

# Engaging the financial sector

## responsAbility's Discussion Papers

responsAbility publishes Discussion Papers on a regular basis. They are aimed at providing state-of-the-art information on actual topics relevant to microfinance and to our clients. Their aim is to support the ongoing discussion with our partners, clients and stakeholders with the ultimate objective of developing a common understanding of key issues in the field.

### Only a small part of the market potential of Microfinance is being used

World-wide there are about *500 million micro-enterprises*<sup>i</sup>, mainly in the informal sector in developing countries. Considering that their average annual need for credit is in the range between USD 500 and 1'000 and that only about 5% of that demand is covered, we conclude that the untapped market potential for Microfinance is of the order of magnitude of several hundred billion USD.

According to estimates by CGAP and UNCTAD there are about 10'000 Microfinance institutions (MFIs) in the world today, of which about 200 to 300 are considered commercially viable and sustainable, and this number is constantly growing.

Recent statistics<sup>ii</sup> on the global outreach of MFIs report that over 30 million families presently have access to microfinance services, of which about 20 million are categorised as being among the poorest. This can be seen as a great achievement of Microfinance but at the same time shows that only a small part of the potential of Microfinance is being used. Since the global Microcredit Summit Campaign has been launched huge progress has been made, but the Campaign target of 100 million of the poorest to be reached by 2005 is still far away.

A closer look at the statistics also shows that a large majority of MFIs are very small, serving less than 2,500 clients each. This typically leads to high transaction costs for structuring and implementing investments, a topic that we will discuss later in this paper.

### The need to bring in the commercial financial sector

At present, international sources of capital for Microfinance have primarily been provided by donors and International Financing Institutions (IFIs), such as national development banks, multilaterals, bilaterals, development foundations, NGOs, as well as by Social Investment funds.

Microfinance specialists agree that in order for Microfinance to fulfill its growth potential, existing international sources of finance and domestic commercial debt capital markets will be insufficient. It is therefore important to tap into international commercial debt and equity capital markets.

Well-managed MFIs have proven that microcredit can be provided on a financially sustainable basis and that the microfinance sector can earn a positive return on capital. In the past years, leading MFIs have reported strong profitability, as well as strong returns on equity. It is therefore surprising that the private sector has to a large extent ignored this market until now.

In the next sections we ask ourselves why the commercial financial sector has been cautious in engaging in the Microfinance market and what conditions must be met in order to increase its participation.

### Prerequisites to attract commercial equity and debt capital

The two major hypotheses to explain the fact that Microfinance is not sufficiently attracting commercial capital are:

- The perception that financial returns on Microfinance investments are not commensurate with

their level of risk. This might be the case for both equity and debt investments, as we explore in the next paragraphs.

- High transaction costs of this still small market.

### 1. The high perceived risk and illiquidity of equity investments in Microfinance

To date, there have been very few examples of MFIs which have provided monetisation or exit opportunities to equity investors, either in the form of a cash dividend or in the form of a cash sale of shares. There have been in the past a small number of transactions in which equity investors have successfully sold shares for cash to other investors. We believe that the emergence of investment "platforms" (e.g. equity funds or investment companies such as IMI, LA-CIF, Horus/LaFayette) providing virtual exit markets to investors will improve the liquidity of this market and ultimately change the negative perception of private investors.

In the long-term MFIs will need to demonstrate a dependable track record for commercial equity investors. This will go along with the further growth and maturity of leading MFIs providing a higher frequency of "monetization events" such as: MFIs start paying out cash dividends (given the high growth rates of the sector, presently MFIs prefer to re-invest earnings in the

company, which makes sense also for investors)

- Commercial banks begin acquiring MFIs
- MFIs grow to the point where they themselves can go public.

### 2. The perception that interest rates for debt investments in Microfinance often do not sufficiently reflect risk

If we turn to the provision of debt capital, we observe that most MFIs have access to "soft money" sources (e.g. IFIs, NGOs, social investment funds) which provide debt at rates that the private sector perceives as being "below-market". In many countries "soft money" financing is plentiful and therefore MFIs have little incentive to seek out commercial investors which, on average, would require higher rates<sup>iii</sup>.

In the past years we have observed an additional erosion of Microfinance debt rates in some regions, partly due to the general trend toward lower rates in many countries, but also due to the following reasons:

- Donors and IFIs continue to provide large amounts of "soft money" even to MFIs that can afford to pay market rates
- The lack in sophistication of international capital sources, which often provide debt capital at flat rates, without sufficiently taking into account country risks and different degrees of maturity of MFIs

- The sudden inflow of larger capital amounts in very small and immature Microfinance markets leading to "destructive competition" and the collapse of rates.

If the trends described above should continue, this would clearly hinder a more substantial entry of the private sector into the Microfinance debt market. But there are positive signs of an increased awareness of all market actors of the importance of creating financially sustainable markets with the stated goal of increasing the share of private sector participation.

### 3. The relatively high transaction costs for Microfinance investments

The still relatively high transaction costs for investors to originate and structure Microfinance investments are an additional important impediment for a stronger engagement of commercial investors in Microfinance.

Even the largest MFIs are presently small institutions relative to other corporations which attract international debt capital.

At present, the largest loans to MFIs are no larger than \$5-\$10 million. This is quite small relative to most corporate loans from foreign lenders, which are at least \$50+ million, if not hundreds of millions. Therefore, the transaction costs of lending to MFIs (the cost of due diligence, as well as

legal structuring and documentation costs) are extremely high per dollar lent relative to larger corporate loans.

For Microfinance investments to remain competitive in the eyes of commercial investors it is therefore crucial to increase the average size of transactions which goes hand in hand with the emergence of larger, more mature MFIs, but could also be achieved in part by the application of innovative financing techniques, such as securitisation of MFI credit portfolios, the emission of local bonds etc.

#### The way forward

In summary, we would like to highlight the key requirements to ensure a higher engagement of commercial investors in Microfinance:

- Probably one of the most important factors will be the emergence of a segment of larger, more mature MFIs capable of engaging in larger and more sophisticated transactions (lowering transaction costs), of providing a track-record of "monetization events" (to increase the perceived liquidity of Microfinance equity investments) and willing to pay market rates for debt. It will be this segment that will ultimately catalyse the entry of the private sector in the Microfinance market.
- An additional important development would be the coordinated decision of the larger donors and IFIs to subsequently pull out of

this top segment of most mature MFIs in order for the commercial sector to step in. This process will require a considerable amount of "fine tuning" and coordination. Other segments of the Microfinance market would still receive capital subsidies but these would be linked to stronger incentives for growth and more efficiency. Private sector social investors will play an increasingly important role for these less mature segments, by providing long-term capital and supporting the transition of the MFIs to a more mature stage.

Last but not least, we believe that a move away from flat rates towards risk-adjusted rates, the emergence of new private sector investment initiatives and investment funds and financial innovations particularly in the field of securitisation will contribute to increasing the attractiveness of Microfinance for the commercial financial sector.

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i International organisations estimate that 80% of all enterprises, 50% of all urban enterprises are micro-enterprises, generating 20% of GDP

ii Microcredit Summit Campaign, October 2001, "State of the Microcredit Summit Campaign Report 2001"

iii The comparison between commercial banks and MFIs in the same developing country has shown relatively small differences their average implied interest rate on debt, even though commercial banks were considerably better risks (larger, better, diversified business portfolio). This seems to indicate that MFIs, because of their access to "soft money" sources, are not being charged market rates.