CHAPTER 14:

Microfinance Investment Funds: Looking Ahead

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Introduction: Thesis and Core Questions

In many developing countries, microfinance has clearly proved successful: the growth rate of microfinance institutions (MFIs) has been consistently high; loan volumes are becoming sizeable; and professionalism and governance have markedly improved. In addition to furthering social goals, the growth of microfinance suggests its potential as a sound investment opportunity for private investors and commercial institutions. MFIs have traditionally been funded by donor organisations that seek to provide financial services to low income households. However, the ability of donor organisations to support MFIs is often limited by their financial and technical capacity. As the market for MFI services grows and investment performance improves, private capital and know-how could play a critical role in bridging that gap.

Our main thesis is that, due to demand pressure in the huge informal markets of developing countries, the microfinance industry will grow rapidly and steadily. It will soon attract mainstream capital market institutions and institutional investors, boosting interest through the launching of additional products and innovations. Heightened interest is already creating a demand for investment vehicles that allow microfinance institutions to expand the range and quality of their services. We focus here on one vehicle: microfinance investment funds (MFIFs).

Microfinance investment funds are defined as funds that include microfinance institutions in their portfolios, and that provide a diversified, well-balanced, socially-minded investment opportunity to private and institutional investors, both locally and abroad. MFIFs come in many forms and cater to a variety of potential investors, and can thereby mobilise capital from sources otherwise hesitant to invest in microfinance.

The dynamic importance of MFIFs includes their potential to make microfinance markets more efficient, both for investors active in capital markets as well

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as for MFIs serving poor microentrepreneurs. Even more important, however, will be the fundamental changes in framework conditions that influence local savings, commercial law and property rights. These processes should be supported by donor organisations, which should shift their focus on microfinance away from direct support for MFIs and MFIFs that have become sustainable. Rather, they should promote innovation and support risk mitigation in ways that accelerate the flow of private capital to microfinance.

Given the central role envisaged for MFIFs, this paper focuses on two key questions:

- How will current market trends influence the future development of MFIFs?
- What factors favour MFIF success?

MFIFs: The Critical Demand-Supply Link

Since its inception, microfinance has struggled to raise capital to meet the demands of millions of economically active poor households across the world. This demand[2] cannot be fully met by donor agencies, making commercial investments therefore necessary. The industry has already made significant progress in linking up with the commercial finance mainstream by increasingly promoting the commercial viability of microfinance institutions, by generating awareness and by advocacy, thereby creating an interest among potential investors. MFIFs have emerged as vehicles for linking the microfinance and mainstream commercial markets.

MFIFs provide the essential missing piece in the microfinance jigsaw puzzle – positioned appropriately between the supply (the investors and the capital markets) and the demand (the MFIs). With the requisite skills and distribution capabilities, MFIFs can bridge the gap between sophisticated, resource-rich capital markets and the often remote and simple MFIs. The realisation of this inherent value appears to have favoured the mushrooming of many MFIFs around the world. As of October 2004, there were reportedly 55 MFIFs[3] in operation.

MFIFs also help to further the goals of the UN Year of Microcredit 2005, one of which is building inclusive financial systems. An important focus of inclusive financial systems must be the participation of the international capital markets in microfinance and, if possible, the participation of microfinance in capital markets. MFIFs, as the critical link between supply and demand, will be essential in achiev-

[2] It is estimated that there are nearly 500 million households (source BlueOrchard, CGAP) that could successfully use microfinancial services. Assuming a conservative loan amount of US$ 200 per such household, hypothetical worldwide demand for microcredit would be US$ 100 billion.

[3] Based on the survey conducted by CGAP. Please see Ivatury and Abrams in this volume.