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Reality Check: Preparing MFIs for Commercial Capital—Are We Ready?

Abstract

The commercial sector is increasingly recognizing the enormous potential of microfinance, and today the supply of private and commercial financing far exceeds donor dollars. Institutional transition and preparation for commercial investments and relationships demand creativity, strong leadership, and technical finance skills. This Progress Note profiles the experiences of three microfinance institutions preparing to access commercial debt; they were presented at a workshop in June 2006 at the U.S. Agency for International Development Learning Conference. The Progress Note also highlights practical steps for managers of microfinance institutions to consider in preparing for commercial investments.

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Background

Since its early beginnings over 30 years ago, the microfinance sector has developed and matured to become a recognized financial service mechanism for poor people who remain underserved by the formal financial services sector. The industry has expanded and continues to show strong growth. While microfinance began with extensive donor support, current analysis suggests that it has entered a new age by accessing additional financial support from commercial and private capital.

Donors have historically provided between US $500 million and $1 billion a year to the industry.[1] However, market demand for microfinance services is estimated at more than $300 billion; market supply is roughly $4 billion.[2] A small amount of this "capital gap" can be filled with retained earnings. However, fewer than 20 percent of microfinance institutions (MFIs) are profitable, and for many of those that are profitable, portfolio growth requirements often exceed the rate of profit generation, which limits this source.

Savings is another hope for much needed MFI capital, but only a minority of players, including credit unions and transformed institutions, are legally regulated to take savings. Only the capital markets with a wide variety of investment instruments and terms—long-term debt in local or hard currency, subordinated or convertible debt options and equity—are sufficient sources for the necessary capital.

As donor resources and appetites for funding loan capital wane, and as capital requirements to fuel expansion continue, managers need to address their growth plans creatively. Their conventional focus on "sustainability" needs to broaden to include financial savvy about balance sheet structure, borrowing from local banks and international institutions, and managing measured financial risks

Institutional Context

In recent years, attempts have been made to classify MFIs into levels of development and maturity. Finan-

1. Julie Abrams and Ivatury, Gautam, *The Market for Foreign Investment in Microfinance: Opportunities and Challenges*, CGAP Focus Note, no. 30 (Washington, DC: CGAP, 2005), 1.

2. Robert Peck Christen, Richard Rosenberg, and Veena Jayadeva, *Financial Institutions with a "Double Bottom Line: Implications for the Future of Microfinance*, CGAP Occasional Paper, no. 8 (Washington, DC: CGAP, 2004), 2.

Table 1. **Where Is the Real Money?***

	Traditional Philanthropy	Private Investments with Social Goals	Socially Responsible Investment Funds	Traditional Corporate
Investment objective	Maximize social return, no financial return	Social mission with financial return expectations	Market-rate financial return with some broad social return	Purely profit-driven
Capital types	Donations and grants	Below-market capital or mix of donations and market-rate capital	Market-rate capital	Market-rate capital
Estimated market size	US $225 billion	$16 billion	$2.16 trillion	$17 trillion

* Adapted from Shari Berenbach and Jacqueline Kohn, "Private Investment for Social Goals and the Blended Value Capital Market," discussion draft, Calvert Foundation, September 2004.

cial performance, regulation, size, and profitability typically characterize the categorization of MFIs. There has been a tendency for the sector's top-tier MFIs to attract the attention and interest of research, public profiling, and certainly the greatest interest from the investment community. Tier 1 MFIs are generally considered "investable" or "bankable." They are financially strong, professionally managed, and externally supervised and regulated—a safe investment risk.

However, private and social investors are increasingly courting the same group of MFIs in tier 1. In spite of the possibilities, most of the investments continue to be forms of debt investment. Very, very few equity partnerships have been forged. With the high flow of debt investments available, it is clear that investors wishing to invest in microfinance will need to broaden the scope of partnerships, range of financial instruments, and nature of microfinance institutions they support. Investors may also need to look at ways to explore partnerships and opportunities with MFIs in tiers 2 and 3. There are risks. There are also ways in which to minimize the risks to the investor.

All of the cases in this Progress Note illustrate the preparation MFIs face in applying for commercial loans through banks, trust funds, or other mechanisms. The MFIs showcased here were only in the beginning stages of financial integration. What is unique is that the MFIs represented institutions categorized as tier 2 and tier 3 institutions. None of the MFIs were regulated, and some were relatively young in their institutional life. However, their experiences have been stepping stones to growth and expansion and additional financing.

Three Case Studies

Case 1: Grameen Foundation USA and Lift above Poverty Organization

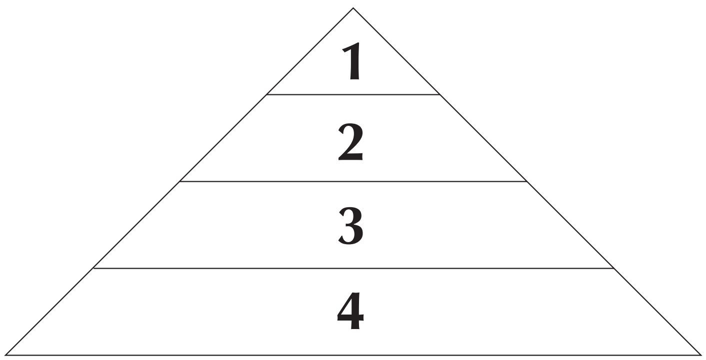
Grameen Foundation is a nonprofit organization that uses microfinance and innovative technology to fight global poverty. Grameen Foundation supports the growth of local microfinance institutions by providing financing, technical assistance, and technology solutions. Its global network of partners has reached over 2.2 million people in 22 countries around the world.

Grameen Foundation has been successful in raising domestic commercial capital for its local microfinance partners through the use of guarantee mechanisms to support financing in the form of term loans, lines of credit, quasi-equity, partnership model financing, portfolio sales, and other innovative mechanisms. In 2005, Grameen Foundation established a capital markets group (CMG) with the objective of developing innovative financial instruments to harness the resources of the financial markets to support rapid expansion in outreach to poor families. The CMG has already launched US $31 million of a $50-million growth- guarantee fund to raise local currency financing for the microfinance sector.

Lift above Poverty Organization

Lift above Poverty Organization

Figure 1. **Breakdown of Specialized MFIs***



Tier 1: Mature and best-known MFIs with strong financial and operational track record. Most are regulated.
2%, at most, of all MFIs, the "top 50 or 100"

Tier 2: Successful but smaller, younger, or simply less well-known MFIs that are at or near profitability. Mostly NGOs; considering conversion. Majority will progress up.
8% of all MFIs

Tier 3: Approaching profitability. Understandable shortcomings due institutional age, lack of capital, weak MIS, or other needs. Nearly all NGOs. Some will progress up.
20% of all MFIs.

