

# The Role of DFIs in the Emerging 3.0 Responsible Funding Landscape – Responsible Corporate Governance and Beyond\*

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## Abstract

Development Finance Institutions (DFIs) have been a major funder in microfinance since the 1990s when they took over from donors and brought in a more commercial approach, coupled with much needed capacity building at all levels of the financial system. In their role as catalysts, DFIs have been successfully crowding in the private sector which has brought a fundamental change and diversity to the microfinance funding landscape. Most importantly, local deposits have emerged as the main source of funding which is encouraging as financial intermediation to a large extent replaces the channeling of cross-border funds.

In equity finance, private social investors, mostly in the form of Microfinance Investment Vehicles (MIVs), increasingly take the place of DFIs and their standard-setting role in the governance of MFIs. Governance is perceived as a key risk in microfinance, as shown in the Microfinance Banana Skins surveys, with weaknesses prevailing in main governance areas such as clear ownership structure, disclosure and transparency, and the role and responsibilities of the board. Equity investors are not fully capitalizing on the opportunity to strengthen MFI governance. They must more actively engage in and beyond the board room and ensure adequate qualifications, commitment and continuity of their board nominees.

Several trends visible today are likely to gain momentum and shape the microfinance funding landscape of tomorrow: (i) public funding and subsidies for microfinance will decline further, (ii) local funding and especially local deposits will become the dominant funding source, (iii) more investors will shift from debt towards equity finance (iv) the diversity of funders and their comparative advantages provide a fertile ground for complementarity, and finally (v) the DFIs will

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continue to play a role as catalysts and standard setters, albeit in a more indirect role from the back seat while MIVs and other intermediaries will be more in the driver seat.

## 1 Introduction

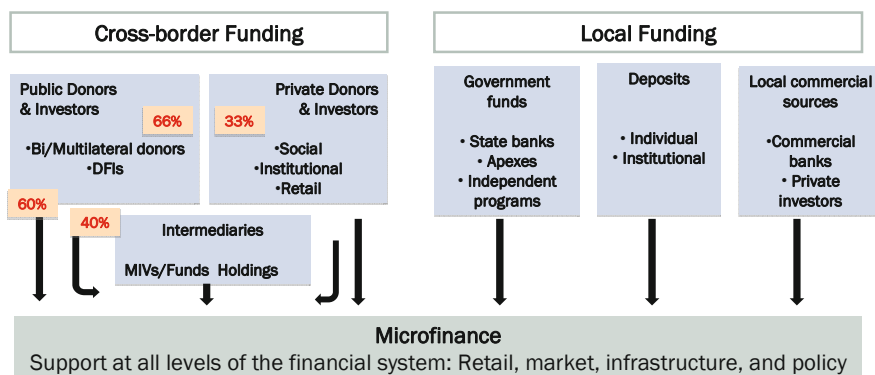
The microfinance industry has experienced a major upsurge in funding over the past couple of years. CGAP estimates that global cross-border funding in 2011 was in the tune of US\$ 25 billion. Development finance institutions (DFIs) have been and continue to be the largest group of funders in quantitative terms but perhaps more important has been their impact beyond funding, i.e. their contribution in setting quality standards in many areas including corporate governance and responsible finance. With the rapid institutional change ongoing in the industry but also with the entry of private investors, the funding landscape is undergoing a fundamental change. This development raises a number of questions: With the crowding in of private investors, is the work of DFIs done? And if so, are DFIs ready to exit? Are the private investors able and willing to step into their shoes and can they maintain the impact beyond funding? Or do we rather see a complementarity of different types of investors, including the DFIs, for some time to come? Who will hold corporate governance in microfinance up to standard? These and other questions are being discussed in the following.

The paper is structured in four parts. Section 2 provides an overview and analyses the pattern of the microfinance funding landscape, characterizes the different investors and the complementarity of their funding, and places cross-border funding into perspective with local funding. Section 3 focuses on the specific role of development finance institutions (DFIs), their specific development role, and their important functions as standard-setters and catalysts of crowding in the private sector. Section 4 highlights the importance of good corporate governance, identifies the key dimensions and discusses the current and future role of DFIs and private investors in promoting good governance. Finally, section 5 sketches an outlook to the future microfinance funding landscape, depicting four main trends.

## 2 The Microfinance Funding Landscape

### 2.1 Overview of Microfinance Funding

With the growth and evolution of the global microfinance industry, funding of microfinance has increased substantially over the last decade and a highly diversified funding landscape has emerged. Today's microfinance funding landscape can be broadly classified into foreign or cross-border funding on the one hand and local funding on the other hand, with public and private funders present on both sides, as shown in Chart 1 below. With Microfinance Investment Intermediaries (MIIs),



**Fig. 1.** The Microfinance Funding Landscape

Source: based on CGAP 2010

a new type of player has joined the scene in recent years. These intermediaries comprise Microfinance Investment Vehicles (MIVs) or funds as well as holding companies of MFI or microfinance bank networks.

Obtaining a comprehensive and consistent picture of the funding flows to the microfinance industry remains a major challenge despite a number of laudable initiatives<sup>1</sup> aimed at increasing the transparency of microfinance funding. Partly, this may be due to the fact that a large part of the microfinance industry is still unregulated and hence not reporting to a central supervisor, and partly due to the large number of diverse funders who have entered the scene in recent years. The MFIs reporting to the MIX Market have debt outstanding from close to *one thousand* (!) different lenders (MBB 2012).

## 2.2 Patterns and Trends of Cross-Border Funding

Total cross-border funding commitments for microfinance has grown considerably to at least US\$ 25 billion in 2011 according to CGAP estimates. Ten years ago, cross-border funding was almost exclusively provided by public funders. Even today, public funders still account for the major share of about two thirds. But with microfinance becoming known as an attractive investment opportunity, private investors became a second important source of funding with a current estimated share of one third. Among 59 funders surveyed by CGAP in 2012, DFIs were still the largest group of cross-border funders in microfinance with a share of 55 %<sup>2</sup>,

<sup>1</sup> The major initiatives comprise the annual funder survey by CGAP, the Funding Structure Reports by the MIX Market, MIV surveys by Symbiotics and MicroRate/Luminis.

<sup>2</sup> DFIs committed \$9.3 billion out of \$17.5 billion total cross-border funding of 59 funders participating in the survey.

however, the DFIs' share has been declining from over 60 % in the last three years with private funders increasing their stake.

Funders use *direct* and *indirect* channels to support microfinance. The emergence of specialized intermediaries – Microfinance Investment Vehicles (MIVs) and holdings – has provided a convenient facility for both public and private funders and fostered a trend towards *indirect* funding. In 2011, 37 % of total funding for refinancing was channeled via MIVs and holdings.

