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ROLE REVERSAL

Are Public Development Institutions Crowding Out Private Investment in Microfinance?

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This paper focuses on direct retail lending to microfinance institutions. Equity and guarantees are not addressed, nor are lending via apexes, or debt or equity investments in microfinance investment vehicles.

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MicroRate

MicroRate pioneered the rating of microfinance institutions in 1996. Today, MicroRate continues to be the premier microfinance rating agency in Latin America and Africa. The firm is headquartered in the Washington D.C. with offices in Lima, Peru and Johannesburg, South Africa. MicroRate has conducted over 300 performance ratings throughout Latin America and Africa and offers credit ratings, structured finance ratings and social performance assessments. MicroRate also leverages its 10 years of microfinance expertise to offer investors microfinance portfolio monitoring services as well as tailored microfinance research and analysis.

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Microfinance Analytics

Julie Abrams heads Microfinance Analytics, a consulting firm dedicated to the use of empirical analysis to further microfinance's transition to capital markets and full integration into the financial sector. The firm conducts financial, investment, and data analyses; emphasizes use of financial risk management in microfinance; and promotes capital markets development.

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Role Reversal:

Are Public Development Institutions Crowding Out Private Investment in Microfinance?

This paper focuses on direct retail lending to microfinance institutions. Equity and guarantees are not addressed, nor are lending via apexes, or debt or equity investments in microfinance investment vehicles.

EXECUTIVE SUMMARY

The rapid growth of foreign private lending to microfinance institutions (MFIs) in the last several years has led to a surprising reversal of roles between government-owned development institutions and private lenders. Development institutions (International Financial Institutions -"IFIs"[1]) are concentrating their loans in the strongest MFIs, leaving private lenders to look for opportunities among smaller, riskier borrowers. Development institutions are "crowding" private lenders out of the best MFIs.

In the last three years, the volume of international private lending has exploded: in 2005 alone, outstanding loans doubled to nearly $1 billion. IFIs publicly claim to take risks the private sector is unwilling to take. One would therefore have expected government-owned development institutions to shift their lending to more risky MFIs as soon as private lenders entered the field. The opposite is happening. Development agencies are today heavily concentrating their funding in the largest and most successful MFIs, exactly the target investment market of private investors.

How did this counterintuitive funding approach happen? A MicroRate commissioned study of funding patterns confirmed that IFIs are not *complementing* private lenders, they are *crowding them out* of the most attractive parts of the MFI market. IFIs nearly doubled (88% increase) their direct funding to top- rated MFIs in 2005. In the largest and most successful MFIs, IFIs are the dominant and growing foreign funding source. MIX[2] data on over 160 MFIs confirm this trend. A number of the largest MFIs in the MIX database have received *all* of their foreign loans from IFIs. In some cases, private lenders wanted to provide funding to an MFI, but were unable to do so because they were unable to match terms offered by IFIs.

Why are development institutions concentrating on MFIs that can attract private lenders? The answer has to do with the nature of IFIs. Their official mission is to go where the private sector does not yet dare to tread; to assume risks that private capital would find unacceptable. Often, IFIs have adhered to these principles. However, in recent years the risk-based division of labor between IFIs and private capital has broken down.

Whether top decision-makers are aware of it or not, there are powerful incentives for IFIs to maximize their microfinance exposure, and to do so by concentrating on the largest and safest borrowers. Microfinance has acquired such a positive image, that a sizeable exposure in this sector has become a sign of an IFI's commitment to development. This is reinforced by an IFI's need to disburse its microfinance budget each year. Since IFIs are not primarily profit-driven, their success is often defined by the amounts that have been lent. If a budget has been allocated to microfinance, that budget must be spent – and spending it on a few large loans to top MFIs is far quicker, cheaper, and less risky than lending to, and nurturing immature institutions.

[1] "IFIs" in this paper refers to an international financial institution (IFI) that is a bilateral or multilateral development agency. This study limits its focus to development institutions that are more than 50% government-owned, and whose microfinance portfolio includes direct loans to retail microfinance institutions. Many IFIs also lend directly to governments, or to second tier funding channels, known as apex funds. A list of the IFIs included in this study is found in Appendix 1.
[2] MIX (Microfinance Information eXchange) is a global web-based microfinance data and information source. www.themix.org.

The rapid emergence of a large number of private lenders is one of the most encouraging aspects of microfinance. If all of those among the poor who can use credit productively are to be reached, then vast amounts of private funding will be needed in the future. IFIs, large as they are, cannot come close to meeting the future funding needs of MFIs. Only private capital can provide that kind of money. By forcing private lenders out of the most lucrative segment of microfinance, IFIs are hampering the development of the very institutions on which the sector will depend in the long run.

RECOMMENDATIONS: WHAT ROLE *SHOULD* IFIs PLAY?

> *"…IFIs, with their low-cost public money, should move away from the same regulated MFIs they have funded over the past several years and encourage them to develop their own links to domestic capital markets. This means focusing more on the next generation of strong institutions, offering seed capital and support for the development or transformation of this new crop of stars."*
>
> - From CGAP's "Access to All: Building Inclusive Financial Systems."[3]

How can IFIs best leverage their microfinance capital going forward? What roles can they play given the rapidly changing landscape of microfinance drawing in ever-increasing amounts of private capital? How does an IFI know when it has accomplished its mission and ought to move on? Their best role is to strengthen the overall capacity and transparency of the industry, and to act as a catalyst for private capital *that would not otherwise invest in microfinance*.

1. **First make IFI funding transparent**
2. **Maximize commercial participation in innovative capital markets transactions**
3. **Seed the next generation of microfinance institutions**
4. **Help develop mechanisms to cover foreign exchange risk**
5. **Promote further private sector channels for microfinance, and finance industry infrastructure**

CONCLUSIONS

IFIs have naturally gravitated towards funding the largest and least risky microfinance institutions. Senior decision-makers, be they members of the Board of Directors or top managers, have not prevented IFIs from opting for volume and low risk at the expense of development impact. This must change. What is happening in IFIs today has its roots in the governance of the microfinance operations of those institutions. An effective governance structure is necessary to compel public development institutions to counter this tendency and act as catalysts for - not substitutes to - private lending.

Reform of IFI lending behavior would be made easier if their microfinance operations were more open to public scrutiny with full and timely disclosure of the details of loans to MFIs. To dampen the appetite of IFIs for funding top tier MFIs, it would help if private lenders were able to monitor IFI lending. It is difficult for individual lenders to do this, but as a group, perhaps through the proposed Microfinance Investor Association, they could evaluate IFI loans as they are being approved and draw attention to those that displace private funding.

Microfinance is a dynamic industry where the pace of change seems to be accelerating daily. In this environment, IFIs urgently need to refocus on how to complement and attract the private sector instead of preempting it and competing with it, as they are now often doing.

[3] Helms, Brigit. *Access for All: Building Inclusive Financial Systems*. CGAP: Washington, D.C.2006, page 103.

1. INTRODUCTION

The rapid growth of foreign private lending to microfinance institutions (MFIs) in the last several years has led to a surprising reversal of roles between government-owned development agencies and private lenders. Development institutions (International Financial Institutions -"IFIs"[4]) are concentrating their loans in the strongest MFIs, leaving private lenders to look for opportunities among smaller, riskier borrowers. Development institutions are "crowding" private lenders out of the best MFIs.