Tier 4: Mix of unprofitable MFIs: start-ups, post-conflict settings, weak institutions, or integrated projects with microfinance components. Some will progress up.
70% of all MFIs.

*Adapted from Positive Fund, as appears in Jennifer Meehan, "Tapping Financial Market for Microfinance," Grameen Foundation USA's Fostering This Emerging Trend, Working Paper Series (Washington, DC: Grameen Foundation USA, 2005).

(LAPO) is a non-profit, poverty-focused microfinance institution based in Benin City, in Edo State, Nigeria. As of June 2006, LAPO had a current outreach of 65,143 clients with a total loan portfolio of US $5 million and savings of $2 million. LAPO has been financially sustainable for the last two years and has an excellent portfolio quality with portfolio at risk at less than 1 percent. LAPO has been a Grameen Foundation partner since early 2003, during which period Grameen Foundation has provided financing for expansion and technical assistance to strengthen LAPO's operational, financial management, and management information automation systems.

LAPO's existing sources of funds include donor financing, internal accruals, and savings. Recent government initiatives in Nigeria, such as SMIES (a regulation requiring banks to invest 10 percent of their profits in small and micro- business sectors), and a new microfinance regulatory policy have created a conducive environment for investment in microfinance. LAPO hopes to benefit from these opportunities by accessing commercial capital from the banking sector and collecting voluntary savings for intermediation, once it transforms into a microfinance bank as provided by the new policy.

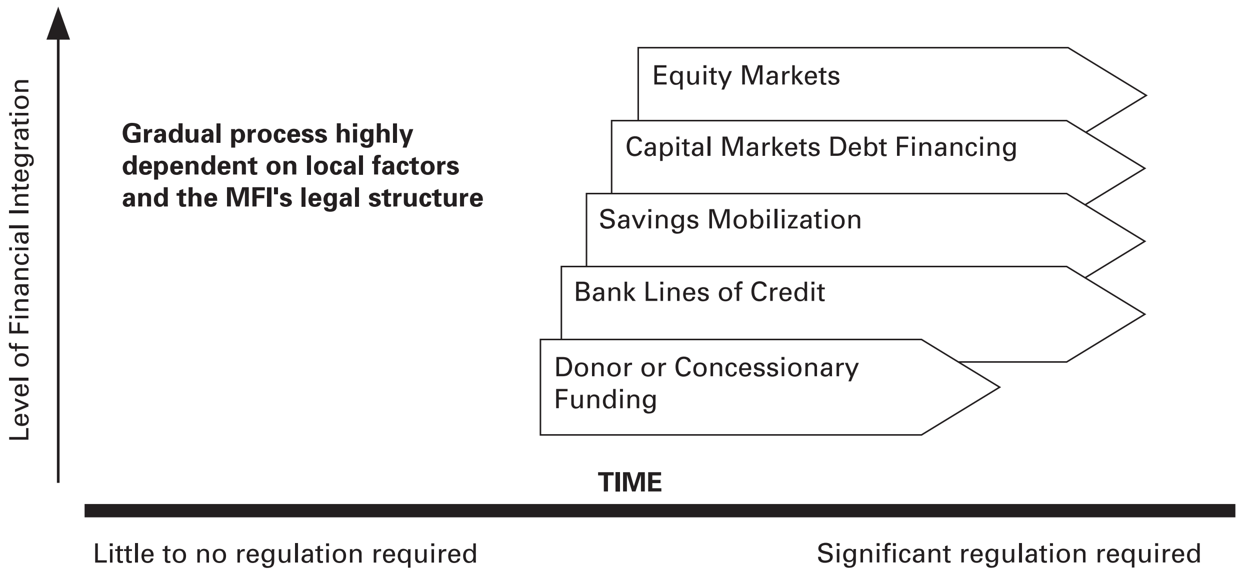
MFI priorities

With a strong institutional framework in place and high demand, LAPO's priority was to achieve exponential growth, and needed access to capital to support these growth plans. It also identified the need for access to equity and long-term financing to support its transformation into a microfinance bank. It wanted to diversify its financing sources to minimize risk and preferred local currency financing to reduce its exposure to foreign currency risk and minimize the cost of capital.

Looking for investors

LAPO targeted two groups of financing sources and/or potential investors based on the identified use of funds. It targeted donors and networks such as Grameen Foundation, NOVIB, CORDAID, and other socially responsible investors for its equity and long-term capital needs. For portfolio financing, it preferred commercial sources of capital because of the size of its financing needs (LAPO projected a financing gap of at least US $5 million over the next few years), the ability of these sources to respond quickly and efficiently to changing needs (once the initial relationship was developed), and the potential, especially in the case of local commercial banks, of value-added services, such as electronic banking, etc.

Figure 2. **Stages of Financial Integration***



* Louise Schneider and Greta Greathouse, "Strategies for Financial Integration: Access to Commercial Debt," table 1, "Stages of Financial Integration," Financial Services and Products Occasional Paper (New York: Women's World Banking, 2004), 1.

LAPO and Grameen Foundation identified major commercial banks, both local and international, with Nigerian operations to approach with financing proposals. The first targets were three commercial banks with whom LAPO already had some existing relationship (Afribank, UBA—United Bank for Africa, and Zenith Bank) and one international bank (Citibank) that Grameen Foundation was working with in other countries. Grameen Foundation proposed providing a guarantee to support a credit facility in any one of these banks with a minimum leverage of 2:1. Eventually, however, only Afribank and Citibank showed interest, and financing transactions are now near to closing with both of these organizations.

In addition, LAPO looked for other international investors, such as commercial microfinance funds on the lookout for emerging investment opportunities in the microfinance sector. With its strong financials and growth performance, LAPO was confident of its ability to attract such investors.

The approach

Despite being a non-governmental organization (NGO), LAPO understood the importance of presenting itself as a professional organization. LAPO developed a detailed business plan and financial projections for a five-year period and cash-flow projections, etc. Each bank was approached with an individualized proposal including the financing needs, use of funds, and proposed terms of the transaction. Both Grameen Foundation and LAPO met personally with senior staff at each bank to present their individual organizations and to educate the target banks about the microfinance sector.

It was also important to create the right incentives for the potential investors. LAPO presented itself as an attractive investment option with low risk and high profitability. The size of LAPO's operations, with more than 35 branches and high cash flows, was also an attractive business opportunity for the retail banks.

Understanding the conservative nature of the Nigerian banks and their lack of familiarity with microfinance sector, the banks were invited to visit on site and meet with staff, and available information was shared with them very transparently. LAPO disclosed to Afribank the due diligence and evaluation reports prepared by Incofin (a microfinance loan fund that also made a loan to LAPO). Both Afribank and Citibank conducted on-site due diligences which were key to helping them develop confidence in the strength of LAPO's operations and the reliability of its projections.