Microfinance funding is being allocated to different uses or purposes. Refinancing of MFIs' microcredit portfolios has been – and still is – the major purpose with 77 % of total cross-border funding (CGAP 2012). 15 % of funding is provided for capacity building, primarily at the institutional or micro level (MFIs) but also at the market infrastructure and policy levels (meso and macro).<sup>3</sup>

Debt remains the main financial instrument with 55 % of total commitments in 2011, but its share has been declining. This reduction is compensated by a growing share of equity investments, now reaching 16 %. Among MIVs, this trend towards equity investments in MFIs has been even more pronounced with the share of equity doubling from 12 % in 2008 to 23 % in 2011 (Luminis 2012). Guarantees increased to 9 % while grants account for 15 %. Grants are primarily employed for capacity building while allocating grants to funding of microcredit portfolios has largely been phased out.

The *regional allocation* of cross-border (predominantly public) funding is quite heterogeneous while investments by (predominantly private) MIVs are concentrated in Eastern Europe/Central Asia and Latin America (74 % of investments), while Africa, Asia and MENA are highly underserved in view of the potential demand.

Funding in *local currency* presents a major challenge for cross-border funders who are generally not willing or able to absorb currency risk. Only 14 % of the direct debt is provided in local currency. MIVs fare better in making investments in local currency with a share of 28 %, the bulk of which was hedged through various mechanisms. Access to hedging facilities like TCX has enabled MIVs to make significant inroads to local currency investments. However, in the latest survey MIV managers named exchange rate volatility as the top factor hurting MIV performance in 2011 and perceive forex risk and hedging cost as the second main challenge for 2012. Expanding local currency funding will remain a key challenge going forward. In many markets, e.g. in the MENA region, cross-border funding may not be able to compete with local funding.

### 2.3 Cross-Border Funders Under the Microscope

The global attention and interest in microfinance over the past decade – and further triggered by the 2005 UN Year of Microcredit and the Nobel prize to M. Yunus and the Grameen Bank in 2006 – have attracted a variety of funders and

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<sup>3</sup> The purpose of the remaining 7 % of funding is unspecified.

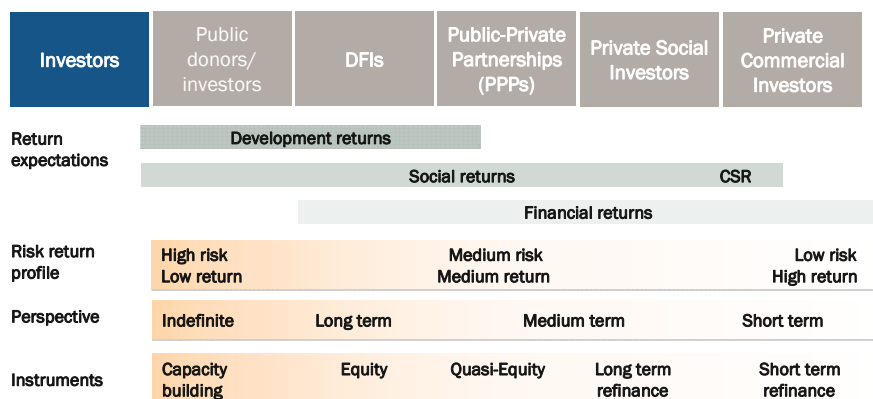


Fig. 2. Spectrum of cross-border funders

investors. They differ in objectives and motives, risk and return expectations, time horizon and instruments (see Chart 2) and can be briefly characterized as follows:

- On the left side of the spectrum are purely public funders that are publicly owned and employ public funds. These comprise bi- and multilateral donors such as BMZ, AFD or the IBRD. They combine social and development objectives in their microfinance funding strategy but do not expect any financial return. The definition of “social return” used in this paper refers to outreach and the social impact on the end-clients while “development return” is focused on building institutions and financial systems as a stand-alone objective.
- Development Finance Institutions (DFIs) are publicly owned but employ primarily market funds or a blend of public and market funds, and hence, may be regarded as a hybrid institution. DFIs generally have social, development and financial return expectations (“triple bottom line”). The employment of capital market funds determines the specific risk and (financial) return profile of DFIs and explains why DFIs prefer to invest in safe MFIs.
- On the right side of the spectrum are the private investors which need to be differentiated. Among the private commercial investors there are probably very few who are investing in microfinance for purely financial returns. More prevalent are institutional commercial investors, like insurance companies or pension funds, which take microfinance as an add-on into their portfolios for reasons of corporate social responsibility (CSR).
- The majority of the newly entering private investors are socially responsible investors with a truly double bottom line perspective, i.e. they combine financial returns (with the view of sustainability) and social returns (in terms of outreach and social benefits for the end-clients). Social investors

generally do not explicitly pursue the development objective of building institutions and financial systems.

- MIVs and holdings have emerged as new type of players in the microfinance funding landscape and function as intermediaries between asset owners and MFIs. At the end of 2011, there were 115 MIVs with total assets of US\$ 7.7 billion (Luminis 2012). Overall, 35 % of MIV funding originated from public and 65 % from private investors. Many MIVs represent a hybrid form where the line between public and private is blurred, e.g. private investor funds with a public guarantee. Some MIVs are set up as public private partnerships, e.g. EFSE or MEF, but there are presumably also many MIVs with private investors only.<sup>4</sup> MIVs are managed by specialized fund managers and investment advisors. Holdings are network structures of either existing or greenfield MFIs or microfinance banks, for example the ProCredit Holding with 21 microfinance banks.<sup>5</sup>

The different types of investors also differ in terms of risk appetite which is highest among donors and lowest among private commercial investors. In terms of investment perspectives, public funders clearly have the longest horizon, private commercial investors the shortest. Each type of investor by nature has its strengths and weaknesses. The long-term horizon of public funders brings stability but public funds are generally scarce while commercial funds from private investors are not limited, at least in principle, but their short-term horizon brings the risk of volatility.

The comparative advantages of different investors can also be read from the type of instruments they provide. While private investors prefer to offer senior (i.e. low-risk) loans with short tenors for refinancing of MFI loan portfolios, donors offer grant funds for long-lasting investments in capacity building and systems development. DFIs, and recently also MIVs, tend to provide subordinate loans, guarantees and equity finance.

Instruments differ greatly in terms of their leverage effect. The leverage tends to be greatest on the left side of the spectrum, e.g. one dollar spent on capacity building might produce a leverage factor 10, and lowest on the very right side, e.g. one dollar expended as one-year loan for refinancing microloans may generate a leverage factor 1 or 2. In between these two poles, a number of high-leverage instruments exist such as equity (with a leverage factor of 8 to 10 depending on the regulatory environment), sub-debt and other hybrid forms.<sup>6</sup> Scarce public funds should therefore maximize their leverage effect.

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<sup>4</sup> There were no data available on the number and share of purely private MIVs.

<sup>5</sup> Other such holdings are Access, Advans, Microcred, and more recently Finca. The greenfield model is discussed in more detail in section 3.

<sup>6</sup> The various funder surveys by CGAP and others do not reflect this leverage effect. Funding provided through different instruments by different investors is simply added up indiscriminately, thus, clouding the real picture.

