InSight

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Who Will Buy Our Paper: Microfinance Cracking the Capital Markets?

The Realities of Linking Microfinance to Local and International Capital Markets

Written by Rekha Reddy and Elisabeth Rhyne based upon speeches and presentations from the "Who Will Buy Our Paper?" conference

Microfinance needs capital to achieve its goal of serving the millions of people who lack access to financial services. As microfinance matures, will investments in microfinance gain mainstream acceptance in the financial markets? If so, who will buy these investments? Does it make sense to think that microfinance could become a new asset class on Wall Street?

On February 6 and 7, 2006, ACCION International, Corporación Andina de Fomento (CAF) and Deutsche Bank sponsored a conference in New York together with partner Developing World Markets that brought together fund managers, investment intermediaries and microfinance practitioners to consider these questions. The objectives of this conference were to inform the capital markets of the type of offerings microfinance provides and to identify the challenges that remain. This *InSight* discusses the main themes of the conference. It describes successful cases of debt and equity financing in microfinance, at both the local and international levels. This report also discusses constraints and opportunities for the microfinance industry as it continues to move towards the capital markets.

I. What's for Sale? Categories of Investments in Microfinance

The most advanced institutions in the microfinance industry are already accessing national and international capital markets to fund their portfolios. These microfinance institutions (MFIs) are capable of absorbing commercial investment in microfinance and are attractive to investors. They use funding strategies that may be commonplace in the capital markets, but which are relatively new to the microfinance industry.

Table 1. Examples Presented: Microfinance Capital Market Offerings

Types of Financing	**Examples**
Local Bond Issues	Compartamos in Mexico Mibanco in Peru Women's World Banking (WWB) Cali in Colombia
International Debt Issues	Blue Orchard Microfinance Securities I Calvert Community Investment Notes Deutsche Bank Start-Up Loan Fund Deutsche Bank Microcredit Development Fund Global Commercial Microfinance Consortium Global Partnerships Microfinance Notes
Equity Funds	ACCION Investments Opportunity International Balkan Fund ProFund

II. Acting Locally: Cases of Successful Bond Issuance in Domestic Capital Markets

The domestic market is the natural first market for microfinance institutions to approach for raising funds, for a number of reasons:

- Funding is in local currency, with no need to hedge currency risk
- Local market players are often familiar with microfinance and in some cases already recognize specific microfinance institutions
- With fewer investments on offer for local investors, microfinance institutions can be seen as relatively attractive
- The relatively small amounts of funding needed by MFIs can be accommodated by local markets (while international capital markets require larger scale)

On the other hand, bond markets are not well developed in many of the countries where microfinance operates, and local markets do not feature the socially responsible investor category that MFIs like to approach in international markets.

Three cases in which microfinance institutions successfully issued bonds that were purchased by investors in their home countries include Financiera Compartamos in Mexico, WWB Cali in Colombia, and Mibanco in Peru.

Which microfinance institutions are ready for commercial investment?

"Not all microfinance institutions are ready to access the capital markets. There are institutions that are still new, and that need technical assistance or guarantees to improve their governance and daily operations. But there are institutions at the top end of the microfinance sector that need investment and are attractive to investors. These are the institutions that we are talking about today, and they are capable of absorbing investments on competitive commercial terms. These first movers will help the microfinance industry evolve."

María Otero, ACCION International

Why Issue Bonds?

In all cases, the microfinance institutions issued bonds in order to lower their financing costs and satisfy needs for capital to fund their loan portfolios.

Compartamos

This Mexican finance company (SOFOL) had two sources of funding before it decided to issue bonds: foreign lenders, such as multilaterals and international microfinance funds; and credit lines with local Mexican banks, most of them very expensive and with high collateral requirements. Compartamos was looking for new lenders and wanted to press existing lenders to provide better conditions.

Mibanco

Mibanco, a Peruvian commercial bank, had funding sources which were concentrated in the banking sector, and wanted to diversify these sources. It also wanted to obtain better interest rates and longer loan terms. Mibanco's decision makers also wished to change the perceptions of investors in Peru about the level of risk in the microfinance sector.

WWB Cali

WWB Cali, an unregulated not-for-profit microfinance institution, wanted longer-term financing and to diversify its funding beyond its traditional banking sources. Favorable conditions in the Colombian financial markets convinced the institution to issue bonds.

Table 2 summarizes key components of each institution's bond issues.

Table 2: Local Bond Issuance of Three Leading Microfinance Institutions

	Compartamos	Mibanco	WWB Cali
Type of Institution	Consumer finance company (SOFOL)	Commercial bank	NGO
Year of First Issue	2002	2002	2005
Number of Issues	5	3	1
Total public debt placed	US$68 million	US$14.5 million	US$52 million
Rating Agent	Standard & Poor's Mexico	Class and Associates and Equilibrium	Duff & Phelps (Fitch) Colombia

Experiences with Local Ratings

Compartamos

The Central American rating office of Standard & Poor's (S&P) rated the Compartamos bond issues, using its national Mexico scale, rather than an international scale (that is, assuming investors would be Mexican). S&P did not have a methodology tailored to microfinance, and it was the first experience the office had rating a microfinance institution. S&P noted characteristics of the institution that were specific to microfinance, such as its use of group lending methodology, relatively small loan size, and emphasis on willingness to pay as opposed to collateral. S&P also noted that competition was currently low, but that the Mexican microfinance market had low barriers to entry. It also noted that the current legal structure of Compartamos (SOFOL) placed some restrictions on its growth. Still, S&P was impressed by the MFI's diversified portfolio, and the most recent Compartamos issue with its IFC guarantee received an MXAA rating (Mexican AA).