Negotiating the deal
The terms of the transaction and negotiating points were different for each investor:

- Incofin: A microfinance loan fund recognized LAPO as a good investment opportunity and was willing to provide financing without any collateral requirement at competitive market rates. It was, however, only able to give hard currency loans. This increased the cost of the loan for LAPO substantially as it had to take a local currency loan by depositing Incofin's hard currency loan in a local bank as cash collateral, in order to manage the foreign currency risk.

- Afribank: A local Nigerian bank with no experience in microfinance was the most conservative in its approach, and it based all negotiations on the level of collateral that could be provided by LAPO. Despite the fact that Grameen Foundation offered a "first loss" guarantee instead of the more traditional *pari passu*, Afribank has hesitated to give non-collateralized financing to LAPO.

- Citibank: An international bank with some previous experience in microfinance approached the transaction in the most professional manner. Citibank has been willing to negotiate both leverage on the guarantee and interest rates based on its risk assessment of LAPO.

Case 2: World Vision and KADET

World Vision has adopted microfinance as a key intervention to address the economic underpinnings of poverty. The organization has a global microfinance presence in 46 countries. World Vision's affiliated microfinance institutions have more than US $134 million invested in 390,000 clients. Of these, 17 MFIs are operationally sustainable and 11 MFIs are financially sustainable.

Strategy for transitioning MFIs to commercial capital
World Vision has created VisionFund International, a wholly-owned global subsidiary that accesses commercial and social capital for on-lending to its MFIs. As a second component to the strategy, the World Vision-affiliated MFIs are encouraged to access local commercial capital. World Vision also plans to transform MFIs, where feasible, into regulated microfinance institutions.

Background on KADET MFI in Kenya
The Kenya Agency for the Development of Enterprise and Technology (KADET) is a for-profit shareholding company that is a wholly-owned subsidiary of World Vision Kenya. It was developed to enhance access to financial services for the economically marginalized in rural Kenya, especially where World Vision implements its multi-sectoral Area Development Programs. KADET began operating in 2000 and was registered in June 2001. KADET was a latecomer to the MFI market in Kenya and found that public donor grants had dwindled by the time they started.

As of June 30, 2006, KADET had 15,002 borrowers with 7 branches and 50 rural sub-offices and an outstanding loan portfolio of US $3.4 million. It was 80 percent operationally sustainable and 74 percent financially sustainable. Much of its growth has been financed through commercial capital. KADET has grown its outreach in rural areas and simultaneously increased its sustainability.

MFI priorities
KADET needed significant capital for long-term growth, but public donor funding was no longer available in Kenya. Also, private funding was very limited and stayed at levels below the growth projections desired by KADET management and board of directors. To grow, KADET needed commercial capital very early in its institutional life, even though it had not yet met operational sustainability. As a result, KADET management proposed, and its board approved, to take on debt to grow KADET, given the limited funding options.

Looking for investors—Finding the right fit
KADET sought commercial credit for loan capital. It also sought grants for capacity building, institutional transformation, capital assets, and product innovations. There was limited interest from large external lenders, given KADET's small size and lack of a long track record. However, many lenders were willing to support rural lending, which was a good fit for KADET. The minimum size of the loan KADET wanted was at

least US $20,000. KADET wanted debt rather than equity so that its ownership would not be diluted at an early institutional age when its strategic direction needed to be in alignment with World Vision's programmatic priorities. Thus, KADET's board of directors was not interested in having the lender or investor participate in governance. KADET was looking for either a for-profit or a social investor. KADET preferred long-term financing to ensure that it continued to build financial strength before the loans had to be repaid.

KADET staff approached several sources of capital, including local commercial bank loans from Standard Chartered Bank; donor-supported lenders, such as Cordaid of the Netherlands; VisionFund International, a fund owned by World Vision; and Jitigemee Trust, Ltd., which was supported by the Dutch government.

The approach with the lender
KADET had a previous business relationship with the Standard Chartered Bank. KADET staff started with telephone and personal contacts in the bank and the other potential lenders. The next step was for KADET to host roundtable discussions with the KADET management and lender representatives. KADET used its client savings deposits as leverage in the banking relationship. Since KADET mobilized savings for the bank, the bank was more open to consider lending to KADET. As part of the conversations, KADET management provided key financial reports and business plans. As a result of its discussions with KADET, Standard Chartered Bank conducted a credit appraisal of KADET. The loan was consequently approved and disbursed.

Developing interest with the investors
In order to develop interest with the other investors, KADET management sold the lenders on the MFI's strategic direction of rural expansion and the prudent and professional financial management of its senior leadership. Sharing strategic documents such as the business plans helped pique the interest of the lenders. The lenders also liked the success stories that KADET staff shared with them about the changes in clients' lives as a result of financial services.

Anticipating the investor's questions: What were KADET's weaknesses?
In order to address possible questions of why KADET was not yet operationally sustainable, KADET management stressed its commitment to sustainability. Management also showed the bank its growth trends that demonstrated a track record toward sustainability with the added loan burden and a capacity for growth. KADET management also told the lenders that accessing additional capital would help the MFI serve and impact more clients. KADET staff also explained how its strategic direction to serve very poor clients in rural areas drove up costs and lowered sustainability.

Issues: Negotiable and non-negotiable
KADET was in a negotiable position with the lenders, in spite of the fact that it was not yet operationally sustainable. KADET management provided lenders with a business plan that showed when the MFI would attain sustainability. However, KADET was not able to negotiate favorable interest rates from the lenders.

Lenders wanted to see a cash- flow plan to determine whether KADET had the ability to pay the lender without lowering sustainability trends. While the deal provided a business opportunity for the lender, KADET also provided them a loan client that they could grow over time.[3]

Case 3: CHF International

As CHF International's microfinance subsidiaries begin to mature—i.e., having reached financial sustainability and now positioning themselves for the next level of growth—managers are increasingly looking to commercial capital for financing. Over the past year, CHF has relied on a mix of international social investment funds and local commercial banks to raise loan capital. The lessons learned have proven invaluable in negotiating subsequent transactions with other commercial investors and have often been applicable across countries.

3. KADET is also in discussion with VisionFund International for a loan. As mentioned previously, VisionFund International is a wholly-owned global loan fund that accesses social and commercial capital and on-lends it to World Vision's MFIs. VisionFund lends at a floating rate based on the London InterBank Overnight Rate (LIBOR). The loans are usually for five years, but depend on the terms of the funds borrowed. VisionFund is planning to take a majority shareholding position in World Vision's affiliated MFIs. For KADET this would mean moving 100 percent ownership from World Vision-Kenya to VisionFund International.

