

# Reducing Barriers for Investment in Microfinance: The Role of Structured Finance, Rating and Benchmarking

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## Workshop Summary

Forging new connections for continued innovation in generating more private investment in microfinance was the aim of the workshop. Private and public microfinance investors, mainstream rating agencies and microfinance raters, fund managers, and fund and structured finance experts joined the event, organised and hosted by KfW. Their working level and strategic discussions of experiences, existing approaches and methodological issues probed potential changes and tweaks to overcome current bottlenecks in microfinance investments, especially for private investors.

Examples of microfinance securitisations and microfinance investment funds sparked discussions of current ways of tackling common barriers, for instance by transferring risks. Challenges and opportunities through rating and benchmarking provided the focus for further discussions.

The packed agenda of two half days featured these sessions with short presentations or statements by panellists and created space for discussions on the panel as well as actively engaging the participants as the 'extended panel'. In bringing together hard nosed investors and mainstream rating agencies with microfinance investors and raters, the role as well as limitations of public and private investors, of structured finance, and of ratings stood at the centre of their vetting.

'Those were two intensive days well spent. I received many new ideas and a better understanding of microfinance, which will be useful for my work (...)' (investment banker, fund manager)

'Thank you for a very well organized and stimulating workshop. You really put together a useful event with the right format and for one time the right mix of participants.' (microfinance expert)

## Results

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Demand for foreign investment in microfinance is growing rapidly – whereby the quality of the capital is increasingly important with local currency financing in particularly high demand followed by long-term equity investment. Public investors alone cannot meet this demand. Bringing private investors into microfinance hinges on structuring risks and improving transparency and information.

Structured finance, such as microfinance securitisations, transfers risks and is a new pillar of financing for the (as yet) small pool of high performing MFIs – some 80 MFIs worldwide. Although still a new generation instrument for microfinance, such transactions will grow in importance for this market as MFIs mature – thus lowering the need of leading MFIs to tap other types of financing which are accessible to a broader segment of MFIs.

Ratings and benchmarking in microfinance is bound to evolve from the current nascent stage and become more professionalised. Drawing on specialist microfinance ratings to assess underlying assets is a conceivable approach but further work is needed in this area.

Public investors are usually the first movers and invest where no private investors are able or ready to do so. They also contribute to laying foundations, such as in strong governance, and form a core of like-minded investors preventing mission drift, which are prerequisites for private investors to join. As they are, however, fairly cumbersome partners with many requirements, private investors could readily overtake them. An opportunity and useful role for public investors is to strategically fill gaps ('the holes in the cheese') with their range of instruments and thereby bridge private investors into the market.

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- demand for local currency, timely financing in small parcels, for good and not only for top performers

Microfinance investment demand is growing rapidly. In 2003 CGAP estimated it at USD 900 million a year, rising to USD 3.1 billion a year in 2009. A rising share of the demand will come from smaller, non-regulated MFIs, while regulated microfinance institutions (MFIs) are expected to increasingly access local financing sources; demand for equity capital will also grow as more MFIs transform into regulated institutions. Local currency financing needs are increasing and there is already a mismatch in local currency and also in total supply:

Public investors invested USD 1.5 billion in 2005 accounting for more than half of total investments; one fifth of their USD 2.4 billion in overall commitments was in local currencies. Private funds held total investments of USD 1.5 billion per December 2005. (CGAP surveys 2004 & 2006, MicroRate survey 2006)

Only by attracting more private investors can the demand gaps be filled and the bridge to sustainable financing of microfinance through access to capital markets be built. Obstacles to investments include legal and formal hurdles, high transactions costs, country risks, foreign exchange risks and lack of local currency financing.

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- different barriers for different MFIs & markets, different for different types of investors

Hurdles are more pronounced for smaller MFIs typically based in high risk countries, in need of local currency financing, with the right timing and often on short notice, and in small 'parcels'.

Barriers also vary by investor, as for instance funds operate in regulatory contexts which allow for greater flexibility in investments than banks operating under standard supervision.

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- microfinance funds have a mixed but improving record on attracting private capital; bottlenecks include capable fund managers; transparency for private investors

Microfinance investment funds have a mixed but improving record on attracting private capital. Bottlenecks for private investors include the low transparency and lacking familiarity with such funds translating into high costs. Another bottleneck in this market is the relatively small pool of capable and experienced fund managers – the key to successful funds.