Overall, the spectrum is fluid and there are no clear cuts between the different types of investors but rather overlaps. However, the differentiation of investors, their objectives and return expectations, their investment horizon and their specific instruments prepares the ground for an emerging complementarity of public and private funders.

## 2.4 Local Funding for Microfinance

Although comprehensive and consistent data on local funding sources are still lacking, it is evident from existing data sources that local funding for microfinance has become the primary source of funding, much more important than cross-border funding. This structural change in funding was induced by the changing landscape of microfinance service providers. NGO-MFIs have lost their role as the primary vehicle for microlending, while the relative importance of banks and non-bank financial institutions (NBFIs) has increased. As banks and in some legislations also NBFIs are allowed to take deposits, **local deposits** have advanced to the single most important source of funding in microfinance.

Aggregate MIX Market data provide some order of magnitudes. In 2011, a total of 2,656 MFIs reported total assets of about US\$ 115 billion and an aggregate loan portfolio of almost US\$ 78 billion. Local deposits mobilized by the same institutions reached US\$ 69 billion, or 60 % of total assets and over 88 % of the loan portfolio. The remaining US\$ 46 billion or 40 % of assets comprise debt and equity. Earlier analyses found that 60 % of debt financing was from local lenders, primarily commercial banks (MBB 2011). Hence, it is safe to conclude that overall some 84 % of total funding to MFIs originates from local sources, and the balance 16 % or about US\$ 18 to 19 billion from cross-border funders which is largely in line with the results from the funder surveys presented in the previous section.<sup>7</sup>

The trend towards local deposit mobilization as the primary source of funding is even more visible in the leading MFIs in the world. The 20 institutions<sup>8</sup> listed in [Table 1](#) below combine a loan portfolio of US\$ 25 billion and thus represent one third of the universe, serve 40 million borrowers and 60 million depositors. The results are illustrative when looking at the ratio of deposits to loans (bolded column): In almost half of the cases, local deposits are sufficient to refinance the entire loan portfolios of those institutions. For institutions like Grameen Bank, Aceda Bank or even ProCredit, this picture was unthinkable only ten years ago. The major exception is India at the bottom of the list where credit-only MFIs with funding from local commercial banks have expanded outreach to millions of borrowers but have so far been prevented by a very conservative Reserve Bank of India to accept deposits.

<sup>7</sup> After subtracting the funding provided for capacity building.

<sup>8</sup> ProCredit is included as the group of 21 banks.

In view of building inclusive financial systems, this development is encouraging in many respects. The shift – in relative terms – from channeling cross-border funds to strengthening local financial intermediation brings stability and reduces the exposure of MFIs and borrowers to currency risk. It clearly confirms that savings are an essential financial service, especially for the poor. In 2011, aggregate MIX Market data recorded 88 million borrowers and an almost identical number of 88 million small savers. For the MFIs, the mobilization of local deposits brings self-sufficiency in funding and imposes greater discipline and prudence in lending operations. In the medium to long term, relatively cheaper local deposits will lower the cost of funds which can be passed on as benefit to the borrowers.

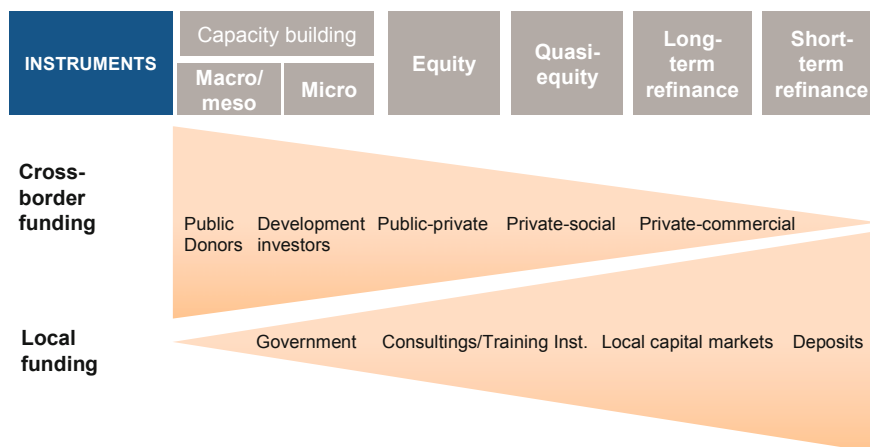
**Table 1:** The role of local deposits in leading microfinance institutions

		Loan Portfolio US\$ bn	Deposits US\$ bn	Deposits/ Loans	Borrowers '000	Depositors '000	Ratio Depositors/ Borrowers
Bangladesh	Grameen Bank	1.0	1.6	159 %	6,610	8,340	1.3
Indonesia	BRI	3.9	5.9	151 %	4,500	19,600	4.4
Colombia	Banca Caja Social	3.0	3.8	127 %	625	5,200	8.3
Kenya	Equity bank	1.3	1.5	115 %	638	5,700	8.9
Cambodia	Acleda Bank	1.0	1.1	110 %	272	822	3.0
Bolivia	Prodem	0.5	0.5	101 %	116	688	5.9
SSA, ECA, LAC	ProCredit Group	5.2	4.8	92 %	558	3,400	6.1
Bolivia	Bancosol	0.6	0.5	91 %	169	485	2.9
Peru	Mibanco	1.6	1.4	88 %	435	571	1.3
Bolivia	Banco FIE	0.6	0.5	84 %	176	477	2.7
Mongolia	XAC Bank	0.4	0.3	66 %	77	382	5.0
Peru	Creditscotia	1.2	0.7	57 %	714	529	0.7
Azerbaijan	Access Bank	0.4	0.2	47 %	118	110	0.9
Mexico	Compartamos	0.8	0.4	43 %	2,300	18	0.0
Bangladesh	BRAC	0.6	0.3	42 %	4,960	6,800	1.4
Bangladesh	ASA	0.7	0.2	24 %	4,420	6,482	1.5
India	Bandan	0.6	0.0	2 %	3,850	0	0.0
India	SKS	0.3	0.0	0 %	3,946	0	0.0
India	Spandana	0.6	0.0	0 %	3,364	0	0.0
India	Share	0.4	0.0	0 %	2,160	0	0.0
TOTAL		24.7	23.5	95 %	40,008	59,604	1.5

Source: Own compilation, based on MIX Market data for 2011



Despite the primacy of local funding, cross-border funders will continue to have a role to play. The challenge is rather to seek complementarity of local and cross-border funding along comparative advantages in terms of the different instruments offered to the microfinance sector. It is clear that refinancing of MFI portfolios will be assumed by local sources in local currency, primarily local deposits, or in case of non-deposit-taking MFIs by local financial institutions. For example, India and Morocco are prominent examples where local commercial banks account for the bulk of microfinance funding.<sup>9</sup>



**Fig. 3.** Complementarity of cross-border and local funders

Cross-border funding is most needed for longer-term refinancing, subordinated and hybrid forms of finance such as mezzanine as well as guarantees, as the local capital markets are still underdeveloped. Equity remains a crucial area where cross-border investors have a role to play in view of the governance that comes with it. Finally, capacity building will be required at all levels of the financial system where cross-border funders have an important role by bringing international good practices and standards.

