European Investment Bank

Definition of an enhanced Bank strategy in the microfinance sector

The present policy document outlines an enhanced strategy for the Bank in the microfinance sector, alongside the European Commission and other Development Institutions and attributes different roles to the different actors according to their specific added value available to the sector. The document underlines the Bank's teaming up and exchanging of information with other DFIs and the Commission and it defines the Bank's principal added value as the triple bottom line approach of securing economic, social and environmental returns in projects it finances.

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1. Introduction

In November 2003, the joint management of DG Development and EuropeAid of the European Commission decided to re-orient the Commission's microfinance policy towards capacity building and away from providing credit lines. This decision followed evaluations of the strengths and weaknesses of credit-lines supported by the Commission in the past years. The CGAP peer review on the Commission's microfinance activities, conducted in 2003, confirmed the weaknesses identified. The joint management decision suggests to leave credit lines to the EIB and other specialised development banks. The Commission should only be involved in giving capacity building for microfinance.

This decision implies a profound rethinking by the Commission of its strategy and goals in this sector and de facto an enhanced role for the Bank, as well as other Development Finance Institutions (DFIs) in funding Microfinance Institutions (MFIs).

2. Background

Microfinance is generally defined as the provision of short-term, unsecured loans. Loan principals may vary from a few euros to a few thousand euros. The size of the principal generally reflects the degree of development of the countries where MFIs operate. In some instances, MFIs also provide savings products and, more rarely, insurance products.

Over the last 20 years, the relevance of microfinance to alleviate poverty has been recognized in light of the impact of pioneering operations in East Asia and Latin America (for example: Graemen Bank in Bangladesh or Banco Solidario in Bolivia). Non Governmental Organisations (NGOs) dedicated to microfinance activities have played a very significant role in establishing the effectiveness of microfinance as a tool to fight poverty and to empower low-income populations.

These early experiences have demonstrated, among other results, that the poor are “bankable” and can represent good credit risk. This is now leading more main-line financial institutions, such as private equity funds and banks, to pay greater attention to microfinance as a relevant market for their activities.

This linking up of traditional financial markets with the microfinance one is however geographically uneven and follows different models. It is more advanced in Latin America than in Africa. It is quantitatively more significant in Northern-Africa than in sub-Saharan Africa.

Opportunities are now emerging to scale-up microfinance services, ensure sustainability and de-link microfinance from grant providers whose resources are too limited and not always well suited to support the evolution of the sector:

- Micro-credit financed on grants does not always emphasize the need for credit repayments, hence addicting recipients to “free-credit”, undermining any credit-culture that might have existed and consequently the chance for permanent long-term and often commercial operators to succeed;

- Grant funding is dependant on political agendas from donors, which varies from one region to another, from period to period, and is always vulnerable to cut backs; and
- Sourcing outside funding is a time consuming effort for MFIs that diverts management attention from transforming MFIs into independent sustainable institutions.

To become sustainable, microfinance must (i) integrate itself into the local financial sector which is the key source of local currency funding (ii) be managed by well-trained professionals.

Local currency funding is required because all micro loans are denominated in local currency and MFI should not bear foreign exchange risks.

Professionalism is necessary because microfinance is a specific financial activity, combining banking and social goals, which is technically difficult and costly. Whereas a small microfinance initiative, on a village scale or neighbourhood level, can be managed without much infrastructure and at a low cost, the management of larger operations is complex and demands appropriate MIS. MFIs can neither survive nor grow without good management tools: experience has shown over and over again that the lack of timely identification of and reaction to arrears quickly lead to portfolio contamination and bankruptcy.

In conclusion, there is a concurrent need for (ii) change of emphasis in the way credit is provided, away from grants and more towards equity/debt and guarantees funding which can be provided by the Bank and other DFIs; (ii) continued, and even increased, grant funding for technical assistance and IT.

3. Bank's proposed investment in microfinance

The Bank has a long experience in lending and providing equity participation to financial intermediaries for the benefit of medium, small and even very small business. More recently, it has embarked prudently in the financing of a few loans to and equity participations in MFIs: 10 operations totalling EUR 22m since 2000, in the ACP, and one loan in the FEMIP countries. Most of these operations are still under disbursement. It is exclusively within the ACP and FEMIP countries that the Bank has the appropriate instruments required to fund these activities.

It has always been the intention of the Bank to further develop its operations in microfinance as part of its mandates under Lomé and Cotonou, which provides, inter alia, for the strengthening and deepening of the local financial sector in the ACP countries. The recent decision of the Commission to withdraw from the financing of micro credit gives the Bank's roles more visibility.

Under the IF, the Bank will continue to pursue its operations in microfinance following sound banking principles and in line with Credit Risk Policy Guidelines (CRPGs) supporting initiatives that spearhead the industry, and acting as a strategic investor, aiming to leverage other funding be it for investment (commercial funding) or for technical support (grant funding).

Available instruments would be varied, including: equity, quasi-equity, subordinated and conditional loans to generate equity-based returns, ordinary debt at market related rates and guarantees to third party lenders, such as local banks, to support their involvement in the microfinance sector. In this regard, the capacity to provide local currency loans under the IF gives the Bank an opportunity to be a leader among its peers in the provision of "smart capital" to the microfinance sector.