CHF International's priorities in accessing commercial capital
Over the last year, CHF International has begun to diversify its sources of funding and seek out commercial investors to supplement and/or replace traditional sources of donor funding. Thus far, CHF has borrowed from two quasi-commercial funds,[4] two social investment funds,[5] and four local commercial banks. CHF has also formed nine local bank partnerships under which both parties share risk and profits.

Priorities in accessing commercial capital were as follows: flexible borrower criteria, local currency funding if available, option to borrow at a fixed rate, longer-term financing options in order to match asset and liabilities terms, and fast disbursement with prepayment and renewal options. It was important to emphasize the desire to build long-term relationships with commercial lenders, both to secure future financing options and also to invite interest from other private investors.

Identifying potential investors
To date, CHF has used a variety of methods to identify potential commercial investors and to ascertain which investor would be the best fit for its subsidiary MFIs, depending on their degree of price sensitivity, ability to manage currency risks, and size of financing requirements that would require some collateral basis.

For funds interested in moving beyond the "top 50" MFI performers, a network organization such as CHF can offer a new investment opportunity, while assuring a "filter" of technical assistance and accountability from the parent to offset risk. For local capital, it was almost always a personal contact with a banker or a board member referral that helped with the first approach. In some cases, CHF took the long-term approach of first establishing a business relationship with the best-qualified local bank to offer general banking services to the MFI, and later opening dialogue for financing once there was a track record and degree of familiarity. Country conditions also play a huge factor: for instance, in Lebanon where banks have plenty of excess liquidity, CHF found three commercial banks willing to start small and test out a partnership model, and recent government legislation now offers incentives for these banks to use a portion of their local currency reserve with the Central Bank for on-lending to MFIs.

Negotiating the deal
Negotiating each transaction is highly individual in nature and depends upon the predilections and limitations of both borrower and lender. For instance, socially-responsible investors may have limited flexibility in setting interest rates, as they must guarantee a certain return to their own shareholders. Local banks may have more room with interest rates, but may be legally precluded from non-collateralized lending or unwilling to make a long term loan. Borrower and lender must candidly communicate to the other party what is and is not negotiable.

Conclusion

The three cases illustrate several emerging themes: 1) Management capacity and financial transparency are critical to investors; 2) MFIs must be better informed and able to weigh the risk factors—particularly currency risk and collateral requirements—of a potential deal so that they are on more equal footing at negotiating table; and 3) MFIs need to understand the lender's perspective, and learn to operate in that arena.

These three cases included MFIs that had not undergone legal transformations or were subject to Central Bank regulations. They represent the vast majority of many growing MFIs in the world today. While Many tier 3 and tier 4 MFIs may look at mergers or other forms of consolidation in order to make wise business decisions and maintain client services, there are just as many that will need to address commercial and private capital investments—either debt or equity.

There are a number of specific themes that will need further exploration and emphasis in the future:

- **Greater, long-term capital.** MFIs whose sole source of capital remains commercial debt or bank lines of credit still face a huge challenge for realizing

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4. CHF identifies the Overseas Private Investment Corporation and Swedish International Development Agency as quasi-commercial, due to their similarity in financing requirements to many private investors, such as financial covenants, performance and reporting requirements, business plans, etc.

5. BlueOrchard's St. Honore Fund and Oikocredit. For more information, see http://www.blueorchard.org/jahia/jahia/pid/67 on St. Honore and http://www.oikocredit.org on OikoCredit.

Table 2. **Closing the Deals: Terms and Conditions**

Grameen Foundation USA	World Vision	CHF International
Grameen Foundation and LAPO were negotiating a line of credit with 2 commercial banks—Afribank, a domestic bank, and Citibank an international bank with operations in Nigeria. The proposal was for the banks to provide an overdraft facility to LAPO, based on a guarantee provided by Grameen Foundation of up to 50% of the credit facility. **Closing the deal: Afribank** Afribank is offering a cash-credit facility to LAPO of US $450,000 against a guarantee of $300,000. The term is expected to be annual with leverage amount and interest rates to be reviewed, based on LAPO's performance during the period.	**Closing the deal: Line of credit from Standard Chartered Bank** The local bank provided a local currency overdraft facility of up to the equivalent of $145,000 initially. (Currently, the line of credit is $1.5 million.) The interest rate was 10.75% per annum, the bank's base lending rate less 1%. Collateral was based on the cash collateral from clients held in the commercial bank. As this lowered the risk for the bank, the bank was willing to offer a preferred interest rate. The term of the loan was annual and renewable every year. The bank did not require the balance of the line of credit to be brought to zero, as it was not in their interests to lose interest payments with a zero balance. The line of credit has been accessed only as needed, since the accounts also carry client transactions and a fair bit of movement during any given period. The loan was approved in four months. The delay was on World Vision's side because the borrowing had to be approved by the national, regional, and global offices.	**Closing the deal: Revolving line of credit with local bank for LIDER, Bosnia** CHF's subsidiary in Bosnia, LIDER, with a portfolio of $4.2 million and 3,881 active clients, secured a KM 1-million ($610,000) revolving line of credit from a local bank. LIDER had already established a business relationship by opening an account and using the bank's services for clients' disbursements and repayments. LIDER sought a business referral in order to reach managers with appropriate seniority, i.e., individuals with signing authority. The marketing approach was to "offer" a partnership, rather than "ask" for a loan, which in the end worked to LIDER's advantage by placing it in a better negotiating role as a "partner." The bank initially requested 20% collateral in the form of a cash deposit of the total loan amount; however, once LIDER's management made time to educate the bank about the risk profile of a typical microfinance client, it ultimately negotiated to have the collateral reduced to 5% of total amount, with the balance replaced by a pledge on the portfolio financed by the loan. It also secured an interest rate near the prime rate local banks charge their best customers, with interest payable only on amounts drawn, no commitment fee, and an option to prepay the loan in full. In 2006, LIDER was able to raise the KM 500,000 limit to KM 1 million.
Closing the deal: Citibank Citibank offered a credit facility of $1.2 million in financing, backed by a guarantee of $500,000, a leverage of 2.4 times on the guarantee amount.	**Closing the deal: Concessional loan from CORDAID** This loan was a local currency loan valued at $216,048. It carried an interest rate of 6% + inflation rate. The lender changed the terms because the terms became untenable with the low inflation rates in Kenya at the time. Later, the lender changed the terms to the treasury rate minus 2%; current rates are roughly 7%. The collateral was the book value of the portfolio. The loan had a two-year grace period with quarterly payments. The loan was approved in four months. The delay was caused by waiting for someone with CORDAID from the Hague to approve the loan. CORDAID also provided KADET a €100,000 ($126,430, at exchange rate $1.2643 = €1) grant for capacity building. KADET is currently awaiting the next tranche of $216,048. The total amount of the loan was €400,000 ($505,720).	**Closing the deal: Overdraft facility and revolving bank loan with local banks for MEMCO, Jordan** CHF's subsidiary in Jordan, MEMCO, with a portfolio of $6.6 million and 3,210 active clients, closed an overdraft facility of JD 400,000 ($560,000) and a revolving loan of JD 500,000 ($800,000) with two local banks. The overdraft facility may be used as loan capital by making "healthy movements" in the account. This means managing the account to reflect genuine business activity, i.e., the account should have frequent swings from a deposit balance to the maximum overdraft amount.** For the revolving loan, each withdrawal up to the credit ceiling is payable within 12 months, with interest payable only on amounts drawn. Because of its track record and strong balance sheet, MEMCO was able to negotiate 50 basis points above the prime rate on a non-collateral basis. Although there is a commitment fee, there is no prepayment fee.