But first, a brief word about how this report came to be. MicroRate analyzes microfinance institutions. Hundreds of MFI ratings over ten years have allowed MicroRate to observe funding patterns. One of those patterns is the growing willingness of foreign private lenders to invest in MFIs. In the last three years, the volume of international private lending has exploded: in 2005 alone, outstanding loans doubled to nearly $1 billion. It was surprising to see that official development institutions, far from supporting this strong private commitment, as their policies require them to do, are often undermining it. IFIs publicly claim to take risks the private sector is unwilling to take. One would therefore have expected government-owned development institutions to shift their lending to more risky MFIs as soon as private lenders entered the field. The opposite is happening. Development agencies are today heavily concentrating their funding in the largest and most successful MFIs, exactly the target investment market of private investors. IFIs covered by this paper include the large international and regional development banks and institutions (IFC, EBRD, BCIE, CAF, etc.). But they also include national development finance institutions like KfW (Germany), at present the largest source of loans for MFIs, and AFD (France). Finally, there is AECI, a part of the Spanish foreign ministry, which is not a development bank, but a window through which budget allocations are channeled to microfinance. In terms of amounts lent to MFIs, KfW leads, with AECI and IFC, in second and third place. Also included in the analysis are IFIs that are majority owned by their governments, such as FMO (Netherlands) and BIO (Belgium). Appendix 1 contains a description of IFIs included in this analysis.

How did this counterintuitive funding approach happen? We decided to investigate. Backed by a grant from Calmeadow, a Canadian foundation with a distinguished record in microfinance, MicroRate commissioned a study of funding patterns in microfinance. Research confirmed what we had observed in our ratings: IFIs are not *complementing* private lenders; they are *crowding them out* of the most attractive parts of the MFI market. This report documents what we found. IFIs nearly doubled (88% increase) their direct funding to *"alpha"* rated MFIs in 2005 (see section 3). In the largest and most successful MFIs, IFIs are the dominant and growing foreign funding source. MIX[5] data on over 160 MFIs confirm this trend. A number of the largest MFIs in the MIX database have received *all* of their foreign loans from IFIs. Section 4 cites examples of cases where private lenders wanted to provide funding to an MFI, but were unable to do so because they could not match the terms offered by IFIs.

Which leads to the question: why are development institutions concentrating on MFIs that can attract private lenders? The answer has to do with the nature of IFIs. Their official mission is to go where the private sector does not yet dare to tread; to assume risks that private capital would find unacceptable. For example, FMO (Netherlands) puts it succinctly, stating that, "*thanks in part to its relationship with the Dutch government, FMO is able to take risks which commercial financiers are not - or not yet - prepared to take.*"[6] The policy statements of many IFIs contain such language. Often, IFIs have adhered to these principles. As described in section 6, some IFIs have been very effective as catalysts that mobilize private funding. Indeed, IFIs have been instrumental in a number of innovative transactions, including creation of some of the private vehicles

[4] "IFIs" in this paper refers to an international financial institution (IFI) that is a bilateral or multilateral development agency. This study limits its focus to development institutions that are more than 50% government-owned, and whose microfinance portfolio includes direct loans to retail microfinance institutions. Many IFIs also lend directly to governments, or to second tier funding channels, known as apex funds. A list of the IFIs included in this study is found in Appendix 1.

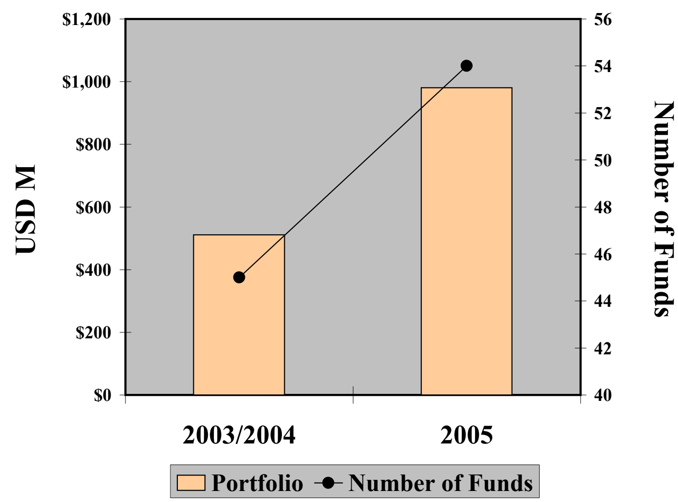
[5] MIX (Microfinance Information eXchange) is a global web-based microfinance data and information source. www.themix.org.

[6] FMO. Program Description. The Hague: FMO, 2006.

that now lend to MFIs. So why has the risk-based division of labor between IFIs and private capital broken down in recent years?

One answer could be that the rapid emergence of private lending to MFIs has taken IFIs by surprise. The number and size of so-called Microfinance Investment Vehicles (MIVs) has recently mushroomed, as can be seen in Chart 1. In the last two years, available private and public foreign funding has grown much faster than the capacity of top-rated MFIs to absorb these funds. The loan portfolio of Latin American MFIs tracked by MicroRate has grown by about 40% annually since 2001. MicroBanking Bulletin data published by the MIX, which cover over 300 MFIs, show a similar growth rate (36%).[7] Forty percent compound annual growth is extremely fast growth. But private lending nearly doubled in 2005 from $ 513 M to $ 981 M[8], while IFI microfinance exposure jumped from over $1 B to $2.4 B from 2003 to 2005, with an additional $750 million in IFI funding to be invested in 2006. By the end of 2005 IFIs had invested $1.5 billion directly in MFIs.[9]

Chart 1: MIV Portfolio and Number of Funds, 2003/2004 and 2005



Capital markets instruments have been an important element in the accelerating flow of private funding for microfinance. Bond issues, securitizations, collateralized debt obligations and many varieties of funds are all channeling private foreign funding to MFIs, as seen in Table 1. The number of transactions is growing, and at the same time, average deal size is getting significantly larger, with just three transactions in 2006 accounting for over $ 300 million.

Because the situation is changing so quickly, top IFI decision-makers may not be aware of the extent to which their loans are displacing private funding. A look at official IFI announcements of loans to MFIs supports this impression. IFIs tend to emphasize the unique role they play, and imply, or even sometimes assert outright, that private funds are not available at suitable conditions, such as in the case of KfW lending to Compartamos, described in box 2 of section 5. Whether top decision-makers are aware of it or not, there are powerful incentives for IFIs to maximize their microfinance exposure, and to do so by concentrating on the largest and safest borrowers. A strong reason is the need for IFIs to demonstrate their development engagement. Microfinance has acquired such a positive image, that a sizeable exposure in this sector has become a sign of an IFI's commitment to development. This is reinforced by an IFI's need to disburse its microfinance budget each year, leading to a "*built-in conflict between volume and quality targets*."[10] IFIs are not primarily profit-driven, thus success is often defined by the amounts that have been lent. Volume becomes a proxy for development impact. If a budget has been allocated to microfinance, that budget must be spent – and spending it on a few large loans to top MFIs is far quicker, cheaper, and less risky than lending to, and nurturing immature institutions. The tendency of IFIs to bulk up their budgets with microfinance operations has given rise to what some call "trophy lending," where IFIs make MFI loans not where they are most needed but where they can be placed with less expense and risk. As CGAP described in a recent

[7] MBB. *Trendlines 2001-2004 Benchmarks*. Washington: MBB, 2006.
MicroBanking Bulletin is a leading benchmark source for the microfinance industry. www.mixmbb.org.
[8] MicroRate. *Microfinance Investment Vehicles: An Emerging Asset Class*. MicroRate, Arlington, VA: 2006, page 2.
[9] Reille, Xavier, Hannah Seidek, and Nicole Pasricha. *CGAP IFI Survey 2006.* CGAP: Washington, D.C, 2006, pages 8-9.
[10] Berglöf, Erik. *Results Measurement at EBRD: Current Practices, Lessons Learned*. PSD Forum 2006. London: EBRD, 2006, page 21.

aid effectiveness study, "*development agencies always face pressure to defend their budget and staff levels by disbursing high funding volumes…the problem is widely recognized and deplored*."[11] AECI, the Spanish aid agency, is an example of a public funder that is disbursing large loans to top MFIs. It receives a large annual budget allocation for microfinance (currently € 100 million). Clearly, it is easier to make a few large loans to top-rated MFIs - to go for the "low-hanging fruit" - than to fund smaller, risky institutions. AECI is an extreme case, because it is a political agency. But this tendency is present to a greater or lesser extent in a number of IFIs.