### 3 Impact Beyond Funding: Role of DFIs in Promoting an Inclusive Financial System and a Responsible Finance Landscape

DFIs have engaged with microfinance programs and institutions globally, taking the lead in the early 1990s from donor agencies that have been supporting micro-

<sup>9</sup> India due to priority sector lending.

finance initiatives in the early phases. The DFIs assumed the risk of a sector that had an unproven business model, bringing in a more commercial approach, coupled with much needed capacity building and technical know-how.

Beyond this quantitative lead, DFIs have had – and continue to have – an important qualitative role in the funding landscape and have had an impact on the development of microfinance which extends beyond funding. At least three important functions of DFIs should be highlighted: (i) their role as “development investors” focused on building inclusive financial systems at macro, meso and micro levels, (ii) their role as standard setter, e.g. in corporate governance, responsible finance and other fields, and (iii) their role as catalyst and match-maker by crowding in private sector institutions.

### 3.1 Development Role: Capacity Building for Financial Systems Development

DFIs perform a crucial function in the development of financial systems by building capacity at the macro, meso and micro level. This development role clearly distinguishes DFIs from private investors, even socially responsible investors, and from most MIVs.

DFIs engage at the policy (macro) level and work with lawmakers, governments, regulators towards creating a conducive framework for finance in general and microfinance in particular. At the meso level, DFIs support the development of the financial sector infrastructure. The IFC, for example, has been active in setting up credit bureaus in several countries and has recently supported the establishment of mobile banking platforms. In Bosnia and Herzegovina, KfW and USAID were instrumental in setting up the deposit insurance which has boosted the confidence among small savers to deposit their money in local banks. Another prominent example is the Currency Exchange Fund (TCX), a hedging facility set up in 2007 by a group of leading DFIs which has since played a key role in expanding local currency funding.

At the micro level, DFIs have significantly contributed to institution building of banks and MFIs. To this end, DFIs have pursued a three-pronged strategy of down-scaling of commercial banks, transformation of MFIs and setting up of greenfield microfinance banks. Through debt and equity investments coupled with technical assistance many commercial banks were introduced to lending to micro, small and medium enterprises (MSMEs) and after a phase of learning and experimentation have been convinced of the business case of MSME finance. DFIs played a key role in the transformation of former NGO-MFIs into successful microfinance banks which are regarded as the leading players such as Aceda Bank in Cambodia, XAC Bank in Mongolia and Compartamos in Mexico, to name a few.

But the model which DFIs are most prominently associated with, is the establishment of greenfield microfinance banks. The first bank was founded in the mid-1990s and today the model is well-known: Several DFIs join forces and form a

club of reputable shareholders, and jointly with a strong technical partner prepare and set up a specialized bank for microfinance. During the start-up phase, the technical partner provides management and technical advisory services. The experience has shown that, within two to three years, a Greenfield bank can reach break even.

ProCredit has been the precursor of this model (Laude 2009) with meanwhile 21 microbanks newly established on three continents over the past fifteen years. In a second stage, the banks were subsumed under a holding company where again DFIs have been key shareholders. In the process, many DFIs swapped their earlier shareholdings in the retail banks with a stake in the holding company. In the meantime, the model has been replicated by other technical operators which have created holding companies with DFI participation: Access, Advans, Microcred, Swiss Microfinance Holding. Together with ProCredit Holding, these five holdings today control 42 microbanks serving 1.2 million borrowers with a combined loan portfolio of US\$ 6 billion and 4.3 million savers with a deposit volume of US\$ 4.8 billion. This is a remarkable achievement in terms of sustainable massive outreach in a relatively short period of time. The banks are spread across Eastern Europe, Africa and Latin America while the whole of Asia and the MENA region have so far not been a target for the greenfield model. Furthermore, international MFI networks like Opportunity International, Finca and CHF have recently adopted a similar model of transforming retail MFIs into for-profit companies under a holding structure, some with participation of DFIs.

DFIs also provided a major impulse in the field of product development beyond microfinance. They have been pioneering into green finance including energy efficiency, agricultural finance and more recently education finance. In many countries, banks and other financial institutions have integrated these products into their portfolio.

### 3.2 Setting Standards in Good Governance and Responsible Finance

Impact beyond funding has also been achieved through standard setting in the young industry, and DFIs have played a leading role in many areas. Promoting good corporate governance has been one of the areas where DFIs have set standards across the industry through their engagement as shareholders in the transformation of MFIs and in the greenfield model described above. The promotion of good governance is the special focus of this paper and is discussed in the next section.

Closely linked to good governance is the area of responsible finance where DFIs have been equally instrumental in setting standards and promoting industry norms and codes. Responsible finance is being understood in a wider sense than social performance and client protection.<sup>10</sup> DFIs, and specifically the IFC, were

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<sup>10</sup> The term “responsible finance” first appeared in February 2008 as the lead theme of a conference organized by KfW and Frankfurt School of Finance and Management.

the first to set *do no harm* standards and introduce environmental and social exclusion lists. Anti-money laundering requirements and integrity standards are further important elements in a responsible finance framework. These insertions have become important building blocks of the bridge between the microfinance industry and the global ESG (Environment-Social-Governance) standards adopted by the mainstream finance and investment industry.

The holdings, international MFI networks and the MIVs have become a prime platform for DFIs for putting responsible finance on the agenda, thereby reaching out to a large network of retail microfinance institutions. For example, the European Fund for Southeast Europe (EFSE) as one of the largest MIV where all major DFIs are invested conducted a series of high-level responsible finance events jointly with the central banks in several Eastern European countries. EFSE's Development Facility was the first to conduct an in-depth study on over-indebtedness in the microfinance sector in Bosnia and Herzegovina, and further research in other countries has followed since.

### 3.3 Catalyst and Matchmaker: Crowding in the Private Sector Through Public Private Partnerships

The most important and powerful function of DFIs is their catalyst role of fostering the entry of private sector institutions into areas considered as high risk or unprofitable. This is done through demonstrations ("lighthouse examples"), capacity building and effectively enhancing the institutional governance of their investee companies as shown above, but also through various forms of public private partnerships and arrangements.

The prime comparative advantage of DFIs lies in their enhancement power which derives from the AAA-Rating that most DFIs have. This allows them to provide credit enhancement in financing structures, e.g. subordinate tranches, as well as guarantees which are considered first-class by regulators across the world. In many financing structures which at first sight appear to be private market transactions DFIs have taken catalytic positions by providing enhancement. BOLD (BlueOrchard Loans for Development 2006–1)<sup>11</sup>, the first collateralized loan obligation (CLO) in microfinance in 2006 is just one example where a DFI, the Dutch FMO in this case, took a crucial first loss position and made the structure feasible.