Mibanco

Mibanco was required to solicit two ratings to meet Peruvian regulatory requirements. It contracted the Peruvian agencies of Pacific Credit Ratings, Class and Associates and Equilibrium. Both ratings are listed in Table 3. The two ratings agencies gave the first two bond issues the same rating. Both bestowed a rating of AA, which reflects a high capacity to repay. However, the ratings for the third issue differed: Class and Associates rated the issue AA- and Equilibrium rated it A+.

WWB Cali

Raters Duff & Phelps (Fitch) in Colombia rated the WWB Cali bond issuance. Duff & Phelps had a number of concerns about WWB Cali. The institution was an NGO and a credit entity not subject to regulation. It lacked shareholders, which meant that no one with "deep pockets" would be available to support the institution in case of trouble. Finally, the lending methodology of the MFI was of concern to the raters, as WWB lent funds to individuals without collateral.

Like S&P, Duff & Phelps did not have a specific rating methodology for MFIs, and compared the WWB affiliate to other financial institutions. WWB Cali performed favorably relative to mainstream financial institutions in Colombia. The WWB Cali rating process began in the environment of a severe economic downturn in 2002-2003. Although past due loan ratios skyrocketed in the banking sector, past due loans for WWB actually decreased. The ROA of WWB Cali was also far superior to that of the banking sector. Duff & Phelps viewed WWB Cali's strong management and strict self-regulation favorably, and with the trust arrangement described below awarded the bond issue a rating of AA+.

How Access to the Capital Markets Can Translate into Lower Costs for Microentrepreneurs

The goal of MFIs accessing the commercial capital markets is to lower their cost of capital. Compartamos obtained a yield on its first issue that provided a significant savings of 450 basis points over the cost of local commercial lines of credit. This reduction has enabled Compartamos to launch initiatives to reduce costs and improve services for its clients, such as absorbing the costs of providing life insurance for all clients.

Mibanco also reduced its cost of financing. Its managers noted that they pay 10 percent interest on deposits from individuals, but only 5.5 percent on funds raised in the capital markets. This reduction in costs has enabled Mibanco to lower the interest rates charged to clients by more than 7 percent.

Following its bond issue, WWB Cali's average financing costs decreased and the term of its financing increased. Prior to the bond issue, it paid approximately 14 percent on debt with an average 2.2 year maturity. After the bond issue, its average financing cost decreased by 360 basis points while average maturity rose to 3.2 years. Clara Serra de Akerman of WWB Cali noted that since funding costs have been reduced, WWB Cali has lowered its interest rates as well.

The Role of Credit Enhancements in Domestic Bond Issuances

In each of these cases, the institutions chose to use risk mitigation mechanisms to reduce the risk of their bond issues. Compartamos and Mibanco purchased credit enhancements, which allowed them to appeal to new groups of investors that had not previously been willing to invest in microfinance. Enhancements were also used straightforwardly as a way to reduce the cost of borrowing, although purchasing a credit enhancement is a cost to the MFI. The evolution of the bond issues over time is displayed in Table 3 on the following page.

Compartamos

Compartamos did not acquire a guarantee for its first three offerings, which were sold mainly to private banking clients. However, for its latter subsequent issues, Compartamos purchased an IFC guarantee that acted as 34 percent collateral for the issues. This guarantee enabled pension funds to invest in the Compartamos issues, because it increased the rating of the bond issues to AA. Although Compartamos had the minimum rating required by the market without the enhancement, the pension funds worried about the possibility of a downgrade and without the AA rating were unlikely to invest.

Table 3: Conditions of Bond Financing

Number of Issue/ Year of issue	Amount Placed (US$ million)	Amount placed/ Amount Demanded (# times over subscribed)	Coupon	Term (years)	Rating	Credit Enhancement
Compartamos						
1/2002	10.0	1.0	90 day CETES +250 bp[1]	3	MX A+	None
2/2002	5.0	1.0	90 day CETES+250 bp	3.25	MX A+	None
3/2003	5.0	1.0	90 day CETES+290 bp	3	MX A+	None
4/2004	16.6	0.95	28 d TIIE+ 150 bp	5	MXAA	Yes (34%-IFC)
5/2005	31.0	3.0	28 d TIIE+ 117 bp[2]	5	MXAA	Yes (34%-IFC)
Mibanco						
1/2002	5.8	1.1	12%	2	AA& AA*[3]	Yes (50%-USAID)
2/2003	5.8	2.3	5.75%	2.25	AA& AA	Yes (50%-CAF)
3/2003	2.9	1.7	5.75%	1.5	AA-&A+	None
WWB Cali						
1/2005	20.0	1.87	10.78%	3	AA+	None
1/2005	10.0		CPI+5.5[4]%	5		None
1/2005	22.0	3.15	CPI+3.4%	6	AA+	None

Source: Presentations by Rafael Llosa (Mibanco), Fernando Alvarez Toca (Compartamos), Clara Serra de Akerman (WWB), and *Small Enterprise Development* "The Financing of Microfinance" March 2005

Mibanco

On its first offering, Mibanco solicited a 50 percent from USAID on the principal. Still, it paid a relatively high interest rate on its first issue, partially due to the unfamiliarity of the capital markets with microfinance. For its second bond issuance, Mibanco solicited a 50 percent guarantee from CAF and its interest rate dropped as investors became more comfortable.

