

Focus Note

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FOREIGN INVESTMENT IN MICROFINANCE: DEBT AND EQUITY FROM QUASI-COMMERCIAL INVESTORS

Introduction

Microfinance institutions¹ (MFIs) will only be able to serve massive numbers of the poor with high-quality financial services when these MFIs have tapped commercial sources of funding and deposits. Commercial and quasi-commercial foreign investment is one growing and potentially important source of funds for promising MFIs. For microfinance institutions that are eligible to receive it, foreign investment can help achieve scale by mobilizing local investment and improving management and governance. A recent CGAP study on the volume of foreign investment in microfinance has revealed that foreign public and private investors have allocated US\$ 1 billion to microfinance, and have already committed about US\$ 680 million to MFIs through debt, equity, and guarantees.

Foreign investment is defined in the study as quasi-commercial investment in equity, debt, and guarantees, made by private-sector funding arms of bilateral and multilateral donor agencies (*development investors*); and by socially-motivated, privately-managed investment funds financed by both public and private capital (*social investment funds*). Although social investment funds are smaller than development investor funds, they are growing dramatically. Both types of investors generally take a commercial approach in the rigor of their investment analysis and monitoring, but are not fully commercial in the sense of trying to maximize profit. They take greater risks and accept lower returns than purely profit-maximizing investors. The study excluded grants, soft loans from traditional donor agencies, and all domestic sources, such as commercial bank loans, bond issues, and deposits.

Based on responses from the foreign investors interviewed, the study results indicate that:

- Almost 90 percent of this US\$ 1 billion in foreign investment comes directly and indirectly from public sources.
- Total foreign investment amounts to a small percent of the estimated global total of microfinance loans outstanding delivered through a variety of institutions,

¹ Microfinance institutions are defined here as financial intermediaries, structured as non-profit organizations, non-banking financial intermediaries, and microfinance banks, that provide microcredit and other financial services to the poor.



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1818 H Street, NW
Washington DC 20433

Tel: 202 473 9594
Fax: 202 522 3744

E-mail:
cgap@worldbank.org

Web:
www.cgap.org

including NGOs, commercial banks, state-owned and postal banks, credit unions, and others (US\$ 15 billion).²

- About 50 percent of foreign investment goes to Eastern Europe and Central Asia, and 28 percent to Latin America and the Caribbean.
- Debt instruments (commercial and quasi-commercial loans) comprise 73 percent of all foreign investment, with equity (20 percent) and guarantees (6 percent) far behind.
- About 70 percent of foreign investment is denominated in hard currency.
- Capital invested in social investment funds is expected to double to about US\$ 565 million by mid-2004, from US\$ 270 million in mid-2003.

Scope of Study

Thirty-six existing development investors and social investment funds, plus ten new social investment funds (see table below), were surveyed to determine the following characteristics of their investments in microfinance institutions:

- Fund size
- Geographic focus
- Proportion of funds committed
- Financing instruments used
- Currency of investment
- Expected capital increases

Data was gathered from the Microfinance Information eXchange (the MIX)³ and requested directly from investors. Development investors and social investment fund managers were also invited to comment on the preliminary findings of the study.

The results presented are based on responses from the 36 development investors and social investment funds surveyed, unless noted differently. Funds planned after the survey closed in July 2003 (such as the responsAbility fund) have not been included in this paper. Given the diffuse and evolving nature of

the industry, this list is unlikely to include all such foreign investment sources for microfinance. Although social investment funds are presented as one category of foreign investor, they comprise an extremely diverse set of institutions. Funds differ in their profit orientation, their level of private funding, and their business model. Further research is required to better categorize social investment funds and analyze their performance.

Study Results

Volume and Source of Foreign Investment

As of June 30, 2003, the development investors and social investment funds surveyed have allocated over US\$ 1 billion for the microfinance industry. About US\$ 900 million is in public funds from development investors, and about US\$ 250 million is in public and private money from social investment funds. However, about one-half of the capital invested in the social investment funds was invested by development investors. After adjusting for this double accounting, the dominance of public funding is clear: US\$ 1,025 million (89 percent) comes from development investors and US\$ 125 million (11 percent) comes from private participants in social investment funds. These private participants include individuals, private foundations, pension funds, insurance companies, and other institutions.

Foreign sources of funding, including foreign investment and donor grants and subsidized loans, probably comprise only a small percentage of the financing for the US\$ 15 billion global microloan port-

² The US\$ 15 billion represents a rough estimate of the combined microloan portfolios of institutions that conduct microfinance lending, such as NGOs, non-banking financial institutions (NBFIs), state-owned banks, rural banks, postal banks, credit unions, cooperatives, and other institutions. Almost half of the US\$ 15 billion loan portfolio is held by NGOs, NBFIs, credit unions, and cooperatives. For some rural and agricultural banks, the institution's entire loan portfolio was considered due to the difficulty of breaking out microfinance loans only, so this estimate probably errs on the high side.