As outlined above, over the past ten years DFIs have increasingly taken catalytic positions in holdings and MIVs. In most cases, they take a subordinate stake, typically the mezzanine piece, thus catalyzing private investors who opt for the senior and lower risk tranches. This has been the model for public private fund structures like EFSE, REGMIFA, MEF and others. Interestingly, DFIs act as a catalyst not only for private investors but, in their mezzanine position, also vis-à-

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<sup>11</sup> BOLD raised a total amount of USD 99.1 million for loans disbursed to 21 MFIs, in 13 different countries, and 5 different currencies.

vis purely public investors and donors who value the leverage power and regard the DFIs as the ‘middlemen’ to the private sector and the link to the capital markets. When providing valuable first loss funding, some bilateral donors make it a condition that DFIs provide mezzanine investment on top or in parallel.

The participation of DFIs in wholesale structures or retail institutions brings reputation and credibility for the investees and provides a quality seal for other investors and especially for regulators. The fact that a MFI has undergone a thorough due diligence by a DFI is frequently perceived as an entry signal to MIVs and private investors. Most importantly, however, is the DFIs’ clout in the negotiations with regulators. The experience with transformation of MFIs and setting up greenfield microbanks has proven that the presence of DFIs as reputable shareholders – direct in the retail institution or indirect via a holding – is crucial for obtaining a license as a deposit-taking institution where shareholders need to be approved by the regulator. While socially responsible investors and MIVs may be well-known in the microfinance community, they are a blank page for most regulators, to say the least. Some regulators are “reluctant” to “suspicious” to approve “investment funds with strange names” as shareholders of banks.<sup>12</sup> On the other hand, as the regulatory environment is not always conducive, the presence of DFIs brings protection for retail MFIs in dealing with the authorities and is very useful in assuring a smooth relationship in volatile political environments.

Crowding in of the private sector is a main pillar in the mandate and *raison d’être* of the DFIs. It is intended and encouraged as it demonstrates the sustainability of the business model, and often made a condition for DFI engagement. And the DFIs’ role and presence is generally valued by the private investors. Despite good intentions, the relationship between DFIs and private investors is occasionally exposed to some tension. The debate revolves around three contentious issues which are closely interrelated: (i) technical assistance, (ii) the different roles of public and private investors, and (iii) exit.

On (i) technical assistance and capacity building, private investors are somewhat ambiguous. On the one hand, they value the much needed capacity building and technical know-how provided by DFIs in the development stage of MFIs which has brought many institutions to the level of investor-readiness. On the other hand, DFIs are perceived to have a competitive advantage in terms of offering capacity building programs and technical assistant packages as “deal sweeteners” which does not necessarily level the playing field (Sanyoura and Espejo 2011). While the criticism may be valid for single cases, closing down technical assistance by DFIs would be like throwing out the child with the bathwater. More encouraging is the trend among several private investors and MIVs of setting up their own technical assistance facilities for capacity building of their investees. Many investors have realized only during the financial crisis that even well-performing 1<sup>st</sup> tier and 2<sup>nd</sup> tier MFIs urgently need institutional strengthening – beyond financial investments alone – in areas such as risk management and internal controls.

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<sup>12</sup> Personal communication with supervisors from two central banks.

Behind the second issue, concerning the different roles of public and private investors, is the view expressed by some private investors that DFIs have been slow to adapt to the growing appetite of private investors to engage and provide funding for the microfinance sector, not making enough room for the private investors. In the case of senior loans, there seems to be an overlap of DFI funding and private investors in view of the growing yet still limited number of MFIs ready to absorb commercial funding. This could lead to an over-supply of funds to certain market segments, while there is still much unmet demand in others. The critics say that DFIs continue to invest in mature 1<sup>st</sup> and 2<sup>nd</sup> tier MFIs while they should make room for the private investors and move “downstream” to small 3<sup>rd</sup> and 4<sup>th</sup> tier institutions because DFIs should be assuming the risks that private investors are still not willing or able to assume. The counter-argument is that DFIs, albeit being public-owned institutions, employ capital market funds and hence need to maintain a certain standard of credit risk rating, thereby inducing the tendency to stay within a relatively conservative circle of mature and well-performing MFIs. This is further reinforced by the DFIs’ limitations – given their operating cost structures – of making small ticket investments as needed by early stage MFIs. These risk and cost considerations prevent DFIs from expanding the frontier beyond a certain limit. Going forward, it will be important to ensure that there is no overlap but complementarity.

This discussion leads to the third issue, exit by DFIs. Long-term commitment in a certain geographic region or a certain sector is crucial to any DFI’s development mission. Especially during the financial crisis of 2008 when private investors significantly reduced their commitments, the DFIs’ motto “we are here to stay” was welcome and appropriate. The DFIs’ ability to act as lenders of last resort and thus help stabilize unsettled funding markets is recognized also by private investors who generally have a much shorter investment horizon than DFIs. The theory is straight-forward: *When a MFI has the capacity to mobilize resources from financial markets by the quality of its financial statements, the aim of the DFI may be considered as having been reached. It is then time for the DFI to withdraw. It is then desirable for it to recycle its equity investment and allow its client to bring in carefully selected private institutional investors. This will undoubtedly make the mission more sustainable.* (Laude 2009) However, in practice it is not always obvious – particularly when it comes to equity positions. The case for debt, especially short-term senior debt to refinance microcredit portfolios, is clear: in many cases the time is right to now leave the field to the private sector and especially to local fund providers including depositors.

The situation is more complex with equity investments. While DFIs may have an initial investment horizon of say eight years, there seem to be little or no specific internal guidelines in terms of the stage of the investment at which a DFI should exit. As a consequence, DFIs tend to stay longer than anticipated (Sanyoura and Espejo 2011).<sup>13</sup> The governance role associated with an equity invest-

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<sup>13</sup> More research would be required to firmly substantiate this statement.

ment adds a further dimension and raises the question of *responsible* exit strategies to be discussed below.

The ongoing trend in the greenfield model of DFIs consolidating their individual equity stakes in retail microbanks into one larger stake at the holding level can be seen as a first stage of exit. In addition, this “upstream” consolidation brings cost savings through economies of scale. Occasionally, however, a DFI is already invested at the holding level and yet takes another major stake in a retail greenfield bank newly to be established under the same holding. This is useful in order to create value at holding level; however it is critical for DFIs to consider when to exit the affiliate, once it has matured and reached full sustainability.

### 3.4 Future Role of DFIs

Financial systems in most countries are far from being inclusive. The work is not done and, going forward, DFIs will have a role to play. DFIs need to sharpen their instruments and interventions, strictly adhering to their comparative advantages and additionality: remain a development investor, standard-setter and catalyst. This is when DFIs achieve the greatest impact beyond funding.

DFIs can provide additionality in funding by developing and providing a variety of financing instruments so far not offered by private investors, for example subordinate and mezzanine finance, guarantees and other enhancement products. There is a role for building local capital and bond markets to allow such products to be offered locally in the medium and long term.