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- securitisation and structured finance, more generally, is new but increasingly important for financing in microfinance with a direct and a leveraging effect for the MFI; appropriate only for high performers, it reduces their tapping into financing for maturing MFIs

Structured finance is a new pillar of financing for high performing MFIs with good and standardised documentation and systems, accordingly still a small but fast growing pool of currently some 80 MFIs.

While a new generation instrument for microfinance, structured finance transactions will grow in importance for microfinance as the market and MFIs mature – thereby lowering the need of leading MFIs to tap other types of financing which are accessible to a broader segment of MFIs.

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- microfinance is a new and different asset class in structured finance; structured finance offers the most flexible and innovative financing instrumentation

Whether microfinance as an asset class is in fact less volatile and has a low or no correlation with country risks is probable but still needs to be tested more fully.

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- rating - consensus on necessity of public, recognised ratings to improve transparency and create benchmarks as a basis for growing the market; rating with microratings conceivable; relatively high transaction cost

Information as a key ingredient for growing the microfinance investment market sustainably was undisputed.

The position that ratings should be encouraged as ultimately a necessary step in the investment process stood next to the perspective that ratings should not be required as they are too far ahead of the bulk of the market and constitute a barrier to financing. Yet, many public as well private investors engaged or interested in the market are severely hampered without mainstream ratings; which drives up costs and restricts financing.

Rating and benchmarking in microfinance are bound to evolve and professionalise from the current still very nascent stage in all three categories of ratings: ratings of Microfinance Institutions, Microfinance Investment Funds, and of structured tranches or transactions (e.g. securitisations). Drawing on specialist microfinance ratings to assess underlying assets is conceivable but subject to further work.

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- role for public – consensus on importance of public to attract private investors and to 'fill the holes in the cheese'

There was consensus that public investors are usually the first movers and invest where no private investors are able or ready to do so. They also contribute to laying foundations, such as in strong governance, which are prerequisites for private investors to join. Yet they are fairly cumbersome partners with many requirements so that the presumably nimbler private investor could readily overtake them given the right risk appetite.

An opportunity and useful role for public investors is to strategically fill gaps ('the holes in the cheese') with the range of instruments from technical assistance (TA) to financial tools (e.g. equity investment, debt, credit enhancement) and thereby bridge private investors into transactions and into the market.

Heeding the absorptive capacity, pricing according to credit risk and showing investor discipline to not heighten the risk of default were among the pleas for expanding and developing a sound market as was the request to build financing practices and processes by starting from strong MFIs.

## Details.

Highlighting the current most pressing barriers as well as demand and supply for investment in microfinance from the perspective of investors as well as investees, the first session set the context for the workshop. Estimates of the total microloan retail demand suggest numbers in the range of USD 25 billion. Demand for the corresponding foreign debt investments alone was conservatively projected to reach USD 3.1 billion a year in 2009. While regulated microfinance institutions (MFIs) are expected to increasingly access local financing sources (debt and/or deposits), a rising share of the demand for foreign investment will come from smaller, non-regulated MFIs. Demand for equity capital will also grow as more MFIs transform into regulated institutions.

Compared to the estimated demand, outstanding portfolios totalled USD 1.2 billion at the time of the projection in 2003, with 44 % invested by private funds (CGAP survey 2004 – Focus Note 25). In 2005, public investors held total portfolios of USD 1.5 billion accounting for more than half of total investments; one fifth of their USD 2.4 billion in overall commitments was in local currencies. Private funds held total investments outstanding of USD 1.5 billion per December 2005. (CGAP surveys 2004 & 2006, MicroRate survey 2006)

Only by attracting private investors can the gaps be filled. And only by attracting private investors can the bridge to sustainable financing of microfinance through access to capital markets be built.

Obstacles to investments include legal and formal hurdles, lack of transparency, high transactions costs, country risks, foreign exchange risks and lack of local currency financing. These are partly due to the lack of market data and performance indicators as well as of ratings from internationally recognised rating agencies. The hurdles are more pronounced for smaller MFIs typically based in high risk countries, in need of local currency financing, with the right timing and often on short notice, and in small 'parcels'.

To what extent structured finance solutions can serve the financing demand beyond the top performing institutions was raised as a question for further discussion in the subsequent sessions. The careful balancing of roles and investment terms of public investors so as to 'crowd in' rather than 'crowd out' private investment was another topic launched for discussion throughout the workshop.