Table 1: Examples of Recent Microfinance Transactions
(Amounts in $, some issued in local currency, denoted "LC")

YEAR	BOND ISSUES	SECURITIZATIONS, COLLATERALIZED DEBT OBLIGATIONS AND IPOS
2001	Fin America LC $ 2 M	
2002	Mibanco LC $ 6 M Compartamos LC $ 5 M	
2003	Mibanco LC $ 9 M Compartamos LC $ 5 M	
2004	Compartamos LC $ 17 M	BlueOrchard Microfinance Securities I $ 40 M
2005	Compartamos LC $ 29 M WWB Colombia LC $ 52 M Faulu Kenya LC $ 7 M ProCredit Ukraine LC $ 10 M ProCredit Kosovo LC $ 9.5 M	BlueOrchard Microfinance Securities II $ 47M Global Commercial Microfinance Consortium $ 75 M European Investment Fund $ 25 M Global Partnership Microfinance Fund $ 2 M
2006	WWB Colombia LC $ 20 M	BlueOrchard Loans for Development (BOLD) with Morgan Stanley Partially LC $ 99 M XXEB $ 60 M BRAC LC $ 180 M MicroVest/Calvert/Dignity Fund $ 2 M Equity Bank IPO LC $ 28 M

The rapid emergence of a large number of private lenders is one of the most encouraging aspects of microfinance. If all of those among the poor who can use credit productively are to be reached, then vast amounts of private funding will be needed in the future. IFIs, large as they are, cannot come close to meeting the future funding needs of MFIs, a fact most IFIs willingly acknowledge. Only private capital can provide that kind of money. By forcing private lenders out of the most lucrative segment of microfinance, IFIs are hampering the development of the very institutions on which the sector will depend in the long run.

[11] Rosenberg, Richard. *Aid Effectiveness in Microfinance: Evaluating Microcredit Projects of the World Bank and the United Nations Development Programme*. Focus Note No. 35. Washington, D.C.: CGAP, 2006, pages 7-8.

2. IFIs PLAYED AN EARLY CATALYTIC ROLE IN ATTRACTING PRIVATE FUNDING TO MICROFINANCE

In the past, IFIs have often been on target in their efforts to promote microfinance. The microfinance sector would not have advanced to where it is today had it not been for the essential role played by international financial institutions (IFIs) in the late 1990's and the early years of this decade.

At a recent microfinance investors' meeting, Steve Hardgrave, formerly of Omidyar Network, noted that IFIs "*have been instrumental in getting the industry to where it is today*."[12] IFIs were ideally placed to actively promote unproven microfinance institutions. Institutions such as the Inter-American Development Bank (through local apex institutions), the European Investment Bank (EIB), Corporación Andina de Fomento (CAF), the International Fund for Agricultural Development (IFAD), and others, were early lenders to today's leading MFIs long before they became household names. The Inter-American Investment Corporation was one of the early funders of pioneer microfinance bank BancoSol. Some, such as International Finance Corporation (IFC), supported about 20 greenfield microfinance institutions, including what have become some of the highly successful ProCredit Banks.[13] The Andean Development Bank (Corporación Andina de Fomento - CAF) had a significant development impact by funding what have since become thirty of Latin America's largest and most successful MFIs. But, like many other IFIs, CAF has found it hard to recognize when it is no longer needed. At the end of 2005 CAF had $53 million invested in 30 MFIs that now boast impressive statistics that would fit nicely in any private investor's investment portfolio: average MFI portfolio size of $ 76 million, aggregate deposits of $ 1.2 billion, past due portfolio of a mere 1.4%, and average return on equity (RoE) of 21%.[14]

Yet, some IFIs do know when to step back and let private funds take their place, such as the Inter-American Development Bank's Multilateral Investment Fund (MIF), which has a good track record in this regard. Aware that private lenders are entering the market, the MIF has insisted on selling assets and not renewing loans to strong MFIs, and has shifted its attention to new and underfunded MFIs to ensure that it does not crowd out private investors. IFIs justly deserve credit for assuming the risk of funding young MFIs at a time when microfinance was much less proven as a sector, and local and foreign private investors were less eager to lend to MFIs. From this perspective, IFIs can count as successes both the MFIs, and the private investors that are now flocking to fund microfinance. The success of MFIs that IFIs helped to fund has also motivated some commercial banks to provide microfinance in domestic markets, known as downscaling. Clearly, IFIs played an important role in early funding of microfinance institutions. But are IFIs still funding these same MFIs, even though by now they have become the industry's success stories? Are they crowding out private investment in the process? This question is addressed in the next section.

3. TOP MFIs RECEIVE DISPROPORTIONATE AMOUNT OF IFI FUNDING

To check whether complaints about IFIs "crowding out" private funders are based on facts, we analyzed IFI debt as a percentage of MicroRate clients' foreign debt for 2004 and 2005 to see how predominant IFI funding was. Any MFIs with no foreign debt at all were excluded from the review. The analysis was limited to the last two complete calendar years so as to capture only recent trends. The results can be seen in Table 2, which shows that IFIs are directing nearly all of their new loans to MicroRate's most creditworthy, *alpha*[15] rated clients. IFIs are concentrating their funding on the largest, most commercially

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[12] Comment at Omidyar Network at Microfinance Investor's Roundtable, Washington, D.C., October 2006.

[13] ProCredit Holding AG is the main shareholder of 19 ProCredit banks in Africa, Latin America and Eastern Europe, providing credit to micro and small enterprises, with nearly € 2 billion in outstanding portfolio.

[14] Soriano, Alejandro and José Eduardo Padrón A. *Analysis of Microfinance Institutions, 2005*. Caracas: CAF, 2006, pages 6-15.

[15] Alpha rated clients are well-functioning, fully credit worthy MFIs. Beta rated MFIs are viable institutions but they present issues and risks that need to be mitigated. These range from moderate (*beta plus*) to major *(beta minus)*.

successful MFIs, as measured by size (gross portfolio), profitability (return on equity - RoE), efficiency (operating expenses/gross portfolio), and portfolio quality (portfolio at risk greater than 30 days - PAR30). Remarkably, IFI exposure in alphas nearly doubled, increasing by 88% in 2005. IFI lending to the beta plus rated MFIs increased by 12%; exposure in the betas remained unchanged, and actually dropped by 25% in MFIs rated beta minus – precisely the kind of up-and- coming institutions where IFI funding is most needed today. Since the average portfolio of alpha rated MicroRate clients is more than three times greater than the beta rated institutions, this implies not only an increasing percentage, but also a *far higher volume* of IFI investment going to alpha rated MFIs. As Table 2 shows, among MicroRate clients, IFIs continue to invest heavily in the most commercially successful MFIs.