WWB Cali

WWB Cali was offered credit enhancements, but felt its long-term debt rating (AA+) from Duff & Phelps to be sufficiently high that it did not need to incur the additional cost of the credit enhancements even for its initial offering. Since WWB Cali is not regulated by the Banking Superintendence, it structured the bond to include a "Fiduciary Trust" figure that would monitor

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[1] All issuances have been placed at variable rates relative to CETES or TIIE (Mexican treasury bills). The final cost to Compartamos of the first issue was 13.08 percent, including all taxes and fees.

[2] Although the rate for issue number five was TIEE+117 basis points, the spread with all costs (including the cost of the IFC guarantee) is around TIEE+200 basis points. This also applies for issue number four, which also had an IFC guarantee.

[3] Mibanco was required to solicit two ratings to meet Peruvian regulatory requirements. The rating listed first in the table was given by Class and Associates. The second rating was given by Equilibrium.

[4] Bonds with a term of 1-3 years accrued a fixed interest rate, while the interest rate on bonds of more than five years was referenced to Colombian inflation (CPI).

liquidity and solvency indicators, portfolio quality, and operational efficiency, among other indicators. FiduCorfinsura, a Colombian fiduciary services company, monitored the indicators and published them as the Banking Superintendence does.

How Microfinance Debt Was Sold to Local Investors

Each of these three microfinance institutions were the first in their country to issue public debt, and microfinance was relatively unknown by the capital markets. The institutions did road shows to educate potential investors about the characteristics of their offerings. As local investors became more familiar with the microfinance institutions with each subsequent offering, the demand for the paper increased. In addition, the need for credit enhancements diminished, and the interest rates or coupon payments paid to investors was reduced over time.

Despite the newness of microfinance, each issue was fully subscribed locally—in many cases oversubscribed—by investors in local currency. The distribution of placements for these bonds is described in Table 4.

Table 4: Who Bought these Microfinance Bonds?

Issue Number/Year of Issue	**Distribution of Investors in Microfinance Bonds**
Compartamos (Mexico)	
1/2002	Individual investors (70%), institutional investors (30%)
2/2002	Individual investors (50%), institutional investors (50%)
3/2003	Individual investors (100%)
4/2004	Individual investors (60%), institutional investors (40%)
5/2005	Individual investors (30%), institutional investors (70%)
Mibanco (Peru)	
1/2002	Pension funds (83%) and mutual funds (17%)
2/2003	Pension funds (26%), mutual funds (33%), public entities (29%), banks (10%), and insurance companies (3%)
3/2003	Pension funds (20%), mutual funds (21%), and public entities (59%)
WWB Cali (Colombia)	
1/2005	Pension funds (31%), financial institutions (24%), brokers (37%), others (8%)
2/2005	Pension funds (17%), financial institutions (42%) trust funds (19%), and others (22%)

Source: Presentations by Rafael Llosa (Mibanco), Fernando Alvarez Toca (Compartamos), Clara Serra de Akerman (WWB), and the Small Enterprise Development Journal "The Financing of Microfinance" March 2005

Compartamos

For Compartamos, private placements were an important starting point. Its first three issues were sold through private placements by a brokerage firm owned by Banamex Citigroup. Most of the investors at this stage were individuals (70 percent in the first issue). The IFC guarantee enabled Compartamos to do a public placement on its latter two issues, directing the bonds to institutional investors with a lower tolerance for risk than individuals. Although investors were slow to take up this fourth issue, Compartamos was helped by *Latin Finance* magazine naming the bond the "best structured bond" in Latin America. Its fifth issue was three times oversubscribed, with 70 percent of the offering purchased by institutional investors.

Mibanco

Even after its road shows, Mibanco's 12 percent interest rate on its first issuance was much higher than desired, considering that the issue was credit-enhanced. The vast majority of the first issuance was purchased by pension funds, with the remainder purchased by mutual funds. The second issuance was received positively as the local markets grew familiar with the bonds; the interest rate dropped to 5 percent. For the second issue, mutual funds and pension funds continued to purchase a majority of the bond, but were joined by public entities and other banks. For its third issue, which had no credit enhancement, demand was so healthy that Mibanco placed a limit of not more than US$3 million per institutional investor. Public entities purchased 59 percent of this issue, with pension funds and mutual funds purchasing the remainder.

WWB Cali

The first tranche that WWB Cali offered was purchased by a mix of brokers, banks that had financed the NGO in the past, pension funds, individual investors and others. The composition of investors differed in the second tranche: the bond was purchased by financial institutions, trust funds, pension funds, individual investors and others. Thus, there was progress toward new and more institutional investors.

Two Local Investment Firms That Considered Local Microfinance Debt Issues

GBM Investment Funds, Mexico

GBM is a Mexican brokerage firm that manages about US$2 billion in investments. After seeing the road show given by Compartamos, GBM fund managers discussed Compartamos internally. GBM viewed Compartamos as a strong investment opportunity because of the IFC guarantee on 35% of the capital, high local rating, healthy financial ratios (asset quality, ROE and ROA), and strong performance relative to other sectors during difficult times for Mexico's macroeconomy. Although GBM bid on the fifth Compartamos issue, demand for this issue far exceeded supply, and its bid was out of range.

AFP Integral, Peru

AFP Integral is one of the largest investors in Peru. When Mibanco entered the capital markets, AFP had no experience with microfinance. However, Mibanco offered decent rates, there was no currency risk, and the Peruvian economy was in good shape. The USAID credit enhancement added a greater element of comfort, securing a strong risk rating. The issue was structured to be attractive, with a short maturity (2 years) and a 12 percent yield, which was more than 362 basis points above the interest rate for government bonds. AFP viewed Mibanco's balance sheet as solid and was impressed by the rate of repayment of microenterprises relative to the businesses served by the traditional banking sector. Finally, AFP's analysts were impressed by Mibanco's growing market share in what they viewed as a growing industry. In addition, as AFP had not previously invested in microfinance, the investment would help diversify AFP's portfolio.