DFIs continue to have a role as equity investors, at least in the back seat of MIVs and holdings. Especially in deposit-taking institutions where regulators look for reputable shareholders before granting a license DFIs can offer additionality in credibility and standing. MIVs, particularly closed-ended equity funds are often not the preferred candidates as shareholders in banks as they are less able to respond to a capital call in an emergency. When MIVs have the backing of DFIs, the notion of patient capital and deep pockets are convincing factors.

Should DFIs move “downstream” to smaller 3<sup>rd</sup> and 4<sup>th</sup> tier MFIs? The answer would be: generally no, for three reasons. Firstly, it is not their comparative advantage to work directly with very small and high-risk MFIs for reasons mentioned earlier. DFIs have started to delegate this work to privately managed MIVs and holdings in which they invest, and these are more agile and flexible in dealing with smaller institutions. Secondly, the business case has been made that microfinance is a sustainable and profitable venture in the pioneering work by the DFIs since the 1990s. Especially the greenfield model has shown that microfinance banks set up as a franchise can reach profitability within 2 to 3 years. Also, DFIs have demonstrated how to develop and transform small MFIs into successful profitable operations. In this respect, the demonstration work of DFIs is done, and the time is right for the private sector to replicate the approach. Thirdly, there is a general trend among DFIs to move “upstream” and focus resources and effort on the specialized intermediaries,



i.e. MIVs and holdings. This trend is also visible in the DFI funding flows: the share of indirect funding through MIVs and holdings increased from 38 % (2007) to 48 % (2011). It is clear that DFIs are increasingly taking the backseat and invite MIVs, holdings and their managers to take the driver seats.

Could or should these private sector vehicles not take over the breeding of small existing or new MFIs? In fact, early initiatives in this regard are emerging. Several MIVs formed a working group in 2011 to explore ways and means to support smaller MFIs. The group plans to build a directory of 2<sup>nd</sup> and 3<sup>rd</sup> tier MFIs, to reflect on foreign exchange hedging and small transactions sizes, and to coordinate much-needed technical assistance (e-MFP 2011). With the development blue print on the table, the demonstration of the business case done, the know how and tools available, the case and the vision for private venture capital to take over may be ripe: *It is time for the sector to come to terms with the reality that more venture capital type investors are needed to ramp up the business model in order for it to become truly mainstream.* (Sanyoura and Espejo 2011)

## 4 Special Focus: Promoting Good Corporate Governance

### 4.1 Why Is Corporate Governance so Important in Microfinance?

The quality of corporate governance is a key factor – and also a key risk – for the performance of MFIs. Some piece of evidence to support this is annual Microfinance Banana Skins' survey conducted among several hundred microfinance practitioners, analysts and regulators. Since the first survey in 2008, corporate governance has consistently ranked high on the scale of perceived risks. In the latest survey in 2012, it ranked second overall (see Chart 4) while some key stakeholders – regulators and investors – even named corporate governance as the number one risk in MFIs.



Fig. 4. Corporate Governance in Microfinance Banana Skins Surveys



The growing importance of corporate governance is also induced by the ongoing transformation of the microfinance sector and the resulting institutional change. Many MFIs are in transition to larger and more professional institutions with a more differentiated organizational structure, delegation of authority and wider array of checks and balances. As the institutions mature, they gradually formalize functions previously executed informally, in their boards, their management and among their staff.

In particular, the transformation of MFIs into deposit-taking institutions demands greater responsibility and prudence where strong shareholders, a solid capital basis and good governance are key factors, on the one hand. On the other hand, by being able to offer a wider range of services, especially savings, MFIs expand their client outreach to poorer segments who do not have the capacity for micro-credit. In this respect, good governance is directly linked to client outreach and social performance.

Finally, good governance is central to the overall performance of an MFI. In a recent pilot project, the MIX tested a new set of governance indicators among a sample of 162 MFIs across 57 countries. Reporting on these indicators showed a positive correlation among factors such as the presence of risk management functions, internal auditing, and Board committees, suggesting that good MFI governance procedures do not exist in isolation from each other (Pistelli et al. 2012).

BANEX in Nicaragua is an example where more effective governance could have mitigated the impact or even averted failure (McKee 2012). Other examples show that crises and financial distress can create huge additional strains on governance.

## 4.2 Principles, Dimensions and Areas of Good Corporate Governance

Broadly defined by the OECD, corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance. The OECD Principles of Corporate Governance issued in 1999 have become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide. They focus on the following key dimensions: (i) ensuring the basis for an effective corporate governance framework including legal and regulatory requirements, (ii) key ownership functions and the rights of shareholders and their equitable treatment, (iii) disclosure and transparency, and (iv) responsibilities of the board. The Financial Stability Forum has designated the OECD Principles as one of the twelve key standards for sound financial systems.

An effective corporate governance framework should promote transparency and efficiency, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities (OECD 2004). The internal governance framework comprises – in addi-

tion to the board as the key element – different organs and actors, including specific board committees, executive management, risk management separated from operations and an independent internal audit. In addition to the key governance dimensions listed above, corporate governance covers a wide range of areas such as internal and external reporting (linked to the dimension of disclosure and transparency), non-financial and financial incentive structures including compensation schemes, addressing conflicts of interest, internal systems of accountability, code of conduct among staff and several more. From the range of areas it becomes clear that the topic of governance is multi-faceted and, while there are generally accepted principles, the governance structure in an organization also has to fit to the business culture of that organization.

Governance in microfinance is inherently more complex than in other sectors due to the industry's implicit double bottom line. In recent years, governance has become a prime topic for research and discussion and a growing consensus on principles of good corporate governance has emerged in the industry, both on the importance of good governance – as reflected in the results of the Microfinance Banana Skins Surveys – as well as on their implementation – as reflected in several implementation guidelines and tools published recently<sup>14</sup> However, recent research has revealed a considerable gap between the ideal of effective MFI governance and the reality on the ground (CGAP 2012). Some of these shortcomings relate to the key dimensions of governance selected for further discussion: ownership and shareholder structure, the role of the board and shareholder exit.

#### 4.3 Clear Ownership Structure and Shareholder Rights

Good corporate governance starts with clear ownership. This provides the essential basis for accountability and responsibility in an organization. The absence of clear ownership and an often diffuse stakeholder structure have been inherent weaknesses of NGO-MFIs, and with it, the greatest vulnerability of a large part of the microfinance industry. In the past, most MFIs have been incorporated as foundations, trust funds or associations, i.e. all of them legal forms with no real owners. Over the years, these institutions have accumulated donor grants which were further grown by retained earnings into a sizable capital base which one might want to call “donorship”. The transformation of “donorship” into real ownership remains a key challenge for NGO-MFIs. In most cases, it involves a complex, painful and lengthy process. Several examples of a successful transformation exist, e.g. Bancosol in Bolivia, Acleda in Cambodia or Compartamos in Mexico, but in many environments NGO-MFIs are struggling with legal and/or political obstacles. In countries like Bosnia and Herzegovina, Kosovo, Egypt and lately Iraq the transformation process has been stalled for years.

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<sup>14</sup> These include Rock et al 1998, CMEF 2012, Fundación Mikrofinanzas BBVA 2011, IFC 2010, Vita and Gonzalez 2011.