Table 2: Average IFI debt concentrations in MicroRate clients by rating type, 2005

	RATING	***Alpha***	***Beta Plus***	***Beta***	***Beta Minus***
1	**Number of MFIs in sample**	12	11	6	5
2	**Average 2005 portfolio ($ million)**	$ 50 M	$14 M	$9 M	$11 M
3	**Average 2005 saving ($ million)**	$77 M (3 MFIs)	$12 M (4 MFIs)	$ 0	$ 0
4	**Average 2005 Return on Equity (RoE)**	28%	22%	13%	15%
5	**Average 2005 operating expenses/loan portfolio**	17%	20%	18%	21%
6	**Average 2005 PAR 30**	2%	3%	6%	5%
7	**Average amount of IFI debt 2004**	$ 1.1 M	$ 1.1 M	$ 0.6 M	$ 0.2 M
8	**Average amount of IFI debt 2005**	$ 2.1 M	$ 1.3 M	$ 0.6 M	$ 0.1 M
9	**Average % increase in IFI debt 2005**	88%	12%	0%	-25%

Source: Analysis of MicroRate data

To determine if this trend was widespread beyond MicroRate clients, we analyzed all MFIs with portfolios of $ 5 million or more included in the MIX[16] database that disclosed performance data. The findings were striking. Table 3 shows that as recently as 2004 and 2005, MFIs with IFI funding had double the portfolio and deposits, and triple to as much as fourteen times the profitability of MFIs without IFI funding. And the amount of IFI debt *continued to increase* in the largest MFIs into 2005, increasing an average of 75% among MFIs with any IFI funding. In this larger pool of MFIs, IFIs also tended to fund better performing MFIs, while MFIs with no IFI debt had lower performance results using these same metrics. As we drilled down into the data, as can be seen in Table 4, it was clear that MFIs with both larger portfolios and greater deposit mobilization tended to have a higher percentage of IFI debt in their foreign funding. Thirty MFIs with gross portfolio above $ 50 million received 90% more IFI funding in 2005 than in 2004. Thirteen MFIs with RoE of over 15% received fully 100% of their foreign funding from IFIs in 2005. It is clear from looking at MicroRate clients and at the MIX database: IFIs heavily fund, and continue to increase concentration of funding in top tier MFIs.

[16] www.themix.org

Table 3: Comparison of MFIs with no IFI debt versus any IFI debt, 2004 and 2005

		2004: Any IFI debt	2004: No IFI debt	2004: Multiple of IFI debt vs. no IFI debt		2005: Any IFI debt	2005: No IFI debt	2005: Multiple of IFI debt vs. no IFI debt
1	Number of MFIs	105	57			117	45	
2	Average portfolio ($ M)	$50 M	$23 M	**2X**		$46 M	$26 M	**2X**
3	Average savings ($ M)	$48 M	$28 M	**2X**		$47 M	$29 M	**2X**
4	Average RoE	17%	6%	**3X**		18%	1%	**14X**
5	Average operating expenses/ loan portfolio	19%	24%	**0.8X**		19%	25%	**0.8X**
6	Average PAR 30	3%	4%	**0.7X**		3%	4%	**0.7X**
7	Average 2004 IFI debt/total foreign debt	68%	---	---		60%	---	---
8	Average 2005 IFI debt/total foreign debt	62%	10%	**0.2X**		61%	---	---
9	Average % increase in IFI debt 2004-2005	71%	---	---		75%	---	---

Source: Analysis of MIX data

Table 4: Average IFI debt concentrations in MIX MFIs (portfolios >$ 5 M), 20042005

		>75% IFI debt	>50% IFI debt	0-50% IFI debt
1	Number of MFIs	49	68	48
2	Average portfolio ($ M)	$58 M	$ 55 M	$35 M
3	Average savings ($ M)	$57 M (27 MFIs)	$51 M (35 MFIs)	$43 M (16 MFIs)
4	Average RoE	16%	15%	22%
5	Average operating expenses/loan portfolio	17%	18%	19%
6	Average PAR 30	3%	3%	3%
7	Average 2004 IFI debt/total foreign debt	90%	81%	31%
8	Average 2005 IFI debt/total foreign debt	93%	85%	28%
9	Average % increase in IFI debt 2004-2005	62%	67%	91%

Source: Analysis of MIX data

The next section provides examples of what this intensive IFI funding looks like on the ground, as it bumps up against the growing number of private investors actively seeking out microfinance investment opportunities.

4. EXAMPLES OF CROWDING OUT BY IFIs

> "*If not applied properly, grants, subsidized loans, and excessive guarantees to financial service providers can undermine or crowd out national or international commercial capital markets and/or domestic savers*." - CGAP Good Practice Guidelines for Funders of Microfinance, October 2006. [17]

Private lenders have increasingly complained about being "crowded out" by IFIs. What exactly is "crowding out?" It can mean IFIs supplying MFIs with any combination of below market loans: below-market interest rates, larger loans whose size is a multiple of a private investor's largest loan size, longer tenors, and extended grace periods not offered by a private investor. Crowding out also occurs when IFIs flood an MFI or even a local microfinance market with capital, preempting the need for further private capital. In extreme cases, below-market IFI loans have led MFIs to prepay a private loan and then take out a new IFI loan, often at a lower interest rate, and for a larger amount. In some instances, MFIs will not renew a private loan, replacing it with cheaper IFI debt. Some IFIs are lending to MFIs with successful deposit programs that presumably could source new capital by promoting savings; other IFIs offer free technical assistance that comes with a loan to the MFI.

To be clear: from the demand side, an MFI is completely justified in accepting IFI loans. MFIs will always shop for the best terms they can get. This is what any savvy financial manager should do. However, from the supply side, it is inappropriate for IFIs to undersell private domestic or foreign sources of funding, and thus make loans to MFIs that could and should fund themselves commercially.

Below are some examples of crowding out. There are many more instances that have taken place. Virtually every private lender to MFIs can cite a list of examples. The ones mentioned here are intended to give a sense of what is occurring.

Crowding out occurs by…

❶ ***...pricing loans at lower interest rates and offering higher volumes than private foreign investors…***

- In four West African countries, an IFI crowded out a private investor by offering 6%, 4-year loans. The private investor, who would typically charge 8%-9%, was unable to place the funds with a number of MFIs due to the underpricing by 200 to 300 basis point below market. Another private investor sought to lend to an MFI in Benin but could not match the IFI rates there either.
- In Eastern Europe, an IFI crowded out a private foreign investor by making a 5.8% fixed rate, 4-year loan to an MFI.
- AECI provided 5%, 10-year euro funding to two Eastern European MFIs in 2005 and 2006: Partner (6 million euros) and Altermodus (2.5 M euros), underpricing a private foreign lender by 250 to 400 basis points, and crowding out its lending to the MFIs in 2006.
- A private investor found that one IFI has underpriced it by about 50-200 basis points, and that IFIs in general are underpricing by as much as 200 to 300 basis points.

Some IFIs are offering fixed rate dollar loans of 5% - 6% with 5-10 year tenors. A prototypical private investor would need to charge at least LIBOR[18] plus 5% to cover the cost of processing the loan and funding costs, or about 10.5%, as of early 2007.

[17] CGAP. *Good Practice Guidelines Funders of Microfinance*. Washington, D.C.: CGAP, October 2006, 2nd edition, page 11. (Revised "Pink Book")

[18] As of early February 2007, LIBOR was at about 5.4%.

❷ ***...or by flooding an MFI or even a country market with large loans which preempt MFIs' needs for additional foreign capital for the time being…***

- As seen in Table 5, EBRD lent to several Eastern European MFIs in 2006 for amounts that were 20-30% of the MFI's gross portfolio value (column 4), and 25%-68% of the MFI's liabilities (column 6).