One problem for AFP was that at US$6 million, Mibanco's bond was relatively small. By law, AFP could not purchase more than half the issuance. Mibanco has successfully repaid the bond, and AFP hopes to purchase future issuances.

Succeeding in Local Debt Markets

Compartamos, Mibanco and WWB Cali made significant progress in improving their funding terms. The multiple bond issuances for these three institutions raised millions of dollars at a lower cost of financing than their prior sources of credit. Each institution reduced the interest rate they paid to investors and lengthened the tenor of the funding through successive issues. In some cases, they transitioned away from the need to purchase a credit enhancement or they moved towards attracting mainstream institutional investors.

IV. Tapping the International Debt Markets

Because international debt markets are so enormous, the international appetite for buying microfinance institution debt potentially exceeds the local appetite by a large factor. However, the primary challenge is not that of scale. Rather, the challenge is to provide structures that fit the requirements of international investors. Those challenges include:

- Small scale of funding needed by any one MFI relative to other investment opportunities
- Country risk
- Foreign exchange risk
- Lack of familiarity with microfinance in general and specific MFIs, and shortage of well-understood sources of information
- Requirements by institutional investors to limit investments to very highly rated issues

In response to these challenges, a few organizations active in international markets have created financial instruments, such as loan funds and structured collateralized-debt options (CDOs) in which investors buy into a pool of loans made to MFIs.

Table 5: Transactions Involving International Debt in Microfinance

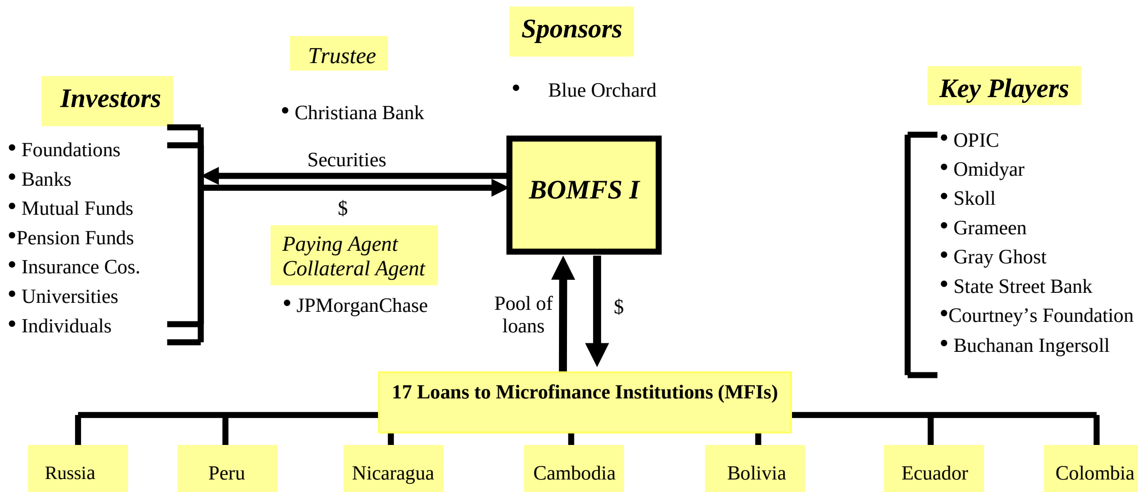
Name	Date of Inception	Description
Blue Orchard Microfinance Securities I	2004	US$87 million in loans to 17 MFIs in Latin America, Eastern Europe and Southeast Asia
Deutsche Bank Microcredit Development Fund	1998	Loans are used to leverage capital from local financial institutions, at least a 2:1 ratio, active portfolio at the close of 2005 was US$3 million
Deutsche Bank Start-Up Loan Fund	2005	New fund that targets early stage, commercially viable microfinance institutions
Global Partnerships Microfinance Notes	2005	US$2 million pilot backed by loans to MFIs in Central America
Global Commercial Microfinance Consortium	2005	US$60.5 million in floating rate notes (with a USAID guarantee of US$15 million) and equity of US$15.25 million.

Cases of Debt Issuance in International Capital Markets

Blue Orchard MF Securities I

The best-known international debt issue for microfinance to date was structured by Blue Orchard Finance, a Swiss microfinance investment consultancy specializing in the management of investment funds dedicated to the micro-finance industry, and Developing World Markets, a socially oriented investment bank. This transaction, shown in Figure 1, channeled US$40 million from 90 investors to nine microfinance institutions. The key element in the success of this issue was a tiering system that allowed different classes of investors to take on different levels of risk. There were five tranches: an equity tranche, 3 subordinated tranches (priced at US Treasury +2.5 percent) and senior notes with a 75 percent OPIC (Overseas Private Investment Corporation) guarantee (US Treasury + 1.5 percent). Investors ranged from individuals to pension funds, with socially responsible investors, foundations, and non-profits taking on the less privileged tiers.

Figure 1: BlueOrchard Microfinance Securities I



Source: Peter Johnson, Developing World Markets

Besides OPIC which provided the credit enhancement for this transaction, other key players in this transaction included the Omidyar Network Fund, the Skoll Foundation, Grameen Foundation USA and Courtney's Foundation which made equity investments along with Blue Orchard and Developing World Markets. Gray Ghost Microfinance Fund and State Street Bank purchased subordinated notes. Buchanan Ingersoll acted as the registrar.

