technical support to a number of MFIs, to create ProCredit, a holding company that united all these MFIs. This made it possible to roll in private investors alongside, including Commerzbank. According to CGAP at the end of 2008 ProCredit’s assets amounted to slightly over 1 billion USD.

STRUCTURED FINANCE VEHICLES

DFIs have also been supporting the creation of structured finance vehicles. By taking the first risk tranche, they have been able to attract private investors into the mezzanine and senior tranches. They have also participated in CDOs set up by asset managers such as BlueOrchard and Deutsche Bank.

Box 9. Example of a structured finance vehicle

Roland Siller explained how KfW learnt to use its funds more intelligently, by crowding in private investors. As an example, the European Fund for South and Eastern Europe (EFSE) was created by putting donor funds that were originally intended for a revolving loan fund for Balkan refugees into the first risk buffer of a much bigger structured finance fund. DFIs like IFC, KfW and EBRD financed the mezzanine tranche, and the third tranche was sold to private investors, including Sal Oppenheim and Deutsche Bank. According to Xavier Reille, at the end of 2008 EFSE’s assets amounted 745 million.
Do DFIs help MFIs keep to their social mission?

Damian von Stauffenberg questioned whether DFIs are helping to make sure that MFIs focus on poverty alleviation. When MFIs become more commercial and transform into regulated institutions, there is a significant risk of mission drift: a tendency to lose sight of their original mission of serving the poor.

To illustrate this, he drew attention to the fact that DFIs tend to use the definition of microfinance very loosely. In Damian’s definition, microfinance is the provision of financial services to the poor in order to help them create wealth on the basis of their brains, their ingenuity. In general, poor people do not have significant physical assets and therefore cannot put up formalized collateral.

“Microfinance is not just making small loans to poor people. Moneylenders have been doing that for millennia, and it was not considered anything remarkable.”
Damian von Stauffenberg

Mr von Stauffenberg uttered his conviction that a large part of the investments that DFIs categorize under microfinance do not in fact fit into that category. Rather, many fit into the category of Small and Medium Enterprise (SME) finance, and SME loans are generally based on formalized collateral. The same goes for MIVs that claim to invest in microfinance.

“Microfinance is also not lending to people who can put up collateral. I am prepared to bet that under this definition, well less than half of EFSE’s portfolio is in fact in microfinance.”
Damian von Stauffenberg

Chikako Kuno reacted by saying that she felt the distinction between micro and SME finance was of little relevance. While its investees provide loans that vary between 250 Dollars and 250,000 Dollars, their average loan size is 5,600 Euros. EBRD believes that the provision of access to finance to microenterprises and SMEs is a way of creating employment and increasing GDP, which indirectly helps to alleviate poverty.

Andre Laude commented that it is unwise for an investor to limit him- or herself to microfinance, precisely because it is unwise for a lending institution to limit itself to microloans. Microentrepreneurs, like any other entrepreneurs, are best off when they have access to a series of increasing loans. Successful micro-entrepreneurs will gradually want to buy more equipment and take on employees. It is good for a lending institution to hold on to its best clients, because this gives it more stability. Since the costs of providing a micro or SME loan do not differ much, serving SME clients allows lending institutions to become more profitable and therefore more sustainable.

“Definitions are probably important, but they are not healthy. Setting a maximum limit on loans is a killer.”
Andre Laude

Roland Siller said that KfW also thinks it is unwise to limit the use of investment funds for microloans. He informed the audience that the German government carefully scrutinizes KfW to ensure its investments further its social mission. Every single investment goes through an ex-post evaluation where the social impact is measured.

“EFSE has an average loan size of 4,500 euros, and most of its loans are not based on collateral.”
Roland Siller
c  Do DFIs help to reduce risks?

Damian van Stauffenberg wondered whether DFIs are in fact helping to reduce risks when they try to crowd private investors into the institutions they support, particularly when they bring them into institutions that largely support SMEs. He implied that the portfolio at risk among SME clients tends to be higher than that among microclients.

"The risk profile of a small business portfolio is totally different from that of a true microfinance portfolio."

Damian von Stauffenberg

Roland Siller strongly disputed the criticism about transparency. Many MIVs and structured finance vehicles that DFIs support are registered under Luxemburg bank regulation and supervision, and are required to publish like any other Luxemburg-based fund. He argued that private investors would not be partnering with DFIs if they did not have the information they needed to make a thorough analysis of their investment.

"I would be astonished if an investor like Sal Oppenheim or Deutsche Bank would put 100,000 Dollars into a fund without scrutinizing it, and asking any nasty questions they would like to see answered."

Roland Siller

Andre Laude agreed that microfinance institutions should only venture into SME lending if they have the knowledge and tools to do so. IFC makes a point of supporting networks and consultants that can provide the technical assistance that MFIs need, in order to develop the skills and methods to move up-market towards SMEs. It always carefully assesses fund managers, to make sure they evaluate the skills of MFIs’ loan officers.

"It is precisely because of this different risk profile that IFC is so keen on proping up the networks."

Andre Laude

Damian von Stauffenberg criticized the transparency of DFIs’ publications, calling on investors to insist on the numbers they need to make a proper analysis. He thereby implicitly put into question the nature and performance of DFIs’ portfolios.
5 WILL MICROFINANCE CONTINUE TO DO WELL?

Xavier Reille presented the results from a global opinion survey among more than 400 MFI managers on the effects of the crisis, which was published by CGAP in May 2009. They are presented in Figure 3. He then asked the DFIs on the panel how their organizations had reacted to the crisis, and how they saw the perspectives for the sector.

a How have DFIs reacted to the crisis?