Table 5: Examples of 2006 EBRD Loans to Eastern European MFIs

MFI	(1) Amount of EBRD Loan (€ M unless noted)	(2) Date of EBRD Loan	(3) 2005 MFI's Gross Portfolio (€ M)	(4) 2005 EBRD Loan as % of MFI's Gross Portfolio	(5) 2005 MFI's Total Liabilities (€ M)	(6) 2005 EBRD Loan as % of MFI's Total Liabilities
EKI, Bosnia[19]	€ 6 M (issued in tranches)	September 2006	€ 27 M	22%	€ 22M	27%
Mikrofin, Bosnia[20]	€ 8 M (including € 4M convertible loan[21])	August 2006	€ 30 M	27%	€ 22M	36%
Microinvest, Tajikistan[22]	€ .23 M (issued in three tranches)	May 2006	€ 0.8 M	29%	€ 0.3 M	68%
Kazakhstan Loan Fund, Kazakhstan[23]	$ 2 M (USD equivalent, loan issued in local currency)	January 2006	€ 9.5M	21%	€ 8 M	25%

Sources: EBRD, European Union, MIX

Similarly, FMO invested in three Cambodian MFIs for amounts also comprising a significant stake of each MFI's gross portfolio and total liabilities (Table 6).

Table 6: Examples of 2006 FMO Loans to Cambodian MFIs

MFI	(1) Amount of FMO Loan ($ M[24])	(2) Date of FMO Loan	(3) 2005 MFI's Gross Portfolio ($ M)	(4) 2005 FMO Loan as % of MFI's Gross Portfolio	(5) 2005 MFI's Total Liabilities ($ M)	(6) 2005 FMO Loan as % of MFI's Total Liabilities
Prasac, Cambodia[25]	$ 3 M	July 2006	$ 11 M	26%	$ 4 M	80%
AMRET, Cambodia[26]	$ 3 M	July 2006	$ 12 M	26%	$ 11 M	28%
CEB, Cambodia[27]	$ 2.5 M	April 2006	$ 6 M	40%	$ 5 M	46%

Sources: FMO, MIX

[19] *EBRD NGO Newsletter*. London: EBRD, 2006, page 5.
[20] Ibid.
[21] According to EBRD, 4 million euros of this may be converted into equity, and it is EBRD's first convertible loan.
[22] European Union. *Bulletin of the European Commission: International organisations and conferences: EBRD Funding*. Brussels: European Union, June 2006.
[23] EBRD. *EBRD Boosts boosts Kazakh MSEs*. London: EBRD, January 2006.
[24] According to FMO, these loans were issued in Cambodian riels, or a combination of riels and US dollars.
[25] FMO. *FMO Boosts Microfinance in Cambodia with Unique Financing.* The Hague: FMO, 2006.
[26] Ibid.
[27] FMO. *Changing the Face of Cambodian Microfinance*. The Hague: FMO, 2006.

Not all IFIs are willing to take on such large exposures as a percentage of an MFI's balance sheet. For instance, IFC will typically not lend more than 10%-15% of an MFI's total liabilities. EBRD notes that its covenants limit its exposure in an MFI at any point in time to 50% of equity. FMO officially states that it does not typically finance greater than 10% of an MFI's assets or 20% of the balance sheet, although exceptions are made for institutions with limited funding alternatives; loan tranches are dispersed accordingly.

❸ ***…or by offering below-market loans so that MFIs do not renew, or in some cases prepay an outstanding loan to a private investor and take a new cheaper loan from an IFI…***

- An Eastern European MFI prepaid its loan to a private investor, and replaced it with an IFI euro loan at 5% fixed rate for a 5-year term.
- A Latin American MFI that had a private loan for $500,000 at a 9% interest rate due in mid 2006 prepaid in 2005, then received a $ 2.5 M loan from an IFI at a fixed dollar rate of 7.99%. The new IFI loan was five times the size of the prior private loan and 101 basis points cheaper.

❹ ***…and by lending to MFIs that already have large local deposit bases.***

- IFC issued a $29 million local- and foreign-currency loan to Mibanco (Peru) in July 2006. Mibanco has a $ 207 M portfolio, $148 M in savings, completed three oversubscribed local bond issues for a total of $ 15 M, and has a 34% return on equity.[28] Mibanco has financed an increasing proportion (currently over 71%) of its portfolio through savings it captures. At the time of the IFC loan, Mibanco had on its books loans from one domestic bank, one international bank, three international private investment funds, and four IFIs (including an earlier loan from IFC), as well as from two domestic apex funds. IFC has justified the loan on the basis that it was the first time any foreign creditor provided local currency funding to MFIs using domestic swap markets.
- In September 2006, EBRD approved a $ 5 million loan to Xac Bank in Mongolia, an MFI whose deposits funded 84% of its portfolio. At the time, MicroVest and other private investors were seeking to lend to Xac Bank, and were crowded out by this new loan. Xac Bank already had international private investor loans from Dexia, Calvert, MicroVest (coming due), ASN Novib, Deutsche Bank, Oikocredit, ShoreCap, Triodos-Doen, and Triodos-Fair Share Fund, in addition to IFC, and two domestic banks. EBRD pointed out this was its first loan in Mongolia, which had just become a member country.

IFIs also offer MFIs technical assistance to accompany their loans, hardly a level playing field with which private investors can compete. Technical assistance funding can be significant: IFIs reported to CGAP that they expected to place $750 million in new technical assistance funding in 2006 alone.[29] While good IFI technical assistance can be of great value to an MFI, offering it as an additional benefit of an IFI loan that a private lender could have provided is certainly not best practice.

In addition to specific instances of crowding out private capital described in this section, many IFIs are generally funding the top tier of MFIs, described in the next section.

5. A FEW EXAMPLES OF RECENT IFI LENDING TO TOP TIER MFIs

The Spanish Government gives below-market loans to top MFIs with non-market tenors and grace periods
The Spanish Government agency AECI[30] issues loans directly to MFIs. Table 7 summarizes publicly announced AECI loans to MFIs from January through October 2006. All loans are significantly below

[28] From MIX Market data.
[29] Reille, Xavier, Hannah Seidek, and Nicole Pasricha. *CGAP IFI Survey 2006.* CGAP: Washington, D.C, 2006, page 6.
[30] Loans are issued through AECI's Fondo de Concesión de Microcréditos (FCM), and issued through the Instituto de Crédito Oficial del Reino de España (ICO).

market in interest rate charged, loan tenor, and grace period of loan. The typical loan is at a maximum of 5% -5.5% fixed interest rate in euros, with a 10-12 year tenor, and frequently providing a 5-year grace period. In no respect are these commercial terms. As a point of comparison, a private fund would typically need to charge about twice as much to deliver a return to its clients. As shown in Table 7, AECI lent four million euros to PSHM (Albania) in 2006, when the MFI already had ten other private foreign investors and five local funding sources. In this instance, PSHM had already received a loan from the Symbiotics Microfinance Loan Obligation at the euro 4.5 year swap rate + 5.17%. The MFI also already had a loan from BlueOrchard at 6-month Euribor +7% in place at the time of the new AECI loan. In Bosnia, AECI lent four million euros to Prizma in 2006, while BlueOrchard had previously issued a loan to the same MFI at the end of 2005 for 500,000 euros at an 8.5% interest rate. This kind of duplication of IFI funding following private funding is quite common by AECI and other IFIs. AECI loans are all issued in hard currency, primarily the euro, requiring the MFI to incur foreign exchange risk. Even euro loans to MFIs in dollarized economies incur foreign exchange risk of the euro against the dollar. There are no foreign exchange hedge products for long tenors in the local capital markets in most of the MFIs' countries. If currency devalues in any of the ten years of these loans, an MFI faces a potentially significant loss.