Deutsche Bank Start-Up Loan Fund and Deutsche Bank Microcredit Development Fund

These two funds were early examples of small scale investments that were primarily sold to the private banking clients of Deutsche Bank. The Start-Up Loan Fund provides loan capital to early stage commercially viable microfinance institutions. The goal of this fund is to identify microfinance institutions operating in underserved areas and leverage resources. This vote of confidence was intended to attract local investors to the institution.

The Microcredit Development Fund makes loans to microfinance institutions to leverage capital from local financial institutions, striving for at least a 2:1 ratio. This facilitates linkages between microfinance institutions and local financial institutions and seeks to graduate the MFIs to commercial sustainability.

The Global Partnerships Microfinance Notes

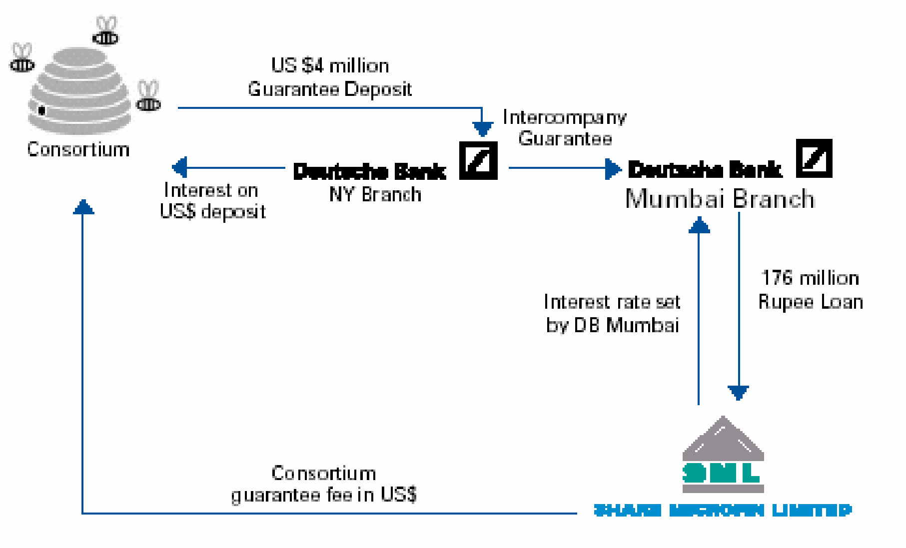
This fund makes loans to microfinance institutions in Central America, which then lend to clients. It was created with the advice of Developing World Markets and is managed by Global Partnerships, a Seattle based NGO. The Fund's assets consist of loans to MFIs with a maximum maturity of five years and cash. MFIs in Guatemala and El Salvador were vetted by Global Partnerships and an independent investment committee. The Fund totals US$2 million as of September 2005. Ten percent of the Fund is in the form of equity provided by Global Partnerships. The rest of the Fund is debt: ten percent in the form of subordinated notes for investors, and the remaining 80 percent in the form of senior notes for investors.

Global Commercial Microfinance Consortium

This consortium, managed and sponsored by Deutsche Bank, facilitates capital access for commercially focused MFIs in local currency. The capital structure consists of US$60.5 million in floating rate notes (with a USAID guarantee of US$15 million) and equity of US$15.25 million. As of November, 2005, 40 percent of the Consortium fund (about US$30 million) had been approved for placement in Africa, Asia, Europe and Latin America by the Consortium's investment committee. There are 18 investment partners besides Deutsche Bank, including DFID, Gray Ghost, and Merrill Lynch.

Figure 2 shows a representative transaction of the Microfinance Consortium in which an Indian microfinance institution was funded. The Mumbai office of Deutsche Bank provided Share Microfin Limited with a Rps. 176 million loan (US$4.2 million) over five years. Deutsche Bank in New York used an intercompany guarantee that enabled Deutsche Bank in India to issue local currency to the MFI.

Figure 2: Sample Transaction of the Microfinance Consortium



Source: David Gough, Deutsche Bank

When these products were being marketed to investors, Deutsche Bank benchmarked them to Collateralized Debt Obligations (CDOs), which are similar in structure. The spread was significantly in excess of comparable investments because it was felt that this pricing would induce new types of investors to participate. As with BOMFS I, governments and socially responsible investors were important facilitators of the Microfinance Consortium deals. The French and British development agencies occupied the first loss position. Deutsche Bank felt this investment was over-collateralized, making it a good deal for investors. Deutsche Bank debated ratings, but getting a rater comfortable with a blind pool of investment opportunities in the developing world would have been extremely difficult.

Who Bought International Debt? International Investor Experiences

The socially responsible investor (SRI) community makes up the majority of international investors in the Blue Orchard and Deutsche Bank deals, as well as in direct lending to MFIs. The examples of Calvert and the Church Pension Fund demonstrate the potentially large amounts of funding available for social investment, as well as the challenge of connecting those sources to microfinance.

Table 6: Selected International Investors in Microfinance

	Total Portfolio	Portfolio dedicated to microfinance	Microfinance Investments
Calvert Community Investment Notes	US$83 million	US$25.5 million	Microfinance Consortium, Blue Orchard Securities, and others
Church Pension Fund	US$8,800 million	US$15 million	Senior debt tranche of Microfinance Consortium

Calvert Foundation

Calvert Foundation manages an $83 million community investment portfolio—and invests 31 percent ($25 million) of it in microfinance. Of this $25 million, about $21 million is lent to US and European intermediaries, while the remainder is utilized as direct loans or loan guarantees for MFIs. Calvert also funds specialized microfinance investment funds. Structured transactions and securitizations have become a significant percentage of Calvert's portfolio in a short time. Calvert invested in both the Blue Orchard securitization and the Microfinance Consortium.