(The ACP-IF experience would of course be available to the FEMIP department, which has recently concluded one microfinance operation in Morocco.)

3.1 Investment goals

The Bank's investment should seek to have a strong developmental impact on the microfinance sector and, as a result, on the countries where the operations are implemented. The Bank's funds should be seen as "smart capital" with the ultimate goal to foster the integration of the microfinance sector in the local financial sector. To reach this objective, the Bank should focus on:

i) Transformation of well-performing NGO MFIs into commercial entities able to attract private equity as well as debt financing;
ii) Scaling up of private microfinance institutions, by providing inter alia equity funding to strengthen their capital structure;
iii) Assistance to commercial banks willing to develop microfinance lending, through refinancing of MFIs, by provision of risk-sharing instruments;
iv) Strengthening the professionalism of MFIs' organization and management, in cooperation with the Commission or other providers of grant funding,

3.2 Debt financing/guarantee

To support the linking up of local banks to MFIs and induce them into developing a portfolio of microfinance risks, the Bank should be ready to share risks with the intermediaries, using inter alia local currency loans or guarantees. In as much as possible, guarantees should be preferred as they educate local banks in appraising and managing MFI risk.

Guarantees would also help recycle substantial excess banking liquidity into local economies and provide MFIs with local currency funding.

3.3 Equity investments

The Bank also could invest in equity. Although the Bank has the option of taking direct equity investments in MFIs, it is preferable to provide equity financing through specialized investment funds where possible.

Fund-managers are crucial for the success of the investments. As the private equity industry has so far had limited interest for microfinance in developing countries, especially in the poorer ones, it is difficult to select fund managers solely on a microfinance investment track record. Present microfinance fund managers gained experience on the spot as NGOs or as technical assistance providers, a path successfully followed by prominent leaders such as Germany's IPC-IMI, and the Latin American ACCION, Profund. This requires from the shareholders a time consuming hands-on approach in governance and administration of the funds.

Performance characteristics of microfinance funds can be summarized as follows:

- the cost of transactions is high. The population of MFIs financed by funds is, for the greater part, made of small institutions rarely able to absorb investments in excess of EUR 2 to 3 million. Hence funds are bound to process a great number of small deals. This adversely may affect their profitability;

- to realize capital gains, funds must either receive dividends and/or realize capital appreciation when disposing of microfinance institution holdings. Generally, institutions that are still in a growth phase distribute little dividends. Also, the lack of development of most local capital markets only exceptionally affords the possibility to float shares on a stock exchange. Hence fund managers seek either to secure put options with existing and longer-term shareholders or use quasi-equity and selfliquidating instruments. The price of these options or instruments generally shows a discount reflecting the lack of liquidity for financial assets;

- most funds are capitalized in US$ or in Euro but invest in institutions operating almost exclusively in local currencies. Hence, the financial returns closely follow the trends of the foreign exchange rate between the local currencies and the currency of the funds.

4. <u>Support to microfinance through technical assistance</u>

Currently the Bank does not have a flexible TA budget to use in preparation, in parallel or in continuation of its investment operations. As the Bank is becoming a significant financier of the sector, it will deploy greater efforts in working with potential and actual donors - the Commission, CGAP and others – so as to tandem its own financing operations with their activities.

Three broad sectors are generally recognized as key bottlenecks for the further growth of a microfinance enabling environment:

i) Development of microfinance infrastructures, technologies, products and processes consistent with industry best practices;

ii) Training programs for private sector as well as public sector staff capable to meet the growing human resource needs of the microfinance industry;

iii) Development of realistic, regulatory frameworks.

4.1 Creating an enabling environment for microfinance

Microfinance works best when it measures – and discloses – its performance. Accurate, standardized performance information is imperative, both financial information (e.g., interest rates, loan repayment, and cost recovery) and social information (e.g., number of clients reached and their poverty level). Donors, investors, banking supervisors, and customers need this information to assess their cost, risk, and return.

Credit bureaus, rating and audit are essential tools to the flow of information required to fully integrate microfinance into capital markets.

4.1.1 Credit bureaus

Credit bureaus provide banks and MFIs with data concerning a borrower indebtness and credit track record. They are instrumental in the development and management of small and medium size credit portfolio.

Banking services for large clients are based on long-term relationships, the constant exchange of information and the mobilization on all sides of significant human resources. This is economically possible because one large client generates a high volume of activities and operations cumulatively generating significant revenue. However, commercial relationships with microfinance clients (as well as SME clients) would not be profitable if banks had to mobilize as much resources as for large clients. Hence, financial institutions targeting large pools of individuals, such as micro credits, must have appropriate tools to scale-up their portfolios and manage risk. Access to efficient credit bureaus and the recourse to statistical scores ("scoring") are the key means to build and manage a large portfolio of credit risks.

The development of credit bureaus would address constraints of small loans operations by mitigating the non-reliability of financial information, and the limited track record of most small clients. These bureaus could be privately held, run as Public Private Partnership organizations (gathering financial institutions, consumers, and public authorities), or as public ones if it does not jeopardize efficiency, reliability and relevance.