Table 7: Examples of AECI 2006 approved loans (January-October 2006)

Funding Year	MFI (Country)	Funding Amount	MFI's other funding sources already in place as of end of 2005
2006	FinComún (Mexico)	€ 2 million	• $ 13 M deposits • Four Mexican banks • Deutsche Bank Microcredit Development Fund
2006	Prestanic (Nicaragua)	€ 1 million	• Eight local sources • Foreign funding from ADA, Alterfin, BCIE, BlueOrchard, Cresud, Etimos, Incofin, Oikocredit
2006	Caja Municipal (CMAC) Trujillo (Peru)	€ 8 million	• $ 84 M deposits • Eight sources of local funding • Foreign funding from BlueOrchard, CAF, Dexia, KfW, LA-CIF
2006	Edyficar (Peru)	€ 3 million	• Five local banks • Four other local funding sources • € 3 M in prior funding from AECI (via ICO) • Foreign funding from BIO, BlueOrchard, CARE, IADB, IFC, LA-CIF, MicroVest, Oikocredit
2006	PSHM (Albania)	€ 5 million	• Two local banks • Three other local funding sources • Foreign funding from Symbiotics Microfinance Loan Obligation, Dexia Fund (BlueOrchard), Deutsche Bank, Etimos, Feu Vert, Land O' Lakes, Oikocredit, responsAbility Fund, Swiss Microfinance Fund, Triodos.
2006	Prizma (Bosnia and Herzegovina)	€ 4 million	• Foreign funding from ASN-Novib, Dexia (BlueOrchard), Cordaid, Credit Suisse, IFAD, KfW, Oikocredit, Triodos-Doen, USAID
2006	Mi-Bospo (Bosnia and Herzegovina)	€ 3 million	• Four local banks • One other local source of funding • Foreign funding from Deutsche Bank, GMF, Hivos-Triodos, IFC, Microfinance Securities XXEB, MicroVest, KfW, Oikocredit
2006	Alter Modus (Serbia and Montenegro)	€ 2.5 million	(MFI does not report to MIX, so information is limited) • Foreign funding from EBRD, Triodos-Doen

Sources: AECI, MFI audited financial statements

New IFI-funded Eastern European Fund pursues a strategy of funding the region's top MFIs

The European Fund for Southeast Europe (EFSE) was created in 2005, primarily with funding from KfW, IFC, EBRD, and FMO. Launched with € 65 million, the fund had grown by September 2006 to 235 million euros, nearly all of it provided by IFIs and governments.[31] EBRD explained its funding, noting the intent of the fund is, "*Demonstration effect: Commercial financing is rarely available to local institutions due to perceived high risks. Successful lending will attract other foreign investors to the region and the sector.*"[32] IFC described the fund's purpose, that it "*will contribute to building public confidence in financial institutions and encourage more intermediaries, such as commercial banks, to extend financial services to this sector…Non-profit institutions (NGOs) that are dependent on continued donor funding have traditionally dominated the microfinance sector. This project, through technical assistance, will contribute to their organizational strengthening.*"[33] Yet thus far, EFSE has used its IFI funding to finance MFIs that already access local and foreign private funding. As of September 2006, EFSE invested nearly one quarter (23%) of its microfinance portfolio in only three ProCredit Banks, whose average portfolio is $241 million, and whose average savings are $269 million.[34] EFSE lends to some of the best known and most successful Eastern European MFIs, including Bosnian MFIs Mikrofin, EKI, Sunrise, Prizma, Partner, and Mi- Bospo; ProCredit Banks of Serbia, Romania and Moldova; Albanian MFI PSHM, and Montenegran MFI AgroInvest. Some of these MFIs were already sourcing funding from multiple local banks. For example, in a 2005 report, PlanetFinance rated Bosnian Mikrofin "A", impressed that, *"The story of the past three years is that of Mikrofin's remarkable ability to obtain loans from commercial funders and of their growing presence in its capital structure…Most remarkably, Mikrofin has managed to get conservative local commercial banks (3 thus far) to commit increasing credit exposure."*[35] Why are IFIs funding this type of MFI? One year after its creation, EFSE had not yet mobilized significant amounts of private funding. It is still early to pass judgment on EFSE. But so far, it has primarily been a channel of distribution of IFI funding to finance some of the strongest MFIs in the region. It is hard to see how a pool of official funding of such size best furthers the cause of *private foreign lending* for microfinance in Southeast Europe, or how it is helping to nurture up-and-coming MFIs in the region.

IFI that promotes going down market stays upmarket

BIO, the Belgian development institution, seemed determined to resist the temptation to concentrate its money in top MFIs. A 2004 BIO publication states, *"In the microfinance industry, BIO will consider stimulating investments in smaller and less mature institutions but with the skills and capacity to become first-rank ones."*[36] Yet in 2005, BIO made new microfinance loans to five MFIs: Banco ProCredit, Nicaragua; Banco ProCredit, Bolivia; CEB, Cambodia; PADME, Benin; and Findesa, Nicaragua. MicroRate has rated all of these institutions except CEB, and by no definition would they be called "smaller and less mature" MFIs. Their average portfolio size is $ 42 million, and two had deposits of $ 20-25 million. Each is either the top, or the number two MFI in its respective country.

[31] EFSE. *Investment Portfolio and Funding Fact Sheet*. September 2006.
[32] www.ebrd.com
[33] www.ifc.org
[34] From MIX data as of June 30, 2006.
[35] Planet Rating, *Mikrofin Bosnia and Herzegovina*. Paris: 2005, page 24.
[36] BIO. *Highlights 2004*. Brussels: BIO. 2004, page 9.

Box 1 Moroccan microfinance market still heavily funded by IFIs; MIV's mostly absent

IFIs have largely preempted private lenders from entering the rapidly growing Moroccan MFI market by offering terms which private lenders cannot match:

- The European Investment Bank (EIB), using funds provided by the European Union, doubled its investment in Al Amana, an *alpha* rated institution and the largest Moroccan MFI, to € 10.5M, in 2005.[37] These loans were at below market rates with concessionary tenors and grace periods: EIB lent € 3 M at 4.85% with a 2-year grace period, and € 2 M at 4.74% with a 3-year grace period.[38] EIB also issued a € 2.5 M loan to FONDEP in November 2005, repayable in ten years.[39] These loans occurred in the same year that EIB President Philippe Maystadt announced a strategic decision to refocus its microfinance resources in 2005 to strengthen equity of several regional investment funds rather than to individual MFIs, noting, "*We believe in a market-oriented banking approach…EIB is not allowed to grant subsidies*."[40]
- AECI also doubled its loans to Al Amana in 2005, to € 6.2 M, charging only 2.45% with a 5-year grace period.
- In February 2006, French IFI Agence Française du Développement (AFD) lent € 1 million to Al Amana, and € 0.5 million to AMSSF.
- CGAP found that just three Moroccan MFIs: Al Amana, Zakoura, and FONDEP received $ 66.4 M in IFI funding as of 2005.[41]