Key messages included:

- Local currency financing needs are increasing and there is already a mismatch in supply.
- While there is good availability of financing for top performing MFIs and large networks, availability and access to financing is much less for smaller and maturing MFIs. Barriers for microfinance investment thus differ by MFI.
- Barriers also vary by investor, as for instance funds operate in regulatory contexts which allow for greater flexibility in investments than banks operating under standard supervision and corresponding investment criteria, including stringent risk management criteria and provisioning with respective cost factors attached.

The role of securitisation and structured finance in breaching the barriers was the theme of the second session with three examples:

- In Bulgaria ProCredit Bank realised a true sale microfinance securitisation, the first worldwide with an underlying portfolio of SME and microloans. The ramp-up facility of up to EUR 120 million was arranged within a short three months and placed by May 2006. Investors include ProCredit Holding AG and an Ireland-based private investor with guarantees provided by KfW (€65 million credit enhancement) and EIF. It provided the bank with direct additional capital as well as capital relief to support the growth of its microloan portfolio. As the first true sale securitisation in Bulgaria, it constitutes a benchmark transaction and contributed a bridge to international capital markets and to the strengthening of the domestic financial sector. Obstacles encountered included the learning curve of partners with no or limited experience with such transactions and the complexity of brokering an agreement between multiple partners with different priorities.
- A global USD 96 million collateralised debt obligation (CDO) was structured by BlueOrchard with Morgan Stanley as arranger and placement agent. The special purpose vehicle (SPV) 'BOLD 2006-1' holds loans to 22 MFIs in 13 countries. Morgan Stanley also provided a swap which enabled BOLD to issue 25% of the portfolio in fully hedged local currency loans. With the help of a structure comprising

senior and subordinated notes and Morgan Stanley adding its reputation as an investment bank, different types of investors could be approached. Investors include banks, mutual funds and insurance companies. The challenges in this transaction included the relatively high levels of negotiation and documentation compared to the transaction size, its novelty for many of the investors and the MFIs, adverse national laws for FDI in microfinance, and placing a CDO by convincing mainstream investors of the credit quality of the MFIs without mainstream ratings.

- Another true sale securitisation was originated by BRAC Bangladesh in Thaka (BDT) with a total volume equivalent to some USD 180 million and individual maximum exposure tranches of USD 30 million. Citigroup with FMO and KfW structured it and FMO and KfW also guaranteed the transaction. Credit enhancement measures in addition to the guarantees include a 50% overcollateralisation, substitution of delinquent loans and a debt service reserve account; there is no sub-ordination. For BRAC the transaction was essential for continued growth of their microlending by relieving financing constraints, providing lower cost funds and a more efficient balance sheet with improved returns on equity and assets allowing for better access to capital markets. Investors include Citibank Dhaka and other local investors along with FMO. Lessons from the transaction include the long lead time and the importance of working with an MFI with a requisite high volume and top quality IT system operating in a conducive legal framework. Receiving local authority approvals as well as conveying and ensuring true sale legal requirements counted among the challenges.

These transactions consistently structured and transferred risks so as to attract a range of investors, and especially private investors. They led to a decrease in the cost of funds for the participating MFIs and laid at least the first paving stones on their path to access to capital markets.

The examples also illustrate several challenges: A fundamental one is the complexity of the transactions. Since many different parties, including government agencies, are involved and typically unfamiliar with the subject, extensive and careful explanations are of utmost importance and can involve long lead times. A lack of relevant performance data and standardised ratings has also deterred many investors which could not risk weight the investment efficiently for standard bank supervision and internal risk management compliance. In addition, the typically still rather small volumes lead to comparatively high transaction costs which can only substantially be reduced by generating or bundling higher volumes.

Key messages include: Structured finance is a new pillar of financing for high performing MFIs with good and standardised documentation and systems, accordingly still a small, though a fast growing pool. While a new generation instrument for microfinance, structured finance transactions will grow conceivably rapidly in importance for microfinance as the market, and MFIs in particular, mature – thereby lowering the need of leading MFIs to tap other types of financing which are accessible to a broader segment of MFIs.