The Calvert Foundation mobilizes investment funds from small investors, more than half of whom place $5,000 or less in these community investment funds. As manager of investments from small investors, the Foundation is very risk averse. When considering microfinance investment, the Foundation is particularly careful to manage country and MFI risk through diversification. The Foundation is not focused on earning the highest yield—in some cases it takes a higher risk position and a lower return for an investment it considers particularly worthwhile. Its average placement size is $500,000 to $5,000,000.

Church Pension Fund

The Church Pension Fund was established in 1914 by the Episcopal Church to manage the pension fund of Church employees, and for related financial purposes. The Fund currently manages $8.8 billion across all asset classes, and began "social" investing in 2000. Most of the social investments thus far have been in American real estate, in projects for urban redevelopment. Based on its experience in socially responsible real estate investment, the Church asked the Fund to look at opportunities for social investment in the emerging markets. Most did not meet the Fund's risk/return hurdle (which is mandated by United States laws governing prudent management of pension funds) with the exception of the Global Commercial Microfinance Consortium, where the Fund currently invests $15 million.

V. What about Equity?

International funding for microfinance also takes the form of equity. Equity is particularly important for MFIs as it provides the basis for institutional solvency, compliance with regulatory norms for capital adequacy, the foundation on which debt can be raised, and ownership. Because of its high risk and its requirement for active involvement at the governance level, equity investment in microfinance to date has come to be provided through specialized equity funds with primarily public sector investors or socially responsible private investors.

Table 7: Examples of Private Equity Funds Specialized in Microfinance

Name ***(date of inception)***	**Capital**	**Description**
ACCION Investments (2003)	US$19.5 million	Provides equity and quasi-equity capital to institutions specializing in microfinance, in Latin America, the Caribbean and Africa
Balkan Financial Sector Equity Fund (2005)	€25 million	A regional private equity fund for South East Europe, focusing exclusively on expansion of the financial sector in the Balkans.
ProFund (1995)	US$22 million	Fund serving for-profit regulated Micro and SME-focused financial intermediaries throughout Latin America and the Caribbean.

ACCION Investments in Microfinance

ACCION Investments makes equity and quasi-equity investments in microfinance institutions. One of ACCION Investments' main objectives is to provide strategic direction in governance, oversight, and distribution of best practices, usually by occupying a board seat. As of February 2006, ACCION Investments was capitalized at US$19.5 million, and had invested a total of US$12.4 million in five institutions. Its investors include both multi- and bi-lateral governmental entities as well as private investors from the United States and Europe, such as the International Finance Corporation (IFC) and the Inter-American Development Bank (IDB). A seven-member board of directors representing its largest shareholders governs ACCION Investments.

Balkan Financial Sector Equity Fund

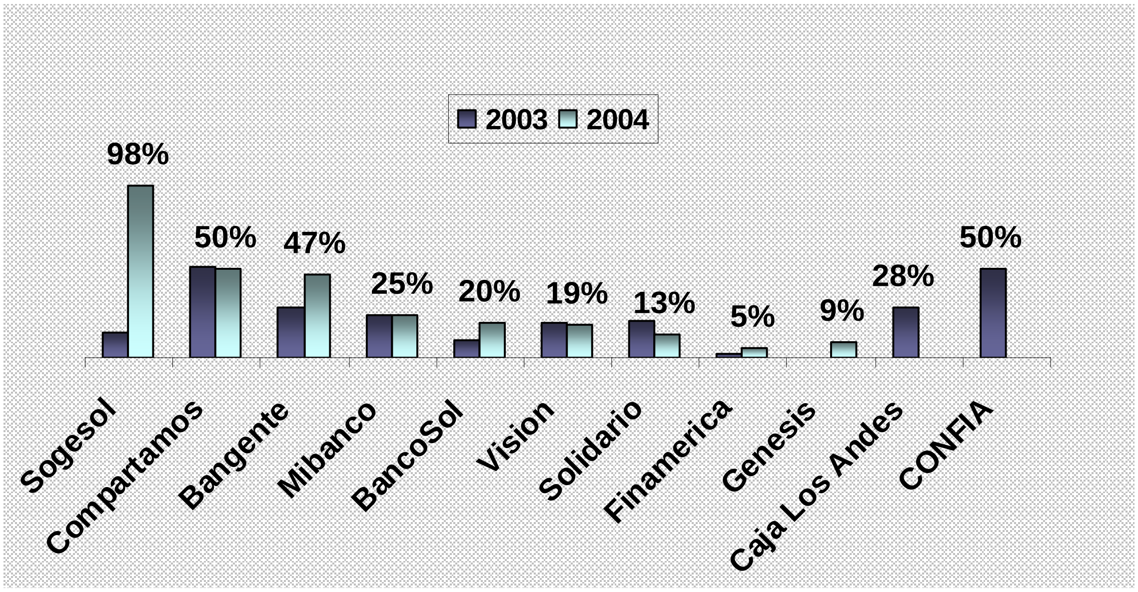
The Balkan Financial Sector Equity Fund, founded by microfinance network Opportunity International, Clive Moody, Anis Kahn and DFE partners, is a regional private equity fund for the Balkans. The €50 million target eight year fund achieved its first closing in December 2005 at €25 million. So far, one-third of investments come from Swiss and German development finance institutions, another third from specialized investors focused on microfinance, with the remainder from purely private investors. Most investors have some exposure to Central and Eastern Europe and some exposure to microfinance. The fund pipeline includes six MFIs, including not-for-profit organizations, transformed MFIs, and smaller local banks. Plans are to fully invest in three years.