Regional development bank provides extensive subsidized loans in Central America

Banco Centroamericano de Integración Económica (BCIE) has been the largest source of subsidized microfinance credit in Nicaragua, and had a portfolio of below-market loans of $ 20 M in Nicaragua alone as of 2005.[42] BCIE provides large and underpriced loans throughout Central America. For example, BCIE funds FINCA Honduras, among other Honduran MFIs, for an amount equivalent to 31% of its total liabilities, at an interest rate lower than the Inter-American Development Bank, local foundations, and local banks.[43]

[37] Al Amana. *Rapport sur la mission de Commissariat aux comptes, exercise arrêté au décembre 2005*. Rabat: Al Amana, 2006, page 18.
[38] Ibid.
[39] FONDEP. *Micro-Credit Rapport des auditeurs independants, Etats financiers selon les directives du CGAP, exercise 2005*. Rabat: FONDEP, 2006, page 31.
[40] Microfinance Matters. *Interview with European Investment Bank (EIB) President, Mr. Philippe Maystadt: On Microfinance at the EIB.* New York: UNCDF Year of Microcredit, Issue 17, October 2005.
[41] $45.1 M to Al Amana, $13.1 M to Zakoura, and $8.2 to FONDEP, per *CGAP IFI Survey 2006.* CGAP: Washington, D.C, 2006, page 37.
[42] Flaming, Mark, Duflos, E., Helms, B., Siedek, H., Summerlin, R., and S. Duarte. *Country-Level Effectiveness and Accountability Review: Nicaragua.* CLEAR Reports. Washington, D.C.: CGAP, 2005, pages 11 and 25.
[43] Finca Honduras. *2005 Audited Financial Statements*. Tegucigalpa: Finca Honduras, 2006, page 11.

Box 2 IFIs still funding Mexican superstar MFI Compartamos

In 2005, CGAP issued a report announcing the demise of subsidized funding to the Mexican MFI, entitled, "*Donors Succeed by Making Themselves Obsolete: Compartamos Taps Financial Markets in Mexico*."[44] By all accounts, Compartamos is one of the most successful MFIs in the world. According to IFC, "*Compartamos is well managed, sufficiently capitalized, has an excellent portfolio, and is remarkably profitable.*"[45] It holds an A+ rating from mainstream rater Fitch. Standard & Poor rated its bonds AA. Compartamos' portfolio was $ 180 million as of 2005, and had grown at a compound annual rate of 76% per year over the past five years. Its RoE averaged 50% (!) over the past five years. Compartamos has issued $66 million in local currency bonds in the Mexican market since 2002. Since starting out as an NGO, it transformed into an NBFI, and as of June 2006, has converted into a commercial bank. Compartamos has clearly shown itself very capable of funding itself through the local capital markets, through local bank funding, private foreign funding, and soon will add deposits to its funding base. Nonetheless, IFIs continue to fund Compartamos:

- KfW issued a $ 6 million equivalent local currency loan to Compartamos in late 2005. Its rationale for the loan was that, *"KfW granted the FC promotional loan in local currency and with a term that is not available from the national banks."*[46] Yet the three-year loan tenor was the same as a larger loan for $8 million equivalent in local currency that Compartamos received from Banco Nacional de Mexico.[47]
- Inter-American Investment Corporation (IIC) approved a $ 20 million renewable medium term local currency loan to Compartamos in June 2006.[48] Given Compartamos' record of successful capital market operations, and easy access to private lenders, it is difficult to see why an IIC loan was needed.
- IFC approved a $ 10 million, 7-year local currency loan to Compartamos in 2006.[49]

These are just a few examples of IFI lending to top MFIs that could and should have been funded by private lenders. To balance out the picture, IFIs have also been investing in a number of innovative and groundbreaking transactions, described in the next section.

6. BEST IN CLASS: INNOVATIVE IFI TRANSACTIONS

The IFIs' tendency to fund low-risk, large MFI loans is a recent phenomenon. In the past, they often fulfilled their development role. Below are some recent examples in which IFIs have played a catalytic role to leverage and attract private capital in very successful ways in a number of groundbreaking transactions.

❶ Taking first loss positions in collateralized debt obligations and securitizations

IFIs have successfully used their public funding to absorb the higher risk position of some recent innovative structured finance and capital markets transactions:

- In 2004, the U.S. Government-owned Overseas Private Investment Corporation (OPIC) made possible the first microfinance collateralized debt obligation (CDO): the Blue Orchard Microfinance Securities I (BOMFS I). It did so by purchasing the subordinated tranche and guaranteeing 75% of the operation. This allowed BlueOrchard to mobilize private funding and to conclude a pioneering issue that has served as a model for others. The second-ever microfinance CDO also involved OPIC and Blue Orchard. In that issue, OPIC was able to reduce its guarantee to 35% of the $47 M issue.

[44] Dugan, Maggie and Ruth Goodwin-Groen. *Donors Make Themselves Obsolete: Compartamos Taps Financial Markets in Mexico*. CGAP Direct Case Study No. 19. Washington, D.C.: CGAP, 2005.
[45] IFC Structured Finance. *Financiera Compartamos*. Washington, D.C: IFC, 2004.
[46] KfW. *Credit Line for Financiera Compartamos*. KfW: Frankfurt, 2006.
[47] Compartamos. *Estados Financieros Dictaminados*. Mexico City: Compartamos, 2006, page 16.
[48] IIC. *IIC Approves a MXN $220 Million Loan to Mexico's Compartamos S.A*. IIC: Washington, D.C., 2006.
[49] Loan was part of a $ 50 million overall funding package for Compartamos.

- In the largest dollar-denominated capital markets operation to date, the 2006 BlueOrchard Loans for Development (BOLD) $ 99 M issue with Morgan Stanley, Dutch IFI FMO played a similar role, taking a 28% first loss position. Commercial investors purchased the remaining $72 million. FMO has since resold $ 3 M of its first loss position to private investor Grey Ghost, freeing up some of FMO's capital to be redeployed, and can sell more to other private investors.
- FMO and KfW played a key role in the world's first true microfinance securitization. In 2006, Bangladeshi MFI BRAC securitized $180 M equivalent of its portfolio. FMO purchased one third of the certificates, which are denominated in local currency. Citibank bought another third backed by an FMO guarantee and a counter guarantee from KfW. (Citibank Bangladesh and two local banks purchased the remaining one third of the certificates.)

❷ Guaranteeing bonds and local bank loans

IFIs are also well positioned to provide guarantees for capital markets transactions such as bonds.

- In a transaction ahead of its time, USAID (not an IFI, but a development agency) guaranteed 50% of a $ 5 million bond issued by BancoSol (Bolivia) in 1996. More recently, USAID guaranteed the first tranche of Mibanco's (Peru) first bond issue in 2002, while CAF guaranteed half of Mibanco's second bond issue in 2003. Significantly, Mibanco's third issue had no guarantee, yet the issue was oversubscribed. Here the public guarantee truly catalyzed the MFI's ability to show its creditworthiness in the local Peruvian marketplace.
- IFC provided a 34% guarantee on $ 46 million of local bonds issued by Mexican MFI Compartamos in 2004 and 2005, allowing the MFI to lead in global MFI bond volume.
- French IFI AFD provided a 75% guarantee on Faulu Kenya's 5-year bond issue in 2004, the first issue by an African MFI.

❸ Helping to launch Microfinance Investment Vehicles

The first microfinance fund, ProFund, was launched in 1995 with equity investments from the IADB, IFC and CAF, among others. The second, the Latin American Challenge Investment Fund (LA-CIF) involved the MIF (an affiliate of the IADB), Scandinavian IFIs and KfW. Since then, IFIs have regularly provided seed funding for MIVs.