Table 2 cont'd. **Closing the Deals: Terms and Conditions**

Grameen Foundation USA	World Vision	CHF International
Closing the deal: Incofin Incofin gave LAPO a clean loan of €250,000 with a 5- year term and interest rate of 7.5%. Additional domestic bank interest on local currency component of the loan was 17%.	**Closing the deal: Concessional loan from Jitegemee* Trust Ltd.** Jitegemee, a trust funded by the Dutch embassy, provided KADET a local currency loan valued at $280,533 with an annual interest rate of 9%. The collateral was a floating debenture of KADET's assets to the extent of the outstanding amount of the loan. The terms were set for two years, with quarterly repayments, and one quarter as a grace period. The loan was approved in four months. The delay was the time it took to prepare the debenture document. KADET was able to generate more interest on the part of the Jitegemee Trust in lending to the MFI because CORDAID had already given them a loan. The total loan amount was $650,000.	**Closing the deal: Network loan to CHF International** Although CHF subsidiaries have been able to secure some local currency funding and tap into local commercial markets—many of which carry excess liquidity— the challenge still remains: How to secure the larger, longer term financing needed to maintain consistent growth and avoid the time, effort, and cost of "piecemeal" financing that is fact of life for most MFIs? Partly in response to this, CHF has begun to explore a more centralized fundraising approach. One example is a € 1 million facility with Blue Orchard's St. Honore Fund, a new fund which permits loans to be made directly to a network, rather than to individual microfinance institutions. Although this is still a small amount compared to CHF's global financing needs ($60 million portfolio), the strategy to start small with an internationally recognized private investor, in order to attract interest from other private investors, has proven successful. Since closing the transaction, CHF has been approached by four other private investors for financing at a network level.

* Jitegemee means "self-reliance" in Swahili.

** A typical swing, or healthy balance, in the deposit account may be three times the ceiling of the overdraft facility.

exponential growth and outreach. Most commercial debt is in smaller amounts (less than US $1 million) and for shorter terms (1–2 years). This places significant constraints on MFIs who are forced to continually seek financing to be able to fulfill their long-term planning.

- **Collateral constraints.** As long as the only collateral used in accessing commercial and private capital is cash, the MFI's loan portfolio—or fixed assets—capital constraints will remain. Commercial investors must learn to take more risk, or MFIs will find themselves with "nothing left to leverage."

- **Relationship building.** Trusting, informative relationships between partners, investors, bankers, and MFI boards and management must be developed and maintained. Client visits, branch visits, and open reporting demonstrate transparency and foster appreciation for the values and objectives of the MFI, and the needs and interests of the banker or investor.

- **External ratings.** The value of external, objective validation through audits, due diligence, evaluations, and rating reports cannot be over emphasized. These build credibility and promote transparency, particularly if investors understand them and trust them. Other investors will remain skeptical—as the industry's benchmarking and information services rely largely on voluntary information provided by MFIs themselves.

- **Currency risks.** To date the majority of international investors deal in hard currency and place foreign currency exchange risk solely on the MFI. Additional solutions are needed to mitigate foreign currency exchange risk, define exit strategies, and strengthen MFIs' capacity in treasury functions (asset/liability management).

Table 3. **What Was Learned?**

Grameen Foundation USA	World Vision	CHF International
Several key lessons were learned by LAPO and Grameen Foundation: • Be professional: Develop a strong business plan with a clear growth strategy and sound assumptions. • Pre-transaction due diligence and field visits are very important in building investor confidence. • External ratings and evaluations by independent parties and institutions are also very important. • Diversify sources of financing because individual institutions take different approaches. • Develop competition between potential investors to increase one's ability to negotiate successfully. • Use language that banks are familiar with. • Be patient and communicate often with the banks, responding quickly to any requests for information. This helps them gain confidence in the strength of petitioning institution.	KADET's management and board learned a number of things from their experiences: • Accessing the commercial market for capital was relatively easy. Commercial sources may be easier to manage than donor sources, as the priority is a good business relationship and on-time repayments. • Develop a relationship with the bankers and learn to work with them. • Instill confidence in the banker with the MFI's performance, although it may not yet have reached break-even. • Adopt new banking methodologies and technologies to maximize service and efficiencies. • Demonstrate reliability with repayments; renewed loans can be negotiated with more favorable rates. • An entrepreneurial board and management comfortable with working in the business world are important. • Management must inspire the lender's confidence to get a loan. Financial performance must support management's projections and marketing efforts. • Commercial relationships strengthen donor confidence in the MFI. • Good performance and bank relationships create a competitive environment; other bankers and investors may approach the MFI in order to get its business. • Borrowing from commercial sources has made KADET more attractive to donor capacity-building funds. The commercial relationship is evidence of a commitment to sustainability and scale. • "Necessity is the mother of invention." The lack of donated donor capital forced KADET to work with the private sector early in its institutional development. This helped KADET to think and act like a private company.	CHF's experience provided some tips for approaching investors: • Develop a concise, professional business plan that will support one's case. • Take a personal approach, i.e., create marketing materials that are specific to the investor and outline a mutually beneficial relationship. • Always be prepared with due diligence materials. • Learn and use the same terminology as the investor. • Anticipate questions and be prepared to respond quickly to further requests for information, and allow time for a new business relationship to develop. • Finally, be visible: lenders talk to each other and one successful closing can lead to increased options with other investors.

- **Transformation.** MFI "transformations" are not simply legal transformations: they are fundamentally a "mental transformation." This includes a business orientation in staff, communications, marketing approaches, and business plans, which puts additional stress on the management team. Likewise, financing to support transformation must also be managed carefully.

