CHAPTER 3:

The Market for Microfinance Foreign Investment: Opportunities and Challenges

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Foreign investment for microfinance is on the rise. Socially-motivated foreign investors have placed US$ 1.2 billion in debt, equity and guarantees in about 500 specialised microfinance institutions (MFIs) and cooperatives.[1] These investments are provided by both privately-managed microfinance funds and public investors (the international financial institutions or IFIs). New and existing private investment funds have an estimated US$ 400 million on hand to invest in microfinance, and were expected to raise approximately US$ 255 million in additional capital in 2005. As the supply of foreign investment in microfinance continues to grow, it will be increasingly important to understand the appropriate role of foreign investors in helping to build strong institutions that provide financial services to poor people.

Specifically, CGAP (the Consultative Group to Assist the Poor) is interested in how foreign investment can help institutions grow and develop, realising their potential to become full-fledged domestic financial intermediaries for the poor. CGAP's interest stems from its belief that the future of microfinance lies with sustainable financial institutions that mobilise public deposits and tap domestic banks and capital markets to finance their expansion and serve poor people over the long term. Today, institutions that fit this description, such as state agricultural and development banks, postal savings banks and community banks, probably deliver financial services to more poor people in many countries than do specialised microfinance institutions, though they require improvements in service quality and efficiency. These institutions do not raise foreign debt or equity investment, which instead has been concentrated in dedicated regulated and unregulated institutions.

This paper analyses the supply of, and demand for, microfinance foreign investment. Its purpose is to provide insights into the behaviour of the market and

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[1] The totals given here are primarily stocks (outstanding amounts) as of 2003 / 2004 as gathered from survey sources.

suggest opportunities and challenges ahead. It does not take into account the US$ 500 million to US$ 1 billion that donor agencies and private foundations contribute in subsidised or grant funding to microfinance each year. The paper builds on earlier work by CGAP and ADA[2] and new data generated by recent surveys of microfinance foreign investors and microfinance providers. This research has found that, unlike traditional foreign direct and institutional investment (FDI and FII), which are largely private and profit-oriented, microfinance foreign investment is dominated by socially-motivated public funding: at least 75 % of all foreign capital in microfinance is provided directly or indirectly by government agencies, particularly the IFIs. Having dedicated most of their funds to the start up and growth of nearly 170 regulated MFIs, many of which now attract private capital and deposits, the publicly-funded IFIs should now finance the growth and development of less mature institutions.

Despite the continued dominance of public funding in microfinance foreign investment, capital from other sources is growing. Today, the amount of capital invested in private microfinance funds by socially-motivated individuals and institutions is approximately three times as large as the amount these funders were estimated to have provided in 2003. In addition, regulated MFIs appear increasingly to finance their assets from commercially-oriented local sources through deposits, bank borrowings and capital market transactions. This is an encouraging sign that indicates that these institutions play a growing role as domestic financial intermediaries for the poor.

Survey Methodology

Between July and September 2004, CGAP, the Microfinance Information eXchange (MIX), and ADA (Appui au Développement Autonome) conducted a joint survey of the supply of foreign investment for microfinance.[3] The survey covered 54 foreign microfinance investors to ascertain their legal structures, investment focus, and financial performance. The detailed portfolio information gathered from this survey yielded data on investments in 505 MFIs and investments in 25 microfinance funds. All data were self-reported, and responses from some investors were corroborated or supplemented with information from annual reports.

To explore the demand for foreign investment, CGAP and the MIX issued an open invitation to MFIs and other financial institutions that serve the poor to complete a questionnaire on their capital structures and funding preferences. The ques-

[2] Ivatury, Gautam and Xavier Reille (2004). Consultative Group to Assist the Poor (CGAP) Focus Note No. 25. *Foreign Investment in Microfinance: Debt and Equity from Quasi-Commercial Investors*. Washington, D.C.: CGAP. Goodman, Patrick (2003), *International Investment Funds: Mobilising Investors towards Microfinance*. Luxembourg: Appui au Développement Autonome.

[3] The authors thank Isabelle Barrès of the MIX, and Patrick Goodman, consultant to ADA, for their collaboration in the survey of investment funds.