³ The MIX website is www.themix.org.

Table 1 Sources of Foreign Investment for Microfinance Surveyed (by category)

Development Investors	Social Investment Funds	
<p>Multilateral</p> <ul style="list-style-type: none"> • CAF (Corporación Andina de Fomento) • EBRD (European Bank for Reconstruction and Development) • IFC (International Finance Corporation) • IADB Multilateral Investment Fund (Inter-American Development Bank) • OPEC Fund (Organization of Petroleum Exporting Countries) <p>Bilateral</p> <ul style="list-style-type: none"> • BIO (Belgiische Investerings Maatschappij voor Ontwikkelingslanden) • DEG (Deutsche Investitions- und Entwicklungsgesellschaft) • FMO (Nederlandse Financierings Maatschappij voor Ontwikkelingslanden NV) • KfW (Kreditanstalt für Wiederaufbau) • USAID Development Credit Authority (United States Agency for International Development) 	<p>Predominantly Debt Funds</p> <ul style="list-style-type: none"> • Alterfin • Calvert Foundation • CORDAID (Catholic Organization for Relief and Development Aid) • Creditosud • Développement International Desjardins (Partnership Fund, FONIDI Fund) • Dexia Microcredit Fund • Etimos • Hivos-Triodos Fund • LA-CIF (Latin American Challenge Investment Fund) • Oikocredit • Luxmint-ADA <p>Guarantee Funds</p> <ul style="list-style-type: none"> • FIG (Fonds International de Garantie) • ACCIÓN Latin American Bridge Fund • Deutsche Bank Microcredit Development Fund 	<p>Predominantly Equity Funds</p> <ul style="list-style-type: none"> • ACCIÓN Gateway Fund • AfriCap Microfinance Fund • IMI-AG (Internationale Micro Investitionen Aktiengesellschaft) • La Fayette Participations, Horus Banque et Finance • Opportunity International–Opportunity Transformation Investments • ProFund • SIDI (Société d'Investissement et de Développement International) <p>Mixed Debt and Equity Funds</p> <ul style="list-style-type: none"> • Open Society Institute • Sarona Global Investment Fund • Unitus • Triodos Fair Share Fund • Triodos-Doen Foundation <p>New Funds (planned as of July 2003)</p> <ul style="list-style-type: none"> • PlaNet Finance Revolving Fund • Deutsche Bank Fund • Microvest • Positive Fund • AIM (ACCIÓN Investments in Microfinance) • ShoreCap Fund • LA-CIF MFI Equity Fund • LA-CIF High Risk Fund • Unitus Debt Fund • Soros Fund

folio. Although cumulative donor grants and subsidized loans to MFIs over the past 5–10 years probably total about US\$ 5–10 billion, most MFIs are likely to have spent these funds to get technical assistance and cover operating deficits. Furthermore, most institutions making microloans, such as state-owned banks and cooperatives, are not eligible for foreign investment and donor funding, or choose not to access these sources. When combined, therefore, the US\$ 1 billion in foreign investment, plus any remaining balance of donor funds

held by MFIs, is likely to be dwarfed by domestic savings, bank loans, and retained earnings as sources of funds for the microfinance industry. And although foreign grants can be a catalyst for the growth of young MFIs and for institution building, the balance between foreign and domestic capital sources often shifts as an MFI matures.

Table 2 Foreign Investment for Microfinance by Region (in US\$ millions)

	<i>Eastern Europe/ Central Asia</i>	<i>Latin America/ Caribbean</i>	<i>Africa</i>	<i>East Asia/ Pacific</i>	<i>Middle East</i>	<i>South Asia</i>	<i>TOTAL</i>
Development Investors	\$547.9 (61.1%)	\$186.3 (20.8%)	\$57.8 (6.4%)	\$32.2 (3.6%)	\$34.1 (3.8%)	\$18.8 (2.1%)	\$877.2* (97.8%)
Social Investment Funds	\$29.9 (11.8%)	\$138.3 (54.4%)	\$25.0 (9.8%)	\$9.5 (3.7%)	\$2.4 (0.9%)	\$7.3 (2.9%)	\$212.4* (83.5%)
TOTAL ALLOCATED CAPITAL	\$577.8 (50.2%)	\$324.7 (28.2%)	\$82.8 (7.2%)	\$41.7 (3.6%)	\$36.5 (3.2%)	\$26.1 (2.3%)	\$1,089.5* (94.7%)

In cases where specific investment policy or goals are not stated, regional allocations reflect actual portfolio allocations.