Chikako Kuno said that EBRD has continued to provide capital and technical support to its partners. It has realized that the pockets of the networks are actually quite shallow, and has therefore started to look harder for strategic partners with deeper pockets that are able to carry these partners to the next stage. The crisis has exposed the need for improving the IT systems of MFIs, supporting the growth of middle management as well as top management, and corporate governance at board level.

Roland Siller said that KfW’s dialogue with governments, central banks, local players and other DFIs has played an important role in reacting to the crisis as quickly as possible. It has dramatically beefed up its monitoring and risk management.

It has given extra support to members of networks like ProCredit and LFS, which would not receive support from governments because they are not of a systemic nature, but which are big enough to need amounts of funding that are not just avail-

Both Andre Laude and Roland Siller talked about the Microfinance Enhancement Facility, which their institutions helped to establish, and which is managed by three of the industry’s leading fund managers. It is a fast response instrument to support first tier MFIs that have a relationship with the capital market.

“Our creed is capital markets integration, but microfinance institutions that are more integrated are feeling the crunch. We put up the Microfinance Enhancement Facility to be able to shore them up through these difficult times.”

Andre Laude

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<tr>
<th>Microfinance Institutions</th>
<th>Microfinance Clients</th>
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<tbody>
<tr>
<td>Loan portfolio is stable or decreasing (64% of respondents)</td>
<td>Clients are somewhat affected (60% of respondents), more so in Latin America, Eastern Europe and Central Asia</td>
</tr>
<tr>
<td>Credit risk is up (69% of respondents), more severely so in Latin America, Eastern Europe and Central Asia</td>
<td>Repayment is down in all regions</td>
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<td>Liquidity constraints are increasing, especially so for smaller tier-3 MFIs</td>
<td>Clients are spending a greater percentage of income on food</td>
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Figure 3 Source: CGAP Research
b What are current risks and opportunities?

Andre Laude expressed his concern that the crisis is leading to a number of risks. The first risk is lack of liquidity for the microfinance institutions that are more integrated and more exposed to international capital markets. IFC and KfW recently did an analysis of MFIs’ refinancing needs across the world, and arrived at an overall funding gap of 1.8 billion US Dollar. The MEF is expected to help address this risk.

“I see two principal risks. The first is lack of liquidity for the microfinance institutions that are more integrated into capital markets. The second is that a rise in non-performing loans.”

Andre Laude

A second important risk is a rise in Non-Performing Loans (NPLs). This risk exists especially in countries with high competition among MFIs, where many people have loans from multiple institutions and are over-indebted. These are often the same countries where the legal environment and regulatory regime have not allowed MFIs to transform into full-fledged fiduciary institutions supervised by the central bank, and where governance is poor because investors cannot be true shareholders of these MFIs. However, it must be borne in mind that while a general rise in NPLs in microfinance is to be expected, this rise is still likely to be within acceptable boundaries. Loan losses are likely to remain well below those experienced in the corporate banking sector.

Chikako Kuno confirmed the risks mentioned by Andre Laude, but also saw important reasons for hope. Many small commercial banks in Central Asia and the Caucasus are starting to learn to serve smaller customers. Because they have learned how to do microfinance well, they have been able to access long-term financing from microfinance investment vehicles. The international capital market now recognizes the safety of long-term financing to that kind of intermediary. She expected microfinance to continue to grow.

“Overall, there is good hope for microfinance, because the businesses of microentrepreneurs are strongly decorrelated from international markets and movements.”

Roland Siller

Roland Siller pointed out, with respect to the risks mentioned by Andre Laude, that higher NPLs increase an MFI’s need for equity. At the same time, reduced access to liquidity makes an MFI cut back on growth, which puts profitability under pressure and reduces an MFI’s capacity to generate its own equity. DFIs will have to play an important role in making sure sufficient equity is available. Another risk associated to the crisis is the instability of exchange rates, which leads to the need to be strategic about local currency.

Well-managed institutions can be expected to continue to do well, but the market is likely to make a correction for institutions that are not managed so well. In Roland Siller’s opinion, DFIs should let that happen and not rescue everybody.

“Overall, there is good hope for microfinance, because the businesses of microentrepreneurs are strongly decorrelated from international markets and movements.”

Roland Siller

Damian, finally, emphatically expressed his opinion that the future of microfinance was very bright. Not because MFIs are so great (some of them are), but simply because the need is so great.

“We have only scratched the surface of the microfinance market. Maybe we have only reached somewhere around 50 million borrowers. The need is around a billion people.”

Damian von Stauffenberg
Higher NPLs are not necessarily something to worry about. When MicroRate assesses MFIs it often finds that portfolio at risk figures reported at 1,5 to 2% are more like 4 to 6%. However, such figures are still much lower than in commercial banks.

Growth rates in the teens are also not necessarily a sign of crisis. It is healthy that, in a worldwide economic and financial crisis, these institutions are still growing. It is to be applauded that they are no longer growing at 50% to 100% a year, because one loses control of an organization at such growth rates, nobody can sustain that.

“In some of the MFIs of today will probably be the banking giants of 10 years from now. As an investor, is it not bad to be in on that kind of thing.”

Damian von Stauffenberg

In conclusion, we should be grateful for the breather.

6 CONCLUSION

Xavier Reille ended the debate by repeating CGAP’s forecast for 2009 of 10% to 25% foreign capital investment growth. This is illustrated in Figure 4. This forecast is based on a survey of major market players. Growth will be mainly driven by public investors, because they are ramping up their portfolio, but also by retail investors. Institutional investors are expected to be relatively stable, with a few new commitments.

In Xavier Reille’s opinion, the conclusion of the debate is best captured by the title of one of Damian von Stauffenberg’s recent publications: we are at a time of ‘cautious resilience’. The debate has shown that while microfinance has done relatively well in the crisis, partly thanks to the support of DFIs, it is important that investors continue to apply their usual care.