CHAPTER 7:

Investing in Microfinance Investment Funds – Risk Perspectives of a Development Finance Institution

Margarete Biallas[1] *and Mark Schwiete*[2]

[1] Senior Risk Manager, Risk Management, KfW Bankengruppe

[2] Principal Sector Economist, KfW Entwicklungsbank

Why Funds?

KfW Entwicklungsbank has a long history of supporting microfinance through funding and technical assistance. Apart from KfW funds, Financial Cooperation funding supplied by the German Federal Ministry for Economic Cooperation and Development (BMZ) is invested directly in MFIs. These BMZ funds are concessional or grant funds. Funding, usually in the form of debt, was initially made available through existing financial institutions that were willing to make smaller loans (downscaling). In a second phase KfW began to support specialised institutions, using two different methods. The first was upgrading, that is, transforming nonbank microfinance lending organisations into full-fledged financial service providers. The second approach was to establish new specialised financial institutions (greenfielding).[1] In a third, subsequent phase, KfW has provided further support for the development of microfinance by investing in microfinance investment funds (MFIFs).

In down-scaling projects, debt is made available to micro, small and medium-sized enterprises (MSMEs) through financial institutions with a well-established track record and the capacity to service the loans made by KfW. Initially, funding was provided exclusively against a sovereign guarantee of the recipient country, which was generally the common and sole hard structural element of these facilities. With the introduction of new debt instruments, funding became more flexible. Sovereign guarantees are of lesser importance and in some instances are no longer required, while risk considerations have become much more important.

---

[1] For a more detailed description of KfW's approaches s. Glaubitt/Hagen/Schütte in this volume.

The credit risk of down-scaled institutions has generally been mitigated through a high degree of portfolio diversification. In addition, the portfolio has been used to collateralise the loan. This has proven to be a very effective form of collateral. Even if the institution itself has failed, the portfolio pledged to KfW usually continues to perform if repossessed quickly enough. Other comforts include guarantees, additional collateral and/or pari passu clauses with other present or future investors. While the risks of down-scaling are controllable for an investor, returns are limited. Also, some countries lack financial institutions with sufficient down-scaling potential.

Specialised financial institutions have a larger developmental impact than conventional institutions, but a similar risk-return profile. As noted, such specialised institutions usually have a track record and receive debt or equity funding to increase portfolio build-up or for transformation into a formal, regulated financial institution. While investments in specialised institutions are associated with much the same risks as in the down-scaling approach, their magnitude is generally more pronounced because funding tends to represent a significant share of their overall liabilities. In addition further risks may emerge from rapid portfolio growth and the management challenges that result.

Most risks of investments in individual microfinance institutions (MFIs) lie in inadequate management information systems or mismanagement, such as failure to realise collateral, lack of monitoring or fraud. These risks are mainly contained through corporate governance. Defaults by any single retail borrower do not constitute a risk to the viability of the potential investee because investments are focused on MFIs with well-diversified, high quality portfolios.

Risks in equity funding centre on exit and on return on investment because potential buyers are hard to identify and returns are often not continuous due to irregular dividend payments. Institutional risks are also higher and, as noted, have to be addressed through strong involvement in corporate governance. The main instruments of risk mitigation are documentation, ensuring significant influence by the individual investor in the investee company, and special shareholder rights for development finance institutions (DFIs). Equity investments are generally required when creating specialised financial institutions. In addition to the risks of similar investments in existing institutions, risks and costs of investments in these institutions include the ability to find and train sufficient staff, to build institutional capacities and to ensure market penetration and acceptance. Few of these risks can be mitigated through commercial structuring, and once again require strong involvement in corporate governance, which ties up substantial resources and subjects the DFI to reputational risk.

In this context, provision of technical assistance (TA) to the investee portfolio company is a risk mitigation instrument. As agents funding the TA, the DFI has control over the TA provider, and thus can develop in-depth insight into the performance of the MFI. Also, some non-commercial risks such as market penetration, product design, and human resource development may be addressed through TA, which is within the framework of German Financial Cooperation provided by BMZ through KfW.