- **Management capacity.** As more and more MFIs access debt and other financial instruments, it is imperative that they are led by professional, skilled managers. MFI managers must be ready to meet the challenge. MFIs must be ready to absorb the significant amounts of available capital from the private sector.

Box 1. **The Next Chapter: Equity Investments**

As MFIs grow, they cannot continue to add debt to their balance sheets without increasing their risks. Excess leverage (the ratio of debt to equity) increases the risk of losses and perhaps failure and, therefore, may eventually cause lenders not to provide additional debt. At some point, the MFI will need to bring in new equity capital in order to keep the ratio of debt and equity at reasonable levels.

What are the main issues that surround the equity transactions? These issues include the same concerns as lenders of debt and at least four more:

1. **Corporate form:** An equity investor cannot invest in an NGO because there is nothing to buy. That is, the NGO cannot distribute part of itself to others. A cooperative has a similar problem. An equity investor seeks to invest in a privately owned institution, even if its single owner is an NGO. This is significant because the majority of the MFIs in the world are NGOs.
2. **Valuation:** When the MFI sells part of itself, it wants to get the best price. Inevitably, discrepancies will arise over the valuation of the company. There are too few transactions between MFIs and investors which can provide precedents for resolving these issues on the basis of traditional measures, such as comparables or discounted cash flow.
3. **Governance:** Because equity investors are owners and usually long-term owners, they have concerns about the governance of the institution. While these concerns may materialize in different ways, the investor's doubts focus on the ability of an organization that was formed primarily for social reasons to consistently make good business decisions.
4. **Exit:** Unlike the most founders of microfinance institutions, the equity investor does not want to be there forever. Equity investors usually want to exit or sell their investment after a period of about five or six years. The sale of their shares in the MFI is difficult because there are very few buyers. Normally, the investor will seek to arrange the exit in advance, but there can be risks to both parties.

These concerns have limited the number of commercial equity providers to a courageous few. However, as the microfinance capital market matures, these numbers will increase and the ability of MFIs to obtain commercial equity will improve as well. Until that happens, many MFIs will need assistance as well as quality performance in order to attract equity capital.

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Appendices

Appendix 1. **Checklist for MFIs: Loan Request Preparation and Application***

* Louise Schneider and Greta Greathouse, "Strategies for Financial Integration: Access to Commercial Debt," Financial Services and Products Occasional Paper (New York: Women's World Banking, 2004).

INTERNAL PREPARATION AND ACTIONS

1. Develop clearly written policies and procedures, demonstrating management of critical risk areas:

Asset quality

- Credit methodology
- Portfolio tracking and follow-up
- Delinquency, loan loss reserves, write-offs

Financial risk management

- Asset/liability management
- Liquidity management
- Foreign exchange risk management
- Risk diversification policies

Operating risk management

- Management information systems/data protection
- Emergency planning

Organizational risk management structure

- Description of structure, participants, reporting lines, and monitoring frequency of risk reporting
- Roles and responsibilities of the board of directors
- Management reporting system and use
- Internal audit function

Governance: Core skill sets, responsibilities, committees, and terms

2. Develop internal guidelines for bank relationship policies

- Diversification policies (counterpart risk)
- Assets and liabilities—deposits and loans
- Income/service tracking and review

3. Package your MFI's story for maximum impact (see Louise Schneider and Greta Greathouse, "Strategies for Financial Integration: Access to Commercial Debt," Financial Services and Products Occasional Paper (New York: Women's World Banking, 2004).

- Background and overview
- Business description: markets served, products/services offered, portfolio diversification
- Three-year trend table with clients, number of branches, and operational and financial indicators
- Comparison against industry best practices, benchmarks, and local financial institutions
- MFI contact information and references

4. Know the existing terms and conditions in the banking market

- Review competitive profile and strategy of banks; identify strategy for relationship development with the bank
- Review loan pricing and market trends, identify individual banks' parameters, practices, and preferences

5. Develop request for terms and structure which meet your needs

- Identify needed draw down schedule, tenor, and amortization based on growth strategy and cash flow projections
- Prepare suggestions for structures which may be new to their normal practice, but exist in other markets
- After securing bank credit approval, make sure to include an "early loan termination" clause when negotiating legal loan agreements

6. Design a strategy for selling your MFI as a desirable client and microfinance as a viable industry

- Present your total potential as a bank client
- Quantify current/project bank product requirements and revenue potential (loan deposits, cash management, remittances, etc.)
- Include a banker on your board of directors who can refer you to banks and improve your image
- Make sure to use a reputable and leading accounting firm as your auditor
- Justify better pricing based on your true risk profile
- Compare financial performance of your institution to your peer group based on ratings (if you have them) or compare to benchmark data if you do not

7. Research credit enhancement options and their costs

- Know which local/international guarantee options have been used locally
- Prepare to discuss their acceptability with your bank
- Negotiate better leverage pricing with the guarantee

8. Prepare in advance to address issues which will receive extra scrutiny from the bank's credit process (e.g., explanation of why your processes work)

- Reliability of data
- Credit methodology
- Portfolio performance
- Client repayment culture

EXTERNAL ACTIONS

1. Regular bank visits and communication to develop broad-based relationships with banks and bankers

2. Raise MFI profile with formal financial sector participants

- Send steady stream of information, quarterly reports, newsletters, rating reports
- Educate them about global trends and developments in microfinance (i.e., MicroBanking Bulletin)
- Have a back-up plan: begin relationship with bank's non-credit products/service (e.g., cash management)
- Capitalize on the visits of networks, consultants, and raters to arrange bank meetings and presentations to banks, focusing on microfinance global developments and performance

3. On-site visits

- Provide specific knowledge building by inviting bankers to visit
- Use everything from annual shareholders meetings to network visits to training sessions or branch visits as an opportunity to include bankers and provide insight to them

APPLY FOR BANK LOAN

1. Schedule a meeting with the bank

- Discuss your credit requirements, structure options, timing needs, etc.
- Identify requirements for the application process, including information required for application, process for approval, anticipated time for approval, documentation requirements, etc.
- Clearly identify their concerns and differences in loan structure expectations (e.g., pricing)

2. Review bank application components and ensure that all required parts are submitted at the same time

3. Schedule a formal meeting to deliver application and use it to discuss additional information you are providing

4. Identify four clear contact points in your institution and in theirs for follow-up

5. Submit a loan application package that includes:

- Institutional summary fact sheet
- Three years of audited financial statements
- Business plan and projections, identifying key opportunities and sensitivities
- Rating agency reports
- Other third party evaluations
- Comparison against best-practices benchmarks, MFI regional and global peers (and financial institutions in-country)

Appendix 2. **Sample Term Sheet for Loan Investment***

* Bill Harrington, "MEDA Investment Readiness Resource Guide, material prepared for MEDA training course at World Visions Summer School-UK (Waterloo, Ontario: MEDA, 2004).