ProFund

ProFund was the first specialized equity fund for microfinance operating on commercial terms in Latin America and the Caribbean. The fund was capitalized with US$22 million. The majority of ProFund's shareholders were from public investors, such as the Swiss State Secretariat, InterAmerican Development Bank, CAF and International Finance Corporation or from socially responsible private investors such as Triodos, Calvert and the Argidius Foundation.

Figure 4 shows the range of ROEs in ProFund's investments. ProFund was a closed life fund with a ten-year operating period from 1995-2005. By the time ProFund sold its investment positions, every institution in which it had invested was profitable.

Figure 4: ProFund's MFIs: Return on Equity (US$)



The IRR on ProFund's cash flow was 9.1 percent before operating expenses were factored in and 6.6 percent afterwards. This was modest, considering the risks the fund took. However, in that period of time many investors in Latin America fared far worse. ProFund's manager, Alex Silva commented, "When the country is in a meltdown, when many banks are not getting paid, microfinance still gets paid." Despite the difficulty of selling minority positions in a financial intermediary in a developing country, ProFund was able to divest all of its investments.

VI. Can Microfinance Become an Asset Class?

Over the past two decades, funding for microfinance has become more commercial. An activity that was once mainly grant-funded by public sector donors now receives much or most of its funding as debt and equity from commercial and quasi-commercial sources. However, microfinance remains at the fringes of the capital markets. It has not proceeded significantly beyond the small socially responsible investor niche. Among the examples presented at the conference, only the local bond issues have penetrated the mainstream markets of their own countries, and that using assistance from risk mitigation mechanisms that helped introduce the issues into the market. In international markets, microfinance remains at the edges of even the socially responsible community.

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Significant changes are happening, however, such as the US$15 million investment in microfinance by the Church Pension Fund, which is required by law to meet high standards of prudential responsibility and which has a total of US$8.8 billion under management. Microfinance may aspire to reach deeper into the portion of the capital markets represented by the Church Pension Fund and Domini Social Investments, which are sensitive to social issues but guided by mainstream norms. To break into such segments, microfinance would need to become an asset class that is understood and accepted by the markets. However, microfinance still faces significant challenges before it will attain the characteristics of an asset class.

A successful asset class, attractive to large institutional investors, even socially responsible ones, needs to provide investors with the following:

- An appropriate risk-return profile
- Ready access to information on risks and return
- Suitable scale to cover the cost of investing
- Liquidity – ability for investors to move easily into and out of securities

How does microfinance fare in each of these categories?

Risk and Return

Many microfinance institutions are sound and able to service debt at a significant interest rate or provide an attractive return on equity. However, actual risks and returns to investors, especially international investors, are complicated by exchange rate risk, country risk and the need for diversification. The costs associated with bringing microfinance to markets, such as the management fees necessary for those structuring debt or equity funds, reduce the return to the final investor. Efficiency gains that reduce these costs as well as improved risk diversification strategies could put microfinance on an acceptable risk/return frontier.

Information

Publicly available information on microfinance can be challenging for mainstream investors to gather. As one conference speaker pointed out, there are hundreds of opinions available on Wall Street's view of Proctor and Gamble, but nothing publicly available about Mibanco. The Church Pension Fund thought microfinance would make a good investment from a social perspective, and that the Microfinance Consortium would meet its risk/return hurdle. However, investing in the Consortium would require much more research time than comparable US$15 million investments. It took influence from the social investment community to get the Church Pension Fund to agree to spend time on this research.

The current solution to the lack of information is the use of credit enhancements from well-known sources and packaging by intermediaries who can gather information.

The current solution to the lack of information is the use of credit enhancements from well-known sources and packaging by intermediaries who can gather information. For example, as part of its efforts to keep costs low, Calvert Foundation staff do not travel a lot or conduct many site visits. One Calvert strategy is to work with networks of microfinance institutions that can offer on-site supervision, technical support and assistance with grants—allowing Calvert to reach nascent MFIs.

To date, microfinance has attempted to create specialized information sources, such as the Microfinance Information Exchange, to promote transparency of financial information and to mimic the activities of more mainstream sources. Specialized rating agencies such as Microrate have been developed for the same reasons. However, mainstream investors want to receive their information from mainstream sources that they trust, interact with on a regular basis, and can use to compare a wide variety of investment options.

Some investors can only invest in institutions whose paper has received a rating from a mainstream rating agency. Mainstream rating agencies are just beginning to learn about microfinance. According to Elizabeth Littlefield of the Consultative Group to Assist the Poor (CGAP), 240 MFIs have received ratings through the CGAP rating fund. Approximately 30-40 of these have been conducted by local affiliates of mainstream raters, such as Standard & Poor's in Mexico, with the remainder being evaluations carried out by specialized microfinance rating companies.

Scale

Microfinance as a whole remains very small compared to the international financial markets, and by its nature, will continue to be relatively small. Only the handful of largest MFIs are big enough to begin to be relevant in their local bond markets, and several top MFIs from around the world must come together to achieve even the minimum volume for an international debt issue. Constraints to scale include the supply of investment-ready MFIs. One optimistic estimate places the number of "investment ready" MFIs at approximately 150, leading to doubts about the ability of microfinance to achieve the volume to be a true asset class. Another scale-related issue is standardization, discussed in the section on securitization below.