Focusing on the role of innovative fund structures in tackling barriers to microfinance investments, the third session built on the structured finance discussion. Three examples illustrated the range of microfinance investment funds:

- Global Microfinance Fund (GMF) provides foreign debt as well as credit enhancements in the form of guarantees to facilitate access to local capital markets. Initiated and managed by Cyrano Management, this SPV has private investors such as Crédit Coopératif, Desjardins and Calvert Foundation and public investors such as IFC, KfW, Belgium's BIO and the Swiss seco. It has a volume of about USD 30 million and is structured in three classes of notes – senior, mezzanine, and junior/quasi-equity investments. Lessons include that a track record is crucial to attract hard-nosed institutional investors.
- FMO's MASSIF, established in 1986 with public funds, has disbursed EUR 398 million with 60% of its assets in 26 different local currencies. Risk management is mainly through an active investor approach, geographic diversification (43 different countries) and relatively small amounts disbursed to the 107 individual institutions. The fund has to date realised an average return of 2.8 % p.a. despite foreign exchange losses of around EUR 38 million. Returns are expected to increase in future due to release of provisions. Accounting for the fund management (ca. 3% p.a.) and other costs, the fund is anticipated to break even or generate a small profit. Building on the fund's experience, CAPCO, a structured successor fund with a much broader base of investors and investments, is in preparation for launch in 2007.
- The European Fund for Southeast Europe (EFSE), launched in December 2005, combines first loss and mezzanine investments of about EUR 200 million with senior investments of close to EUR 50 million (as of September 2006). Promoted by KfW and managed by investment bank Oppenheim

Pramerica and expert microfinance adviser Bankakademie, the fund consolidated a number of smaller country-based funds. EFSE provides equity and debt financing to MFIs as well as to banks with SME or microfinance portfolios. It plans to grow to a total portfolio of EUR 500 million by 2010. Donors are invested in first loss tranches and development finance institutions in the mezzanine tranche, whereas the low risk senior notes are targeted at private investors. The risk buffers of the junior tranche and investors such as FMO, IFC; and KfW as well as the professional fund management are geared to attract private investors. Lack of a standard track record and rating of the senior tranche are among the hurdles the fund is currently working on to attract new, private investors.

Risk in these funds is structured in EFSE and GMF, whereas MASSIF has relied on a highly diversified portfolio. For many MFIs such funds are important vehicles to access debt or equity where commercial finance or donors are not available. They have a greater flexibility than development finance investors in taking risks and speedy decisions. They also contribute to the professionalisation of MFIs, bringing them a step closer to other investment options.

As of yet, such funds have a mixed but improving record on attracting private capital. Bottlenecks for private investors include the low transparency and lack of familiarity with such funds. These translate into high costs in assessing the risks for a relatively small investment volume due, for instance, to the absorptive capacity of the funds and the lower returns compared to the risk than other investments tend to offer. Another bottleneck in this market is the relatively small pool of capable and experienced fund managers – the key to successful funds. The important role public investors and also donors can play as first movers is in helping to build the funds, strengthen governance, and bridge through reputation and risk buffers to private investors.

Ratings and benchmarking and their role concerning the reduction of investment barriers provided the focus of the fourth session. This panel set mainstream raters such as Standard&Poor's and FitchRatings, with a fiduciary rater Telos, and a specialist microfinance rater MicroRate to scope out their market perceptions, current rating issues, and opportunities and trends. Three types of ratings were discussed as increasingly essential: ratings of Microfinance Institutions, of Microfinance Investment Funds, and of structured tranches or transactions (e.g. securitisations).

The mainstream raters contrasted microfinance as an emerging and different asset class to the otherwise highly commoditised asset classes. Structured finance offers the opportunity to transfer risks and satisfy financing demands; of the current financial instruments, it offers the greatest flexibility and ability for innovation. The anticipated future growth of demand in microfinance provides a basis on which commercial investors could likely come in. Microfinance transactions have already gained in interest among private investors. A typical investor looks for volume and pipeline, a specialised investor for relative value. A reasonable approach to sizing credit and default risk is key to making it work. Despite growth, microfinance is very much a niche market. Rating MFIs and microcredit portfolios bears many challenges in terms of the quality of systems, processes, documentation, short term data, and cost relative to scale.

In contrast to ratings of portfolios or asset-backed instruments, fiduciary ratings could contribute to improving transparency for microfinance funds. Such qualitative ratings on governance and management as well as on processes and systems focus on key factors in successful fund management.

Microfinance ratings by specialist raters have developed sufficiently to provide some basis for investment decisions of donors and some of the microfinance funds. They struggle, however, to be accepted by private, especially institutional investors, and also by development finance institutions that have to adhere to regulatory requirements for which specialist ratings are not sufficient. Providing mainly performance and qualitative ratings, such ratings do not provide a probability of default or expected loss rating.

