CHAPTER 2:

Microfinance Investment Funds: Objectives, Players, Potential

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Introduction

Microfinance investment funds (MFIFs) are increasingly seen as a core part of the funding of microfinance institutions (MFIs). MFIFs take various legal forms and structures set up by a variety of players. But all serve the same purpose, which is to channel increasing funding to micro-entrepreneurs via MFIs in developing countries and transition economies.

MFIFs are also a convenient tool to invest collectively in a wide and diversified range of MFIs. Suppliers of funds are able to reach a larger number of local institutions through such diversified vehicles. The latest developments demonstrate that whenever a microfinance investment fund is structured appropriately for its targeted investors, there is no lack of financial resources. Even private donors and development agencies that have been the traditional sources of funding for microfinance are increasingly keen to create such structures in order to attract additional providers of financial resources.

An interesting parallel can be seen in the development of MFIs and microfinance investment funds. The requirements of private donors, development agencies and microfinance investment funds encourage the most advanced MFIs to evolve into true commercial entities having a specific objective: providing financial services to the poor. MFIFs are following the same pattern but are slightly less advanced in their move towards commercialisation. Ironically, microfinance investment funds sometimes require evolutions and improvements from MFIs which

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they are not ready or are not prepared to undertake themselves. In any case there is a sound evolution for both types of institutions.

The next section of this chapter analyses the parties engaged in MFIFs. KfW initiated comprehensive surveys to collect data from all the major investment structures in microfinance. These were conducted jointly by CGAP, The MIX and the author on behalf of ADA in Luxembourg between July and October 2004. The characteristics of the funds, their product mix, the origin and destination of their funding are analysed in this paper. A following section examines the forms microfinance is taking as it becomes increasingly commercial, the new structures being established, and how the traditional financial sector is gradually taking an interest in microfinance. The concluding section summarises the main benefits of microfinance investment funds.

Parallels Between the Development of Microfinance Institutions and the Development of Microfinance Investment Funds

This section explores the way in which investment funds follow a pattern that is similar to that of the MFIs as they gradually become more commercial. While a large number of MFIs and some investment funds will continue to focus on social aspects, institutions of both types which are ready for a more sustained growth should do so through a broader participation in the general financial markets.

Initial Social and Development Objectives

Microfinance institutions very often began as non-profit enterprises with essentially a social objective: helping the poorest through access to credit and to deposits. These institutions have made loans, often at modest interest rates, and those that took deposits did so at little or no interest (in some cases even at a cost) but their primary objective was social. Their activities were made possible mainly through grants and donations.

Similarly, the first financial structures put in place to lend to MFIs were established by private donors and development agencies, again with a development objective in mind. Even Profund, which could arguably be considered as the first microfinance investment fund established with the objective of obtaining a financial return, was initiated and essentially owned by development agencies. Many lessons were learnt from this early initiative that invested mainly in equity participations in MFIs. This was seen as quite risky when the fund was launched in 1995. Probably only a few of the original participants expected to see a decent return on their investment. With an internal rate of return expected to be at least between 7 and 8 % p. a. over the 10-year life of the fund, this is certainly quite an achievement.