*Only about 5.3% of total foreign investment for microfinance has not been allocated by region. Development investors have not allocated US\$ 20.2 million and social investment funds have not allocated US\$ 41.8 million.

Geographic Focus of Foreign Investment

As Table 2 illustrates, almost 80 percent of foreign investment for microfinance is invested in or targeted toward Eastern Europe and Central Asia, followed by Latin America and the Caribbean. However, when the two categories of foreign investment are examined separately, different regional emphases emerge. Development investors are focused on Eastern Europe and Central Asia, led by the European Bank for Reconstruction and Development, which alone provides more than 40 percent of all foreign investment in microfinance by development investors. Social investment funds have allocated more than half of their capital to Latin America and the Caribbean.

The largest and poorest microfinance markets have attracted relatively little foreign investment. For example, although the East Asia, Pacific, and South Asia regions are home to over 66 percent of the world's poor,⁴ they are allocated only 5.7 percent of capital from development investors and 6.6 percent of capital from social investment funds. One possible explanation is that MFIs in Asia have been able to secure funding from governments and regional

multilateral lenders at subsidized rates more easily than institutions in other regions. In addition, many profitable MFIs in East and South Asia have successfully intermediated funding from domestic sources, including deposits and bank loans.

In Africa, according to some fund managers, donor funds may be "crowding out" quasi-commercial foreign investment in profitable MFIs. Furthermore, West African microfinance is largely conducted by credit unions that are not structured for equity investment, and that typically use member savings to fund credit operations.

Proportion of Available Funds Committed by Social Investment Funds

The regional allocations indicated in Table 2 do not necessarily reflect the volume of commitments (funds disbursed, or earmarked for disbursement, to specific MFIs). While data on commitments is unavailable from development investors, social investment funds have committed about 79 percent of the foreign

⁴ IFAD Strategy for Rural Poverty Reduction in Asia and the Pacific, Asia Division, Project Management Department, February 2002.

Table 3 Committed Portion of Investment Allocated Regionally by Social Investment Funds (in US\$ millions)

	<i>Eastern Europe/ Central Asia</i>	<i>Latin America/ Caribbean</i>	<i>Africa</i>	<i>East Asia/ Pacific</i>	<i>Middle East</i>	<i>South Asia</i>	<i>TOTAL</i>
Amount Committed	\$26.7	\$113.1	\$10.1	\$8.0	\$2.3	\$7.0	\$167.3
Percent of Amount Allocated	89.2%	81.8%	40.5%	84.5%	98.1%	95.5%	78.7%

In cases where specific investment policy or goals are not stated, regional allocations reflect actual portfolio allocations. Total capital allocated regionally, but uncommitted, by social investment funds is US\$ 45.1 million (or 21.3% of total capital for microfinance by social investment funds).

Table 4 Instruments Used in Foreign Investment for Microfinance (by investor type)

	<i>Debt</i>	<i>Equity</i>	<i>Guarantees</i>	<i>Not Specified</i>
Development Investors	77.5%	16.7%	5.7%	0.1%
Social Investment Funds	58.1%	32.5%	8.5%	0.9%
TOTAL CAPITAL	73.2%	20.2%	6.3%	0.3%

In cases where specific investment policy or goals are not stated, instrument allocations reflect current actual portfolio allocations.

investment they have allocated by region. However, only about 41 percent of the funds allocated to Africa are committed. This gap can be explained partly by the fact that the AfriCap fund, which comprises a significant portion of allocated funding to the region, recently commenced investment activities and consequently has not yet committed most of its funds.

Financial Instruments

Most foreign investment is made through debt instruments, although social investment funds, particularly the new ones, are more equity-oriented. In part, this reliance on debt reflects the fact that most MFIs are not structured as joint stock companies. More generally, investors are unsure of the potential of

Table 5 Currency of Foreign Investment for Microfinance (by investor type)

	<i>Hard Currency</i>	<i>Local Currency</i>	<i>Not Specified</i>
Development Investors	74.7%	5.5%	19.8%
Social Investment Funds	48.9%	20.0%	31.1%
TOTAL CAPITAL	69.0%	8.7%	22.3%

For investors who have not stated specific investment policy or goals, currency allocations reflect current actual portfolio allocations.

equity investment at this early stage of foreign investment in the industry, and view debt instruments as the best way to become familiar with an MFI's operations and management. Moreover, debt ensures a regular flow of interest income.