Term Sheet For Loan Investment

1. Borrower: The microfinance institution ("MFI" or "the Borrower" or "the Company") a [commercial bank/non-bank financial company/NGO] organized and existing under the laws of ______[country].

2. Project: The project involves a loan ("the Loan") to MFI, for up to [US $ ________]. The Loan would be used for the financing of microfinance loans and other general corporate purposes.

3. Principal documentation: A loan agreement/promissory note/pagaré† between MFI and the FUND providing for the terms and conditions of the Loan. (†Pagaré is a type of check that emphasizes the date that it can be cashed; an official post-dated checks.)

4. Loan: Amount: Up to [US $ _______]

Currency: US dollars ("US $").

Term: Tenor

Interest rate: Fixed/floating of twelve-month US $ LIBOR plus a spread of [____%]

Repayments terms: Quarterly/semi-annual installments (grace period?)

Interest payment dates: Interest and principal will be paid quarterly / semi-annually.

Application fee: [US$ _______]

Upfront fee: Percent of the amount of the credit line payable, to be netted out of the disbursement amount

Commitment fee: Applicable if there is unused revolver or multiple disbursements

Monitoring fee: Applicable for longer term deals

Default Interest: Percent per annum over and above applicable interest rate.

Disbursement and availability: The Loan's first disbursement [US $ ______] will be disbursed [net of any upfront fee] by ________ [date/year]. The second disbursement [US $ ______] will be disbursed by [date/year], contingent upon documentary evidence of good standing.

Voluntary Prepayment: (If permitted) Pre-payable in whole or in part, upon no less than 45 days' written notice to the Fund

Prepayment Penalty: On the date of any prepayment of the Loan, the Borrower shall pay a prepayment premium consisting of an amount in the loan currency equal to [____ %] of the amount of the Loan to be prepaid.

5. Conditions of first disbursement:

(a) All relevant governmental, corporate approvals, authorizations, and other consents needed for the Fund's investment in the Project shall have been obtained.

(b) MFI shall maintain independent external auditors satisfactory to the Fund, and provide the Fund with evidence of appropriate insurance coverage for its properties and business.

(c) The Fund shall have received satisfactory legal opinions from its counsel, concurred by MFI's counsel with respect, inter alia, to the organization, by-laws, existence, and operations of MFI; the validity of the transaction documents; and any other matters relevant to the above referred agreement as the Fund shall reasonably request.

(d) No event of default or potential event of default shall have occurred and be continuing.

(e) MFI shall be fully in compliance with all applicable requirements from the ministry of finance/ the Central Bank of country/ the bank regulating agency.

(f) Other conditions precedent.

6. Reporting requirements:

(a) Within 45 days following the end of each month, provide monthly financial statements and portfolio report to the Fund; and within 60 days following the end of each fiscal year, provide the annual audited financial statements and the portfolio report

(b) Provide an annual management letter and related correspondence, all from the external auditors

(c) Provide any other financial information and analysis, as the Fund may reasonably request.

7. Affirmative Covenants: Unless the FUND otherwise agrees, MFI shall:

(a) conduct its business with due diligence and efficiency and in accordance with all relevant legal and banking regulations in effect in [country], sound business practices, and its corporate by-laws;

(b) at all times, comply with all the requirements established by the ministry of finance, the Central Bank, the bank regulating agency, and by any other authority, as certified by MFI's chief financial officer;

(c) make provisions for its operations and/or assets and liabilities, and/or memorandum accounts implying potential financial exposure of MFI, at all times, in accordance with the levels recommended or required by any supervisory or regulatory agency, such as the bank regulating agency, as the case may be. In the event that the recommendation or requirement of two or more supervisory or regulatory agencies, to whose jurisdiction MFI is subject, are divergent, the most conservative recommendation or requirement shall apply, without prejudice to any of the other covenants in the credit line agreement;

(d) allow representatives of the Fund access to the premises and staff of MFI and to have access to any of its books and provide any relevant information that the Fund may reasonably request on its operations and financial situation;

(e) reimburse the Fund any legal or other outside professional fees, document stamp duties, and taxes, if any, related to the preparation, execution, administration, and registration of the transaction documents;

(f) allow other financial covenants to maintain (maximum portfolio at risk, minimum capital adequacy ratio, etc.)

8. Negative Covenants: Unless the FUND otherwise agrees, MFI shall not:

(a) enter into any transaction except on an arms' length basis;

(b) create or permit to exist mortgages and/or other liens or charges over its assets, except as disclosed in the letter of information. The liens and charges disclosed in the letter of information would include, but not be limited to (i) those that already existed at the date of the letter of information; (ii) those granted to the Central Bank or other official or government entity; and (iii) those that resulted from MFI's ordinary course of business;

(c) enter into any partnership, profit-sharing, royalty agreement, or other similar arrangement, other than those stated in the above mentioned letter of information, whereby the MFI's income or profits are, or might be, shared with any other person; or enter into any management contract or similar arrangement whereby its business or operations are managed by any other person;

(d) change its by-laws in any manner which would be inconsistent with the provisions of the relevant transaction documents; change the nature of its present business or operations; sell, transfer, lease, or otherwise dispose of all or a substantial part of its capital assets (whether in a single transaction or in a series of transactions, related or otherwise); or undertake or permit any consolidation, reorganization or merger;

(e) make any prepayment (whether voluntary or mandatory) or repurchase of any long-term indebtedness (other than the Fund loan), or make any repayment of any such indebtedness pursuant to any provision of any agreement or note which provides directly or indirectly for acceleration of repayment in time or amount, unless in any such case it shall contemporaneously make a proportionate prepayment or repayment to the Fund of the principal amount then outstanding under the Loan;

(f) declare or pay any dividend or make any distribution of its share capital, unless: (i) no event of default or potential event of default shall have occurred and be continuing; and (ii) the financial ratios stated in section 7 above shall continue to be satisfied after such dividend distribution;

(g) lend more than [_____%] of the MFI's loan portfolio to [commercial, mortgage financing, rural financing]; or

(h) have more than [_____%] of the loan portfolio denominated in foreign currency and maintain a net short foreign currency exposure ratio of not more than 25% of equity. "Net short foreign currency exposure" will be determined by dividing (i) the difference between liabilities and off-balance sheet accounts denominated in foreign currency and assets and off-balance sheet accounts denominated in foreign currency by (ii) MFI's equity. Foreign currency is defined as any currency other than [country] currency.

