REVERSING THE COIN

What International Financial Institutions do to change the face of microfinance

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Diversity in the microfinance landscape increased

Today's microfinance landscape appears radically different in many ways from 10 years ago. New approaches and instruments have evolved which increase opportunities for microfinance institutions (MFIs). Private investors (often referred to as socially responsible investors) are the new stakeholders that have emerged on the microfinance scene.

Financial sectors and MFIs have developed asymmetrically and are unique in each country. They differ in maturity, size, level of integration, regulations etc. These factors and conditions affect the approaches, instruments and investment decisions of both International Financial Institutions (IFIs) and private investors. The community of microfinance investors is diverse and comprises roughly 20 foundations, 40 public agencies and 60 funds and other microfinance investment vehicles (MIVs). International banks, private investors, international NGOs and others, increase the number further. In addition, each of these microfinance investment groups is highly heterogeneous.

Demand for finance outstrips supply

The potential of the global microfinance market today is tremendous. Yet only one-tenth of the microfinance market is being served today. Demand for productive loans is estimated by CGAP to be around USD $300 billion, whereas current supply is estimated at some USD $30 billion. This demand is concentrated mainly in the BRIC countries (Brazil, Russia, India and China) and Asia. Africa's potential is also huge. More than one billion people world-wide survive on less than USD $1 per day, whereas only slightly more than 150 million people (or families) currently have access to microcredit.

External funding sources will not be able to fuel the untapped demand described above. Rather, deposit mobilization and access to local capital markets combined with innovative refinancing instruments by IFIs and private investors are required. Markets are evolving and IFIs are responding to this dynamic environment by strengthening and tapping the local financial sector and deposits as well as applying innovative refinancing instruments.

This discussion brief focuses on the role of IFIs in a changing environment and in closing the gap between supply and demand.

Present IFI Market Share

Microfinance is characterized by impressive organic growth and more MFIs are reaching an increasing number of people. MFI assets have doubled over the past three years. IFI funding reflects a similar trend to support this growth: IFI microfinance commitments have increased from USD $1 billion in 2003 to USD $2.4 billion in 2005. However, IFI debt investments

represent only about 20% of MFIs' total debt.[1] The remaining 80% has been funded with domestic sources or by other external capital flows. The real market share of IFIs is even smaller as MFIs that do not have IFI financing are not included in the research. And based on the above mentioned supply estimate of USD $30 billon, IFI share of funding is just over 8%.

Role of IFIs in a Rapidly Changing Environment

IFIs are one of many refinancing sources for MFIs, and are often part of a developmental package. IFI approaches are an investment in sustainable development and typically encompass both a strengthening as well as financing focus on MFIs (micro level) and on financial sector development (meso and macro level). This sets them apart and makes them complementary to private investors. As country reviews show, private investors still pay relatively little attention to financial sector growth and the integration of MFIs. IFIs act as market enablers while in most countries microfinance sectors are still underdeveloped and immature.

Improving the access to finance for more than 3 billion working poor, and satisfying the huge loan demand, requires comprehensive approaches to accommodate and accelerate long-term development and sustainability. The following list provides some examples of the instruments IFIs apply and adapt in a rapidly changing microfinance environment:

1. **Tap local markets** – External sources, whether it's capital from IFIs, commercial banks or other (private) sources, can help to increase supply but will never be able to sustainably meet total demand. Local capital markets must be stimulated and tapped in order to fill the gap. IFIs facilitate linkages between MFIs and local banks and local capital markets.

   Deposits are typically the major funding source for financial institutions. This also applies to MFIs. Deposit mobilization is, however, not a reality in most markets. IFIs contribute to building trust and consumer confidence, and help to design and set up deposit products to stimulate individuals to get the money out from under the mattress and into MFIs. However, in many countries, laws prevent MFIs from taking deposits. IFIs support MFIs on their way to obtaining a license and to implement necessary internal procedures for sound deposit mobilization.

2. **Mobilize funding through innovative instruments** – IFIs have supplemented their traditional refinancing with innovative instruments in recent years. Most of the new instruments provide different risk classes for investors. This opens up opportunities for attracting private investors. In addition, the financial involvement of an IFI is often considered a stabilizing mechanism by both international and domestic investors. See also "Recent Trends – Leveraging Private Capital" below.

3. **Create and strengthen microfinance institutions** - Building new MFIs is important to reach the unserved working poor in countries with no or underdeveloped microfinance. IFIs have traditionally been strong in greenfielding new MFIs or growing young and immature MFIs, as the cases of Compartamos, the ProCredit Group, ACCION network

[1] CGAP IFI survey 2005, based on 100 MFIs listed on MIX market with IFI funding

members and many others demonstrate. IFIs are also strong in setting or improving the right corporate governance standards and improving transparency of performance, for instance, so that new or young MFIs are ready to grow further and attract new investors. Because of their broad knowledge of greenfielding, upgrading and financial sector development, IFIs are well-positioned to play an active role.

4. **Foster stability in a volatile environment** - Supporting the general framework for microfinance is a core task for IFIs. Only with the right regulations will microfinance form an integral part of a financial sector. This is essential for serving the working poor and for the development of MFIs. Only in a regulated market can MFIs make use of the full range of funding sources, i.e. deposits, local capital markets and external sources.

Recent trends: Leveraging Private Capital – Crowding in

In the past few years, microfinance funding has seen the most significant evolution. *Traditional* refinancing instruments and technical assistance for greenfielding, upgrading and downscaling approaches are supplemented by *innovative* instruments such as syndicated loans, bond issues, securitizations of MFIs loan portfolios and innovative fund structures. Characteristic of these innovative instruments is the high degree of private sector involvement. IFIs have been very active in developing and supporting financing structures that are designed to *crowd in* new investors.

Most innovative instruments have been initiated and supported by IFIs. Examples include the European Fund for Southeast Europe (EFSE), credit enhancements for Compartamos and Mibanco, BOLD II, and the securitization for BRAC Bangladesh and ProCredit Bulgaria. Most of the approximately 60 Microfinance Investment Funds that exist today have been made possible with IFI support. IFIs understand this asset class best and are able to prepare the ground for private sector involvement. Risk sharing mechanisms facilitate more investments to respond to the huge demand for finance.

Future Challenges

Current developments in microfinance are encouraging and pave the way for the integration of microfinance into the financial sector. However, meeting the untapped demand for financial services is not possible given the limited capacity and structure of MFIs. MFIs need to become sound financial institutions guided by their missions but with clear status, ownership and governance structures to form an integral part of a financial system and to tap local and international funding.

The challenge is to move quickly from old investments to new opportunities while avoiding the pitfall that long-term IFI supported MFIs do not fall back into weak practices or face problems funding their growth.

IFIs have played and continue to play a prominent role in microfinance development. The role of IFIs is broad and not limited to funding. As market enablers and facilitators, IFIs focus on technical assistance (savings mobilization, upgrading of MFIs), innovative capital market transactions (unlocking domestic markets, crowding in private investors with innovative risk

sharing instruments), local currency financing and greenfielding. These are areas in which IFIs have proven to be successful. There is still ample demand for the role of IFIs, which are fully complementary to growing private investments.