All of the transactions described above share the common feature of *leveraging IFI funds to attract additional private capital* to the sector.

7. RECOMMENDATIONS: WHAT ROLE *SHOULD* IFIs PLAY?

> *"…IFIs, with their low-cost public money, should move away from the same regulated MFIs they have funded over the past several years and encourage them to develop their own links to domestic capital markets. This means focusing more on the next generation of strong institutions, offering seed capital and support for the development or transformation of this new crop of stars."*
>
> -From CGAP's "Access to All: Building Inclusive Financial Systems."[50]

How can IFIs best leverage their microfinance capital going forward? What roles can they play given the rapidly changing landscape of microfinance drawing in ever-increasing amounts of private capital? How does an IFI know when it has accomplished its mission and ought to move on? Their best role is to strengthen the overall capacity and transparency of the industry, and to act as a catalyst for private capital *that would not otherwise invest in microfinance*. Examples are described below.

❶ **First make IFI funding transparent**
IFI investment data are not easy to track down. Those interested in tracking and measuring IFI investment must hunt through multiple sources, only to find limited disclosure and dated information. The IFI with the largest direct exposure to microfinance, KfW of Germany, is also the least transparent. KfW discloses partial information but it does not tell the public which MFIs it has lent to or how much. IFC and EBRD disclose the date and total amount of MFI transactions, and sometimes the tenor, but never the terms such as interest rate charged or grace period. As public development institutions, IFIs should be held to high standards of transparency. They should disclose to what institutions they have lent, as well as the amount, interest rate charged, currency, tenor, grace period, and repayment terms.

❷ **Maximize commercial participation in innovative capital markets transactions**
IFIs are well placed to provide credit enhancements such as first loss positions, wraps, insurance, and guarantees. IFIs are ideally positioned to provide guarantees for capital markets transactions such as bonds, particularly in markets where a guarantor with a well-known name, reputation, and public backing is needed to reassure private investors. IFIs can also leverage their funds by providing MFIs with guarantees for local banks to issue local currency loans to MFIs.

❸ **Seed the next generation of microfinance institutions**
IFIs should once again shift their focus to MFIs that are not yet able to attract commercial funding. IFIs could seed and nurture the next generation of successful MFIs. For example, IFC and KfW are currently funding up to seven greenfield MFIs in Africa through the Microfinance Initiative for Sub-Saharan Africa (MIFFSA).

❹ **Help develop mechanisms to cover foreign exchange risk**
The rapid increase in foreign currency lending exposes MFIs to foreign exchange risk, although some IFIs and MIVs are now offering local currency loans. In most developing countries, it is still difficult and expensive to obtain foreign exchange risk cover. IFIs can play a role in providing a collar to cover risk on local currency loans issued by commercial lenders, and identify other mechanisms for MFIs to cover their FX risk efficiently, particularly in countries where such cover is not commercially available.

❺ **Promote further private sector channels for microfinance, and finance industry infrastructure**
IFIs can help expand microfinance capacity in a number of ways. They can promote local distribution channels for microfinance, such as bank downscaling, and SME lending for MFIs to head upmarket. IFIs can

[50] Helms, Brigit. *Access for All: Building Inclusive Financial Systems*. CGAP: Washington, D.C.2006, page 103.

also support MFIs' initiatives to increase mobilization of deposits. They can help MFIs expand horizontally into additional product lines such as leasing and insurance. Lastly, IFIs can use their risk capital to fund industry infrastructure such as credit bureaus and better use of technology.

8. CONCLUSIONS

IFIs provided key early funding to MFIs. Yet, in the last few years, as microfinance has become increasingly popular, IFIs have all too often given in to the temptation to go for the "low-hanging fruit." Top rated MFIs are receiving large IFI loans, often at below-market conditions, forcing private lenders to shift to higher risk MFIs. If IFIs have any doubts as to whether their funding is crowding out private investors, a quick inquiry to several private investors would suffice to remove any uncertainty. IFIs have naturally gravitated towards funding the largest and least risky microfinance institutions. Senior decision-makers, be they members of the Board of Directors or top managers, have not prevented IFIs from opting for volume and low risk at the expense of development impact. This must change.

What is happening in IFIs today has its roots in the governance of the microfinance operations of those institutions. An effective governance structure is necessary to compel public development institutions to counter this tendency and act as catalysts for - not substitutes to - private lending. Reform of IFI lending behavior would be made easier if their microfinance operations were more open to public scrutiny with full and timely disclosure of the details of loans to MFIs. As far as we know, none of the IFIs reveal planned loans in advance, to find out whether private lenders would be willing to step in. To dampen the appetite of IFIs for funding top tier MFIs, it would help if private lenders were able to monitor IFI lending. It is difficult for individual lenders to do this, but as a group, perhaps through the proposed Microfinance Investor Association, they could evaluate IFI loans as they are being approved and draw attention to those that displace private funding.

Microfinance is a dynamic industry where the pace of change seems to be accelerating daily. In this environment, IFIs urgently need to refocus on how to complement and attract the private sector instead of preempting it and competing with it as they are now often doing. "*AFD constantly assesses itself to ensure it is not crowding out other players, and that it is adding value,"* says Martha Stein Sochas, head of bank and financial market division, AFD.[51] Let that be the goal and practice of all IFIs funding microfinance.

CROSSFIRE COMMENTARY FOR DISCUSSION:

A private investor perspective…

"*IFIs should not fund the best MFIs. The argument that there is not enough private investment money to do that is absolutely wrong."*

-Jean-Philippe de Schrevel, BlueOrchard

An IFI perspective…

"MFIs are growing so fast, that private sources alone cannot meet their funding needs. They have to fall back on IFI funding…KfW presently makes 3-4 loans annually to Latin American MFIs for $12-15 million. This volume (when compared to the total volume of MFI funding) shows that there is no crowding out."

-Quoted from KfW's reply to MicroRate's request for the IFI's position on crowding out. Translation by MicroRate.

[51] Collet, Emmanuelle. *Microfinance: Macro Impact*. adrmagaazine.com. Manila: ADB, 2006.

APPENDIX 1: International Financial Institutions (IFIs) Included in this Paper

International Financial Institution (IFI)	Public Sector Shareholders	Percent of equity held by Public Sector	Geographic focus
Agencia Española de Cooperación Internacional (AECI)	Government of Spain	100%	Global, special focus on LAC
BIO	Government of Belgium/Belgian Corp. for International Investment	81.5%[52]	Global
Corporación Andina de Fomento (CAF)	Multilateral – Latin American governments, and Government of Spain	99.9% 0.1% owned by private financial institutions	Andean countries
European Bank for Reconstruction and Development (EBRD)	Multilateral: Member Governments, EIB, EU	100%	E. Europe/Central Asia
European Investment Bank (EIB)	Multilateral: Member States of EU	100%	Africa, Caribbean, Pacific (ACP)
Netherlands Development Finance Company (FMO)	Government of Netherlands	51%	Global
International Finance Corporation (IFC)	Multilateral: Member Governments	100%	Global
Inter-American Development Bank-Multilateral Investment Fund (IADB-MIF)	Multilateral: Member Governments	100%	Latin America/ Caribbean
Inter-American Investment Corporation (IIC)	Multilateral: Member Governments	100%	Latin America/ Caribbean
Kreditanstalt für Wiederaufbau (KfW)	German Federal Government 80% German States 20%	100%	Global

Sources: IFI websites; CGAP website.

[52] BIO is 50% controlled by Belgian Department of Development Cooperation, and 50% by Belgian Corporation for International Development, which is in turn 63% controlled by public institutions.

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