9. Events of Default: Standard provisions, including:

(a) non-payment of principal, interest, or any other amounts due in respect of the Loan;

(b) failure to perform any obligation under the CREDIT LINE AGREEMENT;

(c) any representation or warranty found to be incorrect;

(d) expropriation, seizure, or nationalization of property or other assets;

(e) bankruptcy, insolvency, or liquidation of the Company or any of its property or assets; and

(f) non-payment of any other indebtedness in excess of [______] under any other loan agreement with a cure period of [_____].

10. Jurisdiction: The Company submits to the non-exclusive jurisdiction of the courts of the United States.

Appendix 3. **Stages of Financial Integration: Strategies for MFIs to Address the Competing Needs and Desires of MFIs and Lenders***

* Louise Schneider and Greta Greathouse, "Strategies for Financial Integration: Access to Commercial Debt," Table 8, "Strategies for MFIs to Address the Competing Needs and Desires of MFIs and Lenders," Financial Services and Products Occasional Paper (New York: Women's World Banking, 2004), 9.

<table>
<tr><th>MFI's Needs</th><th>Lender's Needs</th><th>Strategies</th><th>Examples and Suggestions</th></tr>
<tr><td>Ability to secure bank loans with their MF portfolio</td><td>• Acceptable collateral (real estate, cash, liquid assets)</td><td>Improve banks' understanding of microfinance (MF) and its risk profile, so that MF loans become "eligible" collateral
• Evaluate alternatives for pledging the portfolio
• Focus on MF's high repayment rates and encourage bank evaluation to be on a cash flow basis**
• Help banks develop a risk analysis methodology for MF—work with their senior credit officers</td><td>• Uganda: In 2001, no banks provided MFI loans without 100% cash deposits; by 2002, a few banks provided loans equal to 250% of the MFI's pledged portfolio***
• India: MFIs have pledged their MF portfolio via assignment of specific branches' portfolios
• Colombia: MFIs have pledged their portfolios by attaching updated lists of client promissory notes
• Using well-respected accounting firms has been helpful in convincing banks of the integrity of MFIs' strong performance results</td></tr>
<tr><td>Tenors that allow for growth and planning (2–3 years).</td><td>• Minimize risk and demonstrate repayment capacity (short tenor, less risk)
• Banks themselves may have limited access to longer term funding
• Capital requirements favor short term lending</td><td>• Banks need greater familiarity with MFI performance records
• MFIs need to do a better job of presenting strong business plans (with cash flows), to justify longer term requests</td><td>• PADME in Benin regularly provides copies of its financials to all banks
• AFMIN in Benin has sponsored classes in Microfin to improve MFIs' business planning and projections</td></tr>
<tr><td colspan="4">** While banks may not be satisfied with repayment indicators alone, illustrating the MFI's large cash flow generated from these repayments may be helpful, and motivate them to use a cash-based analysis in evaluating the MFI's loan repayment prospects.
*** FSD, "Accessing Capital by MFIs," proceedings from workshop held in Kampala, February 2002, FSD Series 7, Foundation for Sustainable Development, San Francisco, CA, 2.</td></tr>
<tr><td>Reasonable pricing that reflects the true risk</td><td>• Pricing that reflects the true risk and meets internal hurdles</td><td>• Change banks' perception of the MFI sector as high risk
• Encourage adequate risk-analysis methodology and consideration in compiling MFI ratings
• MFIs will benefit from regular review of bank loan pricing, market intelligence, and bank diversification</td><td>• Focus on low delinquency, diversification of client portfolio, small loan size
• Make joint visits to bankers with rating agencies and introduce MicroBanking Bulletin's benchmarking work
• Colombia: The increased diversification of bank loans by MFIs has allowed many WWB affiliates to lower their pricing by 1–2%</td></tr>
</table>

MFI's Needs	Lender's Needs	Strategies	Examples and Suggestions
Larger loan sizes	• Minimize risk: appropriate legal structures and ownership, justifying increased exposure	• Use of credit enhancement/ guarantee structures† • Formalization process aids access to larger loan size (as discussed earlier)	• USAID DCA guarantees provide a 50% guarantee to commercial banks making loans to MFIs • WWB offers JPM Chase standby letter of credit, partial guarantee
Client relationship with bank that covers both sides of balance sheet (loans and, for example, deposits, cash management, and other services)	• Better profitability (including non-loan services to MFI)	• Bank identification of microfinance as a target client group (Provide banks with market potential data, size of MFI market and its use of banking products) • Expand non-credit product linkages to MFIs • Be informed about products available to MFIs in other markets	• Benin banks can provide loan programs for MFI employees (e.g., PADME) • Ecuador joint ventures between banks and MFIs for money transfers, remittance payments, e.g., La Caixa in Spain and Banco Solidario
Increased leverage	• Non-traditional clients must accept structures and restrictions which assure the bank has minimal risk • High reserve requirements on "uncollateralized" loans (e.g., those loans lacking traditional collateral—cash, real estate, etc.) • Legal status issues	• Change bank perception of MFIs as high risk (prepare data sheet showing MFI performance against various benchmark groups—including other country financial institutions) • Obtain gradual increase in leverage against collateral • Develop a track record with lenders; bankers look closely at relationship experience with other lenders (e.g., the record of loan renewals is a qualitative factor used by lenders in providing higher leverage) • Progress towards formalization, when/if feasible and advisable	• Colombia: A WWB affiliate has increased bank leverage on its collateral from one to three times, in less than three years
Loan structure/ documentation appropriate to MF industry	• Use of standardized or pre-existing loan structures and documents	• Exposure to solutions used in other markets • Set up country-wide task force to develop loan notes and structures that meet local requirements	• Revolving credits with borrowing base monitoring‡
Faster turnaround time on loan applications	• Complete dossiers which provide all necessary information for bank credit committees	• MFIs should develop a standard credit application package, based on local requirements, including all necessary documents, presentations covering major issues, etc.	• Senegal: Both APDF and ADEPME are working to develop a model "dossier" format for SMEs to follow in preparing their credit applications

† See Louise Schneider and Greta Greathouse, "Strategies for Financial Integration: Access to Commercial Debt," Appendix 5, "Guarantee Programs in Operation (2003)," Financial Services and Products Occasional Paper (New York: Women's World Banking, 2004), 23.

‡ Ibid., Appendix 4, "Collateralizing the Loan: An Alternative Approach to Investigate—'Borrowing Base Formulas' under a Revolving Credit-Term Loan," 21.

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SEEP is an international network of over 70 organizations committed to reducing poverty through microfinance and enterprise development. SEEP members are active in over 140 countries and reach over 25 million microentrepreneurs and their families. SEEP promotes professional standards of practice in microfinance and enterprise development, conducts capacity building activities for its members and other practitioners, creates and disseminates publications for application in the field, and serves as a center for collaboration on a broad range of sector-related issues.

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