CGAP introduced draft disclosure guidelines for 'microfinance investment vehicles' (MIV, an inclusive definition, not limited to microfinance funds or structured instruments). In the context of what was labelled as perhaps some 'irrational exuberance in a boom of microfinance investment', the disclosure guidelines might offer a 'third way'. Taking the wide definition of MIV, their investments totalled more than USD 1 billion by the end of 2005 (of a total of USD 3 billion in foreign microfinance investments). 59 MIVs populate the list, 16 of them founded in 2005; another 6 were launched by September 2006. Of the 59 only 10 have an asset pool over USD 50 million, most have assets below USD 10 million. The disclosure guidelines aim to collect a standard set of performance, risk and return data across the MIVs.

Information as a key ingredient for growing the microfinance investment market sustainably was undisputed. Raised for debate was the question of why setting different standards rather than complying with regular global standards was useful or desirable.

In discussions, the position that ratings should be encouraged as ultimately a necessary step in the investment process stood next to the perspective that ratings should not be required as they constitute a barrier to financing: Lacking information rather than ratings hinders market growth and ratings and microfinance as an asset class are too far ahead of the bulk of the market, contented one. Yet, others pointed out, many public as well private investors engaged or interested in the market are severely hampered without mainstream ratings, which drives up costs and restricts financing. Regulatory requirements for banks under supervision according to Basle II, for instance, incur a high opportunity cost due to a high capital adequacy ratio requirement; only external ratings can reduce this effect. Ratings further provide an objective measure for pricing and also contribute to investor and originator education.

Whether microfinance as an asset class is in fact less volatile and has a low or no correlation with country risks is probable but still needs to be tested more fully. Pushing unsustainable assets is not desirable but where the asset justifies it, it can be rated better than the country ceiling or sovereign rating. A methodology to do this for microfinance is conceivable. The current general assumption – based on specific experiences such as in Bolivia or Indonesia – is that microfinance is non-cyclical and performs better than the remainder of the financial sector in times of crisis; though this only holds if it is not lumped together with SME, leasing, or consumer finance, all of which behave differently.

Ratings and benchmarking in microfinance are bound to evolve and professionalise from the current still very nascent stage. In part this will happen by virtue of further transactions, growing or new funds, and interest as well as actual investments by private investors who enter the market. Methodological solutions to rating microfinance are conceivable and will partly depend on the potential pipeline to make the development cost viable. Drawing on specialist microfinance ratings to assess underlying assets is conceivable but subject to further work.

Risks, future trends, and the role of public investors in microfinance dominated the panel and discussions of the final session. Several issues raised during the workshop were taken up and fleshed out in further discussion:

That public investors act as subsidised and therefore unfair competitors to private investors thus crowding them out held little sway as a general assertion. There was consensus that public investors are usually the first movers and invest where no private investors are able or ready to do so. Their financing is typically also longer term than private investments. As their financial investment can be accompanied by technical assistance, they also contribute to strengthening MFIs or microfinance investment funds. Moreover, such value-added often draws significantly on their own staff time spent on investment committees and boards. This is critical in building capacity and especially strong governance, thereby laying foundations which are prerequisites for private investors to join. Yet they are fairly cumbersome partners with many requirements so that the presumably nimbler private investor could readily overtake them given the right risk appetite.

A great potential risk may be posed by populist measures such as interest rate caps and microdebt forgiveness – perennially favoured and sometimes imposed by local politicians in search of votes or at risk of being promoted by celebrity advocates. These can seriously jeopardise not only the development of single MFIs but also of the entire financial sector of the respective country and deter international investors. Microfinance markets could suffer from some volatility if private investors withdrew suddenly or if commercial banks with microfinance portfolios lost interest and left their local markets barren.

Regarding trends, specialist or public microfinance investors will find shrinking demand from the league of top MFIs. Here only the reputation, image, complementary and perhaps long-term nature of the financing as well as loyalty may retain a certain attraction. The growing demand will come from the next tier of MFIs, though anticipated demand is largely guesswork as aggregate data is lacking. Heeding the absorptive capacity, pricing according to credit risk and showing investor discipline to not heighten the risk of default were among the pleas for expanding and developing a sound market as was the request to build financing practices and processes by starting from strong MFIs. An opportunity and useful role for public investors is to strategically fill gaps ('the holes in the cheese') with the range of instruments from investment to credit enhancement and thereby bridge private investors into transactions and into the market.