The greenfield approach pursued by DFIs in cooperation with strong technical partners over the past decade has been straightforward in terms of ownership. The key element and a major success factor of this approach has been the gathering of strategic and like-minded shareholders with common objectives, primarily DFIs<sup>15</sup> and lately also private socially responsible investors. This club of DFI shareholders has enacted a highly effective governance structure, initially through direct shareholding and board membership in the early greenfield operations and today largely in an indirect manner via the respective holding company.

The DFIs have been the pioneers in microfinance equity investments, and through this ownership participation have had a key role in promoting good corporate governance through active engagement. Even today, DFIs are still the largest equity investors with US\$2.3 billion in microfinance equity in 2011 (CGAP 2012). However, in the rapidly changing funding landscape MIVs have grown to become the second most important source of equity capital with almost US\$ one billion in 2011 (Symbiotics 2012).

#### 4.4 Role and Responsibilities of the Board

A key element of good governance is the functional separation of board and management. The guiding concept is a two-tier system of accountability where a supervisory body holds an executive body accountable for performance. The challenges are (i) to structure an effective board in terms of size, composition, qualification, responsibilities, compensation, adoption of a conflict of interest policy, and with the right balance of governance and management, and (ii) to structure effective board processes including the preparation and conduct of meetings, decision-making etc.

The reality on the ground is still far from this ideal and many MFIs have a long way to go in order to achieve those standards. Governance by the board is particularly weak in NGO-MFIs in several respects. Firstly, accountability of board members is structurally weak due to the absence of clear ownership. Secondly, board members are often volunteers with social background and little know how in finance. Thirdly, management capture is the greatest vulnerability in MFIs with weak board governance. It happens often that a charismatic CEO or general manager dominates the board, thus weakening the board's oversight of the MFI and the board merely serving as a rubber stamp for the management.

The opposite may also be the case where the board dominates governance, especially where charismatic founders are in the chair position. Such board may try to manage and not govern. Especially, when the management is perceived as weak the board may engage in operational issues – become a *hands-on* board as the other extreme to the *rubber-stamp* board (Rock 1998) – and hence depart from its govern-

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<sup>15</sup> Many of the greenfield banks had the same or a similar composition of DFI shareholders dubbed as “the usual suspects” which comprised KfW, IFC, EBRD, FMO and EIB.

ance function of setting the policy and strategic framework. One of the most important and delicate tasks in creating good governance is to achieve a proper balance of functions between the board and management, avoiding either board or management capture (CMEF 2012).

Again, equity investors have an important role in strengthening governance through active engagement on the board. A key function of the board is the definition and subsequent implementation of the organization's mission. DFIs have had a pioneering role by appointing representatives to the boards of MFIs whose primary concern has been to keep the organization oriented towards the double bottom line of social and financial returns. Their role within these boards is almost like that of an "activist" constantly working for a dual social and financial objective (Laude 2009).

Setting the responsible finance agenda has become another important topic for the board room. In the wake of some recent excesses and local crises, MFI boards need to provide policy guidance to management on thorny issues such as responsible portfolio growth, transparent pricing and balanced returns. This includes also a debate about overheated markets or market segments in an increasingly competitive environment and the formulation of an appropriate response strategy. In a recent research (McKee 2012), CGAP found the hot button strategic decisions in the boardroom of MFIs surprisingly consistent among a diverse pool of interviewees (see Box below).

**Which Decisions Are Reported to Generate the Most Controversy in the Board Room?**

- How fast to grow and where
- Which new products to offer and which client segments to prioritize
- How to price products and ensure long-term client protection
- What profit targets are appropriate and how should profits be allocated
- What level of executive remuneration is appropriate
- How to handle capital increases, entry of new owners, and responsible exit
- How to handle crisis

Source: McKee 2012

With the growing diversification of the funding landscape, the investors' role and influence in the governance of microfinance is shifting from DFIs to intermediaries like MIVs and holdings. Recent research by CGAP (McKee 2012) found that MIVs and holdings today assume 208 (64 %) out of 325 board seats, with DFIs taking 29 % or 93 board seats. The research concludes that equity in-

vestors are not fully capitalizing on the opportunity to strengthen MFI governance. It concluded that investors should (i) more actively engage in and beyond the board room, (ii) ensure adequate qualifications, time commitment and continuity of their board nominees, and (iii) increase efforts towards aligning shareholder interests. It seems that the new investors have some way to go to step into the DFIs' shoes, to fully assume responsibilities as actively engaged board members and to live up to the expectations associated with their role as active promoters of good corporate governance.

This then raises the question of corporate governance at the next higher level, i.e. the MIVs and their private fund managers, where essentially the same principles and crucial governance issues apply. Apart from anecdotal evidence, little insight is available on the governance in over 115 MIVs. The EFSE, for example, has developed and adopted comprehensive guidelines on good corporate governance. The MIV surveys make an attempt to capture ESG aspects but only two indicators focus on governance, transparency and anti-corruption policy. Accordingly, 86 % of MIVs report on ESG aspects to their investors and 84 % of MIVs apply anti-corruption and/or internal whistleblowing policies to their investments (Symbiotics 2012).

#### 4.5 Responsible Exit Strategies

The double bottom line in microfinance introduces the dimension of equity investors' responsibility with regard to exit strategies. Two aspects are particularly relevant in this regard: the timing of the exit and how to preserve the mission after exit.

When is the right time for an exit from a MFI? There is no universal answer to this question as it differs for different investors. Intuitively, it should neither be too early nor too late. The risk of a too early exit is associated primarily with private commercial investors who tend to have a short-term investment horizon. To mitigate this risk, some shareholder agreements will include a "lock up clause" that prevents shareholders from exiting within a pre-determined period, eg. five years. This ensures that shareholders in advance agree to remain vested in the mission of the MFI for a longer time horizon (CMEF 2012). Exit provisions also help to protect minority shareholders and to maintain a continuity of like-minded ownership. Key exit issues should be anticipated and negotiated early in the shareholders' agreement. With DFI shareholders rather the opposite is the case: as patient investors they tend to exit later than initially anticipated. While this may not pose a risk to the respective investee but it prevents precious DFI equity capital being recycled to other MFIs. In this regard, the gradual exit of DFIs in the greenfield model from retail MFIs and the consolidation at the holding level is a first important step.

The other challenge of microfinance exits is the need to preserve the social mission. DFIs are particularly concerned, given the amount and effort invested in the institution, to sell their stake to carefully selected investors. Some socially responsible investors may prefer to exit by selling their shares to other socially responsible investors, even at lower return (CMEF 2012). Therefore, investor screening

and selection constitutes a key element of responsible exit strategies. Selection criteria would include their objectives and mission, risk and return expectations, investment horizon, ownership structure, integrity and reputation, and their track record in microfinance.