Liquidity

Microfinance investments are generally illiquid. Microfinance lacks information on "daily" deals, aggregated customer data, deal spreads and return spreads, all of which are necessary for a liquid market. Moreover, investors look for securities that are legally transferable. Improvements in liquidity will largely be the result of advances on all fronts just described: information, efficiency, and scale.

Securitization

A particularly attractive idea is that microfinance could be securitized in much the same way that home mortgages, credit card debt and an increasing variety of other assets are packaged and sold. Securitization is the process of pooling a certain type of asset, for example microfinance loans, and selling securities backed by those assets to investors. Peter Johnson of Developing World Markets enumerated some of the reasons why efforts to securitize loan portfolios have proved challenging.

- *Size of loans:* In some countries, institutions may need to pool 10,000 microloans to create an investment of sufficient monetary value to interest investors.
- *Securing pledge or true sale:* The legal status of the sale of assets must be carefully delineated.
- *Perfecting title:* This is difficult to do in a developing country, and even more challenging to do across countries
- *High administrative burden:* Microloans have small loan sizes, and are therefore relatively more expensive to manage. Furthermore, microloans tend to have short durations (4-6 months), therefore assets tend to turn over quickly
- *Collections of past-due debt:* The role of servicing the loans is a unique link between microfinance institutions and the borrower. If the MFI was no longer functional, the collections role could not be sold.

For all of the above reasons, most investments involve pooled loans to MFIs rather than pooling the underlying loans to microentrepreneurs for securitization, although recent cases of securitization of microloan receivables have occurred in Bangladesh and Latin America. A further barrier to securitization is the variety of microfinance loans. In most countries, there exists a range of lending methodologies–solidarity group loans, village banking, individual loans, etc. with many variations in specific characteristics. Only when many MFIs are making substantially similar loans using similar legal frameworks can a true market in securitized microloans be contemplated. These conditions may exist in India, where progress toward securitization is being driven by ICICI Bank.

VII. Beyond Socially Responsible Investment: What Does the Future Hold for Microfinance?

Will microfinance reach mainstream international private investors, or will it remain the domain of the socially responsible investment community? Panelists discussed the directions in which they envisioned the sector moving in the future.

Accessing mainstream international investment capital such as mutual funds is a big stretch for MFIs—but there exists ample opportunity to grow with socially responsible investment funds.

The vast majority of microfinance investment in the international capital markets has been made by socially responsible investors. Although this is an important source of capital, it pales in comparison to the approximately $8 trillion in mutual funds. Microfinance is not yet ready to access this source of capital. It lacks the public information sources and daily pricing of other investment options.

Early-stage investors will find the most attractive deals in microfinance.

Early stage investors, the first movers, have access to the cream of the crop in microfinance investment deals. Many of the panelists spoke of solid investments in microfinance that are overcollateralized and undervalued while the market becomes familiar with the microfinance industry.

The microfinance industry needs to combine the knowledge of the specialized microfinance raters with the ability of the conventional rater to reach investors.

Mainstream investors often require mainstream ratings, so what is the role of specialized raters? These specialized ratings for microfinance, sometimes called "performance" ratings, are tailored to microfinance institutions. Damian von Stauffenberg of Microrate pointed out that in some cases, Microrate rated an MFI independently of the conventional ratings, and Microrate's rating was always more negative. This happened because MFIs were compared to other MFIs rather than banks which tend to have poorer portfolio quality, and higher ROAs and ROEs. If these specialized raters find a systematic way to share their knowledge with conventional raters, both parties can benefit.

Microfinance can use social investors as leverage to attract more attention from mainstream investors.

For example, the Microfinance Consortium initiative is housed in the corporate social responsibility department of Deutsche Bank. Deutsche Bank representative David Gough emphasized the importance of engaging the Bank's treasury management department that look at the Consortium as an opportunity for return, rather than as an expense write-off for corporate social responsibility.

Emphasizing both the social and financial returns of microfinance will lead to growth of the industry.

The microfinance industry will strive to attain investments from both socially responsible investors and mainstream investors—tailoring the marketing pitch depending on the audience. One panelist pointed out those even institutions that do not identify themselves as socially responsible investors, such as university endowments and pension funds, may follow socially responsible principles. Social investors can smooth the way for mainstream investors. Even though they are unwilling to accept a lower return, they may assist in other ways, for example, by performing an intensive due diligence process on a relatively small investment.

VIII. Conclusion

Not so long ago, the microfinance community was asking, "Will investors buy microfinance commercial paper?" It is now clear that microfinance institutions are successfully accessing the capital markets and the discussion has moved to "Who will buy our commercial paper—and how?" Experiences presented at the conference suggest that the main sphere of activity in microfinance occurs in local markets. Investments in local markets may need initial credit enhancements to make local investors familiar with microfinance, but after the microfinance institution establishes a track record, the need for the credit enhancement falls away. International investments have proved to be more difficult, with country-specific regulatory policies and potential exposure to foreign exchange rate risk. However, many innovative examples, particularly in the realm of international debt financing, have contributed to the evolution of the industry. The microfinance industry still has many constraints to overcome before it is to take its place as a true asset class. However, socially responsible investors will smooth the way to mainstream investment, absorbing many of the costs of building the industry.

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Who Will Buy Our Paper:
Microfinance Cracking the Capital Markets?
The Realities of Linking Microfinance to
Local & International Capital Markets

The Conference Program & all PowerPoint Presentations are available at:
www.accion.org/cracking_the_capital_markets.asp

Conference Hosts: ACCION International,
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Developing World Markets

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Other titles in ACCION's *InSight* series include:

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With the exception of *InSight* #2, all of the titles in the *InSight series* are available in English and Spanish. *InSights* #4 and #8 are also available in French.

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