Some social investment fund managers indicate that foreign investors tend to chase the same few institutions. Alex Silva of ProFund, LLC, explains that "particularly in Latin America, international financial institutions (IFIs) should take care not to crowd out the investment funds that they themselves have funded, nor private investors."

Currency of Foreign Investment

Foreign investment in microfinance institutions is predominantly in hard currency (see Table 5).

Compared to development investors, social investment funds have committed four times as much funding in local currency, proportionately. This follows because more of their investment is in equity form.

Many MFIs that fund their local currency loan portfolios with hard currency borrowings find themselves facing large adverse exchange-rate positions. Foreign exchange risk may be covered through structures such as hard currency deposits as guarantees to back local bank loans, but the cost of using these structures can make foreign loans as expensive, if not more expensive, as local currency borrowings.

Expected Capital Increases and Trends in Social Investment Funds

Social investment funds are growing fast: capital is projected to more than double from mid-2003 to mid-2004 (from US\$ 270 million to US\$ 565 million), through increased allocations to existing funds⁵ (US\$ 85 million) and the creation of 10 new funds⁶ during this period (which expect to raise aggregate capital of US\$ 210 million). The new social investment funds also appear to be more equity-focused than existing ones, with a projected split of 60:40, equity to debt.

The industry will soon see its first fund of funds. The Positive Fund will invest most of its assets in other social investment funds that are mainly focused on microfinance. Investment and grant partnerships, such as Unitus and ShoreCap, are another category of social investment fund that is growing fast. These funds maintain grant facilities dedicated to technical assistance in amounts roughly 20 percent of the size of the fund's capital. Technical assistance funding is provided to institutions in which the fund invests to build the systems and skills required to make the best use of investments, and thereby attain scale.

Increasingly, microfinance networks are setting up social investment funds. These networks, which typically function as a group of independent affiliates, are establishing investment arms to provide funding and governance, in addition to the technical assistance that most already offer to member MFIs. These funds include ACCIÓN Investments in Microfinance and Opportunity International's Opportunity Transformation Investments.

Building capacity along with outside, private investment can help microfinance institutions attain the

Table 6 Networks Forming Social Investment Funds

- ACCIÓN
- FINCA
- Opportunity International
- Women's World Banking
- World Vision

quality of management and systems necessary to scale up and attract further investment. In addition, investors in social investment funds may be reassured by the technical assistance offered. But some in the industry argue that combining network management, investment, governance and capacity building in the

⁵ Data from 22 of 26 investors.

⁶ The 10 new funds include 3 debt funds, 4 primarily equity funds, and 4 mixed debt/equity funds.

same organization can also produce conflicts of interest. A network whose mission is to act in the best interests of its members, but which also seeks investment returns from some of these members, may be pulled between the interests of its affiliates and its own investors. Social investment funds that offer donor-funded technical assistance may be tempted to market these to MFIs in which they have invested. Some social investment fund managers argue that although technical assistance grants are valuable, combining them with investment may signal to profit-maximizing investors that microfinance investment must be subsidized or remain donor-driven.

The few social investment funds that are completely privately funded, such as Unitus and the Dexia Microcredit Fund, are generally more transparent about performance than funds capitalized with public funding. In Dexia's case, about 55 percent of its capital is from individual private clients; 42 percent from institutional investors, pension funds, and insurance companies; and 3 percent from socially-responsible investment funds.⁷ Perhaps in response to the private nature of its investors, the Dexia Fund's management at Blue Orchard Finance, S.A., produce a public quarterly performance report that indicates cumulative and annual returns and benchmarks performance against emerging market indices and money market rates.

Conclusion

Foreign investment is an important and growing component of total funding for the microfinance industry, yet it remains small relative to domestic sources of funds. More than two-thirds of all foreign investment is hard-currency debt, and about 80 percent of investment targets Latin America and Eastern Europe. In most countries, domestic financing in the form of deposits and bank loans remains the predominant source of funding for microfinance.

Although foreign investment can play an important role in improving governance, catalyzing local financing, and increasing MFI transparency, these benefits are not evenly distributed. Development investors often target the few mature institutions that social investment funds invest in, rather than other promising, smaller MFIs.

The volume of commercially-oriented foreign investment in microfinance will only increase and reach deeper markets as investors and MFIs adopt greater transparency and standardization. Few social investment funds have a track record, in part because no standard forms of disclosure or benchmarks have been developed to compare performance among funds. Increasing the transparency of social investment funds is essential if they are to begin intermediating between profit-maximizing private investors and microfinance institutions.