#### 4.6 Promoting Good Corporate Governance: Whose Role in the Future?

The changing landscape of microfinance funding is naturally bringing a change in roles of different funders. MIVs and their private managers as well as the holding companies are increasingly taking the driver seats in the governance of MFIs. DFIs are taking the back seats and continue to exert influence more indirectly through their stakes and board seats in the holdings and the MIVs. DFIs must make sure that MIVs and their representatives on the boards of MFIs are professionally and actively engaged. CGAP's recent finding that most microfinance investors are not taking an active enough role should be taken as an early warning.

The other element for promoting good governance in the future is strengthening the "sector governance" through investor coordination (e-MFP 2011). Lenders groups and other peer groups may play a more active role in setting standards and defining codes for the industry. It is encouraging that most of the principles and guidelines on corporate governance, previously the domain of DFIs, come from such peer groups and industry associations.

Most crucial for future governance, however, is the growing importance of a completely stakeholder group, the local savers and depositors who already are or will be the main funders of microfinance in the future. They are represented by the prudential regulators and supervisors in the respective countries. While regulators are generally aligned on principles and practices of corporate governance as they relate to the financial, fiduciary and prudential side, many of them are on a steep learning curve when it comes to social side and how to balance both sides under the microfinance industry's double bottom line. This opens a new dimension for promoting good corporate governance in the future.

### 5 Outlook: The Microfinance Funding Landscape of Tomorrow

The paper has illustrated the microfinance landscape today and its evolution in the past years. It has identified some main trends and some of these will gain momentum in the future.

#### 5.1 Further Decreasing Public Funds and Subsidies for Microfinance

The role of public funders in microfinance will further decrease, particularly in the field of debt financing and with it the amount of truly public funds and subsidies while private investors, mostly socially responsible investors, are likely to further increase their presence and commitment to the sector.

This trend implies that the scarce public resources should be employed in a highly effective manner. This implies two things: (i) to maximize the leverage of public funds and (ii) to use subsidies in a highly targeted and “smart” way. For example, employing scarce public funds as *first loss* tranches in structured funds or similar public-private-partnership arrangements can create a significant leverage. When such structure is further enhanced through mezzanine finance from DFIs the risk threshold is lowered to a level that is attractive for private investors, or that is even acceptable to more commercial institutional investors, thus pushing the frontier even further.

Creating conducive frameworks through capacity building at sector and macro levels have probably the highest leverage as will enable the private sector to flourish. A lot of work is to be done in many countries to make regulations conducive to microfinance, to introduce secured transactions frameworks including collateral registries, to establish or open up credit bureaus for micro borrowers, to name a few activities where public subsidies should be targeted in a smart and effective way.

Going forward, therefore the allocation of public funds for microfinance should be critically scrutinized in terms of their leverage and additionality effects.

## 5.2 Ongoing Trend Towards Increased Local Funding: Local Deposits and Capital Markets

The issue of financial inclusion has been put on the agenda of high-level fora such as the G20 and of many national governments. More and more countries are expected to enact conducive laws and regulations to allow for deposit-taking MFIs. This will enable many more MFIs to offer a whole range of services to clients beyond microcredit, especially savings. There are many more potential savers than potential borrowers among the 2.7 billion poor of this world. Recent research on the state of the microfinance industry concludes that the latent demand for microcredit seems to be limited and the actual gap in serving the poor is much smaller than the estimates frequently put forward (Lützenkirchen and Weistoffer 2012).

What is the ideal share of local versus cross-border funding over time? The experience of the most successful microfinance institutions clearly shows that loan portfolios – which are mostly short-term – can over time be entirely funded by local deposits. Building inclusive and sustainable financial systems is about fostering financial intermediation rather than channeling of cross-border funds. Therefore, the role of cross-border funders *for the refinancing of microcredit portfolios* will clearly diminish. Their market niche will shrink to those countries where MFIs are not permitted to accept local deposits. And even there, as the cases of India or Morocco demonstrate, the local financial institutions with their comparative advantage of local currency financing will likely pick up a larger share in the future.

What role then for the private social investors that have entered the microfinance field with so much enthusiasm and appetite? They will need to seek additionality by offering different instruments such as equity, subordinated debt and



other hybrid forms of risk capital (see below). If their mandate allows, they should also look into longer-term loans to refinance e.g. investment loans to very small and small enterprises, so far the domain of DFIs. Many of these enterprises have graduated from the microenterprise segment and require loan amounts above the microfinance threshold and longer tenors. Most of the greenfield banks are already serving these clients and many existing MFIs look into upscaling into the small enterprise market.

In most countries, local capital markets are highly underdeveloped and in a nascent state. This holds true for both bond and equity markets. Cross-border funders have an important role in filling the gap but also in catalyzing local capital market transactions and building local bond and equity markets.

### 5.3 Increasing Trend Towards Equity and Other Forms of Risk Capital

The current trend towards equity and other forms of risk capital will further increase. From 2008 to 2011, MIVs have doubled the share of equity financing in their overall funding from 12 % to 23 % while the share of debt declined to 76 % (Luminis 2012). The rising demand for equity is a reflection of the ongoing transformation of NGO-MFIs into for-profit companies and microfinance banks. Banks and other deposit-taking institutions per se have higher minimum capital and capital adequacy requirements. Moreover, the recently established microfinance holdings plan to establish at least two additional greenfield banks per year which will create a surge in capital. But also other forms of risk capital will be required such as mezzanine finance or subordinated loans, e.g. in regulatory regimes that acknowledge sub-debt as tier-2 capital, and other hybrid instruments.

### 5.4 Working Towards Complementarity Between Public and Private Funders

As the market for cross-border funders will narrow down, particularly in the field of debt finance, and become more focused, the likelihood of overlaps of different types of investors will also increase. Yet it is important to acknowledge the different roles played by the purely public funders, the DFIs, the MIVs and the private social investors, with a view to foster more differentiation and complementarity. What comparative advantages do different funders bring to the table? What do private investors expect from public funders and DFIs, and vice versa, what do MFIs and public funders expect from private investors? A constructive debate among the different funders on these issues would help pave the way to greater complementarity in a market which – in any case – will be increasingly covered by local funders and local deposits and where cross-border funders will have to sharpen the additivity of their respective offers.



## 5.5 What Future Role for DFIs?

As outlined earlier, DFIs will continue to have a role to play in the future as catalysts and match-makers but also in capacity building, especially at the macro and sector levels, and in promoting high standards in areas like corporate governance or responsible finance. What will change is the level of engagement. The current trend of DFIs working increasingly through intermediaries such as MIVs and holdings will likely gain further momentum and the tendency of working directly with retail MFIs will likely diminish. DFIs will operate more indirectly – from the back seat – while MIVs and private investors will be more in the driving seat.

DFIs will maintain additionality in funding by providing financing instruments, for example subordinate and mezzanine finance, guarantees and other enhancement products, as long as these products are not offered by private investors. Finally, there is a key role of DFIs in building local capital and bond markets to allow such products to be offered locally in the medium and long term. While some of these products may seem overly sophisticated for microfinance today they are an important building block of an inclusive financial system in the future.

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