4.1.2 Rating

Rating, like auditing, provides valuable information to management as well as external MFI stakeholders. It is also a tool to bridge the gap with formal financial markets. Rating also contributes to building capacity within MFI's. While onsite during a rating mission, the rating agency engages in a dialogue with the MFI: this dialogue often contributes to better internal communication within an MFI, enabling management and staff to obtain a more global view of the risk of its business. This exercise builds capacity within the MFI to perform ongoing self-evaluations of program strengths and weaknesses.

Finally, despite tremendous development over the past several years, the microfinance sector remains opaque. To build confidence in the sector, donors, investors and practitioners must have access to reliable and up-to-date information. Rating responds to this need.

4.1.3 Audit

Existing auditing services generally are not geared as well as they could be to audit MFIs and do not yet consider them as a commercially important market. Many MFIs still underestimate the value of regular external scrutiny to improve management performances as well as access to local financial markets.

The emergence of adequate enabling environments may include backing programs to train auditors and MFI officers in the specificities of audits for MFIs, which are often dramatically different from banks, as are the details of their products. Some differences between banks and MFIs include: lack of regulatory systems, governance, products and portfolio structure and funding mechanisms.

4.2 Training

MFIs are too small to create in-house training programs and outsourcing alternatives are not sufficiently available. The Bank will explore with donors the funding of training programs, or scholarships for young professionals to acquire the skills necessary for each and every aspect of MFI governance and management. These programs should target private and public sector cadres including staff to supervise the MFIs activities (see Para 4.3 below)

Banking institutes already exist in many countries, CGAP has set up training hubs in Africa, but their output quantitatively and sometimes qualitatively does not meet current and future needs of the industry sector.

4.3 Developing a regulatory and supervision framework

Microfinance as a component of local financial systems, albeit often unrecognised and informal, can grow to encompass a very large part of a country's financial transactions and its institutions can hold a substantial share of national savings. Because of the systemic risk that MFIs collectively represent, and the fiduciary responsibility vis-à-vis depositors, public authorities should monitor the performance of the microfinance sector and review how to enact specific prudential rules.

Using banking regulations for microfinance institutions is inappropriate, (i) because their typical products are marginal on banks' balance sheets and generally, considered as the riskiest type of assets requiring heavy provisioning; and (ii), the bulk of MFIs' activities are unsecured short-term loans, whereas the bulk of banks' assets are longer term, structured and secured.

Where appropriate the Bank will work with the Commission and other donors to support, in coordination with other specialized actors such as CGAP, Bank programs to assist public authorities in developing microfinance regulatory, and supervisory systems, or improve upon existing ones.

5. Conclusion:

Over recent years, the microfinance sector has come a long way from solely being a field of activity of NGOs, dedicated to development, to becoming a policy priority of the G8 (Sea Islands Summit Declaration – 2004). Article 21.5 of the Cotonou Agreement provides that "support for investment and private sector development shall integrate actions and initiatives at macro, mesa and micro economic levels".

The Bank added value lies in a triple bottom lines approach aiming to secure economic, social and environmental returns in projects it finances. In the course of its operations, the Bank will team up and exchange information with other DFIs and the Commission as well as seek to benefit from knowledge centres such as CGAP, a focal point of expertise and best practices in microfinance.

A realistic operational objective would be to start building up an annual deal flow of 2 to 3 operations in the initial two years - and scale up as quickly as possible to a higher commitment level - along the principles detailed in this note. In terms of staff requirement, this would imply appointing a dedicated officer, in the ACP – R&D Division who would focus on microfinance activities only, including inter alia: preparation of operations, liaison with the Commission in the coordination of strategies and TA programs and portfolio supervision.

Attachment 1

EIB MICROFINANCE PORTFOLIO

COUNTRY	VENTURE	Framework	Amount Signed (EURO)	Date of Signature	Nature of financing
REG. AFRICA	AFRICAP MICROFINANCE FUND LTD	LOME CONVENTION	2 000 000.00	2001	equity
REGIONAL	SHORECAP INTERNATIONAL	COTONOU	2 500 000.00	2004	equity
BENIN	FINANCIAL BANK OF BENIN	LOME CONVENTION	200 000.00	2000	loan
BENIN	ECOBANK BENIN	LOME CONVENTION	200 000.00	2000	loan
BENIN	BANK OF AFRICA BENIN	LOME CONVENTION	200 000.00	2000	loan
BENIN	FINADEV SA	LOME CONVENTION	1 000 000.00	2000	loan
MALI	KAFO JIGINEW	LOME CONVENTION	2 000 000.00	2001	loan
KENYA	CO-OP BANK MICROFINANCE LOAN	LOME CONVENTION	2 000 000.00	2003	loan
UGANDA	UGANDA MICROFINANCE	LOME CONVENTION	2 000 000.00	2003	loan
MOROCCO	Al AMANA, ZAKOURA and AMSSF	MEDA	10 000 000.00	2003	loan
	TOTAL		**22 100 000.00**		