⁷Blue Orchard Finance, S.A., Quarterly Newsletter (July 2003), www.blueorchard.ch/medialibrary/website/Newsletter_2003_07.pdf

Appendix Investors Surveyed

Type	Fund Name	Regions of Operation	% of Local Currency	% of Equity Investments	% of Debt Investments	% of Guarantees
OVER \$100 MILLION						
D	EBRD	ECA	0%	6%	94%	0%
D	IFC	ECA, MENA, LAC, Africa, S Asia, E Asia	N/A	43%	57%	0%
D	KfW	ECA, S Asia, E Asia, Africa, MENA, LAC	N/A	2%	86%	12%
\$40–100 MILLION						
D	FMO	LAC, Africa, S Asia, ECA, E Asia	80%	20%	80%	0%
D	IADB Multilateral Investment Fund	LAC	29%	47%	53%	0%
S	IMI-AG	ECA, LAC, Africa, E Asia	0%	100%	0%	0%
S	Oikocredit	LAC, E Asia, Africa, ECA	21%	24%	74%	2%
\$20–40 MILLION						
D	CAF	LAC	0%	19%	72%	9%
D	DEG	LAC, ECA, E Asia, Africa	0%	44%	56%	0%
S	Dexia Microcredit Fund	LAC, E Asia, S Asia, ECA, Africa	21%	0%	96%	4%
D	OPEC Fund	Africa, LAC, Asia	0%	0%	100%	0%
S	ProFund	LAC	75%	75%	25%	0%
D	USAID Development Credit Authority	Africa, Asia, MENA, LAC	N/A	0%	0%	100%
\$10–20 MILLION						
S	AfriCap Microfinance Fund	Africa	N/A	100%	0%	0%
D	BIO	LAC, Africa, Asia	N/A	60%	40%	0%
S	Calvert Foundation	Africa, E Asia, S Asia, ECA, LAC	0%	0%	100%	0%
S	CORDAID	Africa, E Asia, S Asia, ECA, LAC	N/A	0%	100%	0%
S	Hivos-Triodos Fund	LAC, Africa, S Asia, MENA, E Asia	38%	25%	73%	2%
S	LA-CIF	LAC	N/A	0%	100%	0%
S	Open Society Institute	ECA, Africa	N/A	25%	25%	50%
S	Triodos-Doen Foundation	LAC, Africa, MENA, S Asia, E Asia, ECA	25%	19%	77%	4%
\$5–10 MILLION						
S	Développement Int'l. Desjardins (Partnership Fund, FONIDI Fund)	LAC	N/A	28%	72%	0%

Type: **D** = Development investor; **S** = Social investment fund

Regions: **ECA** = Central and Eastern Europe and Central Asia; **MENA** = Middle East / North Africa; **LAC** = Latin America and Caribbean; **S Asia** = South Asia; **SE Asia** = Southeast Asia; **E Asia** = East Asia/Pacific

Appendix Investors Surveyed (continued)

Type	Fund Name	Regions of Operation	% of Local Currency	% of Equity Investments	% of Debt Investments	% of Guarantees
\$5-10 MILLION continued						
S	ACCIÓN Latin American Bridge Fund	LAC	0%	0%	0%	100%
S	Opportunity International-Opportunity Transformation Investments	ECA	0%	90%	10%	0%
S	Unitus	LAC, S Asia	N/A	6%	66%	28%
\$1-5 MILLION						
S	ACCIÓN Gateway Fund	LAC	80%	100%	0%	0%
S	Alterfin	LAC, E Asia, Africa	1%	4%	96%	0%
S	CreditoSud	LAC	0%	0%	100%	0%
S	Deutsche Bank Microcredit Development Fund	LAC, S Asia, ECA, E Asia, Africa	100%	0%	0%	100%
S	Etimos	Italy, LAC, Africa	N/A	N/A	N/A	N/A
S	FIG	LAC, Africa	0%	0%	0%	100%
S	Luxmint-ADA	LAC, Africa	0%	10%	84%	6%
S	Sarona Global Investment Fund	LAC, ECA	0%	25%	75%	0%
S	SIDI	MENA, Africa, E Asia, ECA, LAC	20%	62%	38%	0%
S	Triodos Fair Share Fund	E Asia, LAC	100%	35%	65%	0%
UNDER \$1 MILLION						
S	La Fayette Participations, Horus Banque et Finance	Africa, E Asia	N/A	100%	0%	0%

Type: D = Development investor; S = Social investment fund

Regions: ECA = Central and Eastern Europe and Central Asia; MENA = Middle East / North Africa;

LAC = Latin America and Caribbean; S Asia = South Asia; SE Asia = Southeast Asia;

E Asia = East Asia/Pacific

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