Linking MFIs to Commercial Financing in Latin America: Inter-American Development Bank Support of ProFund

by Bonnie Brusky

This case study examines how the Inter-American Development Bank (IDB) helped Latin American microfinance institutions (MFIs) tap formal financial markets in the 1990s through ProFund, a pioneering equity fund.

Overview

The IDB played a key role in linking MFIs to commercial funding in the 1990s by supporting a financial instrument then new to microfinance: an equity investment fund. The IDB’s US$ 2.7 million investment in ProFund, created in 1994 to make equity and quasi-equity investments in Latin American MFIs, was instrumental in getting the new fund off the ground.

Following the IDB decision to invest, ProFund secured the support of six multilateral and bilateral development organizations, four private investors, and seven NGOs. By December 2003, it had invested over US$ 22 million in 12 MFIs in Latin America, which collectively served approximately 500,000 clients and had a combined outstanding loan portfolio of US$ 450 million. Most importantly, ProFund’s equity investments allowed these MFIs to make the transition from unregulated NGOs to licensed financial institutions, increase their savings mobilization, and access other sources of commercial financing, confirming their viability as formal financial institutions.

Setting the Stage

The idea for ProFund emerged from the successful transformation of BancoSol in Bolivia from a non-profit MFI to a commercial bank. Based on their involvement in BancoSol’s transformation in 1992, six of the new bank’s investors (ACCIÓN, Calmewoo, Fundación para el Desarrollo Sostenible en América Latina, the Rockefeller Foundation, Société d’Investissement et de Développement International, and individual investor Fernando Romero) anticipated that an increasing number of Latin American MFIs would also need commercial capital to expand their operations. They sought to respond to this market need through a specialized investment fund: ProFund.

“‘There were indicators that several other non-profit organizations [with which] ACCIÓN worked would be converting into financial institutions, and that they would follow the path of BancoSol and require equity capital.’

Maria Otero, President, ACCIÓN International

What is a specialized investment fund?

An investment fund is a privately managed fund in which investors place their money to earn a return. Such a fund is “specialized” when it focuses on a specific sector, such as microfinance. When the specialization has a developmental purpose, its investors may include multilateral or bilateral donors, international non-profit agencies, and socially motivated or other individual investors.
Launching ProFund

The group of BancoSol investors first approached the International Investment Corporation (IIC) of the IDB Group because it had invested in BancoSol. The IDB Group, however, considered its newly created Multilateral Investment Fund (MIF) a more appropriate partner for the ProFund project. An autonomous fund administered by IDB, the MIF was established in 1993 to finance private-sector development projects in Latin America and the Caribbean. “The MIF had been set up to work with microcredit and small businesses. It is specifically cast to support microenterprise development with no profit targets, just generally positive results,” comments Sandy Darville, former IIC investment officer and currently head of the MIF Equity Investment Unit.

MIF staff knew the microfinance sector well. Like the BancoSol investors, they recognized that venture capital was needed to transform mature NGO-MFIs in Latin America into regulated financial institutions. When they received the ProFund proposal, remembers Darville, “it was by no means a given that there would be enough investors to capitalize ProFund.” Despite its doubts, the MIF considered the initiative important enough to test, particularly as the ProFund idea matched the MIF mandate perfectly.

ProFund was incorporated in December 1994 in Panama as a for-profit, closed-end investment fund with a 10-year term. (Its shareholders, with acronyms, are listed at the end.) The fund was originally designed to provide equity and quasi-equity—debt that can be converted to equity and loans that are repaid last in the event of bankruptcy—to NGOs transforming into regulated MFIs. ProFund’s portfolio was subsequently expanded to include new institutions and existing banks that seek to initiate microfinance operations.

What is an equity fund?

An equity fund is capitalized by a group of investors (called shareholders) that seek to invest their money in a business (in this case, microfinance institutions). Equity investments do not have fixed returns. Rather, shareholder returns depend on the profitability of the institutions in which the equity fund invests (called investees). In "closed-end" funds, investments are sold off at the end of a pre-determined period and the proceeds are then distributed among the fund shareholders.

Challenges and Achievements of ProFund

Challenges. One major challenge of specialized equity funds is to prevent donor shareholders from extending subsidized loans to the same MFIs that are being encouraged to access commercial equity funding. The goals of a market-based equity investment instrument—positive returns on market-based funding—are usually not well understood by donors. Many specialized investment funds have thus been undermined by subsidized funding from different departments of the same donors that are shareholders in the funds.

ProFund’s biggest challenge was that multiple divisions of donor shareholders sought to invest in the same MFI at varying rates. ProFund and IDB, for example, disagreed more than once on the entity that would invest in a particular MFI: ProFund (market equity), MIF (partially subsidized direct equity), or IDB (heavily subsidized loans). This type of situation occurred with most of ProFund’s donor shareholders.

ProFund Shareholders: Original Investment in US$
Another challenge of equity funds is the need for a clear donor exit strategy, once a microfinance market succeeds in attracting sufficient commercial funds. “There is a certain dynamic built into funding agencies which can lead to these problems,” remarks Damian von Stauffenberg, former chairman of the ProFund Investment Committee, “and that is the tendency to measure success by volume of dollars spent. This dynamic can crowd out private investors,” he continues. “When working with a market instrument, donors must know when to step back.”

**Achievements.** ProFund’s achievements over the past 10 years have surpassed its goals. They include:

- **An expected internal rate of return of between 7 and 10 percent.** In light of the economic downturns in Latin America over the past decade, this return is remarkable. However, the bottom line will not be definitive until the end of 2004, when all investments have been sold.

- **Operational self-sufficiency.** Thanks to efficient management and good investments, ProFund has covered all operating costs since its second year of operation, rare for long-term capital appreciation funds.

- **Increased savings mobilization.** By contributing initial capital to NGOs planning to convert into formal financial institutions, ProFund has facilitated increased savings mobilization in the region. ProFund investees rely less on subsidized funding and more on deposits, leveraging their equity investments between 5 and 12 times. According to Alex Silva of ProFund, the availability of ProFund financing made it possible for institutions to grow significantly, in some cases by a factor of 10 or more.

- **Demonstration effect for other investors.** ProFund investment in an MFI has often opened the door for other commercial investors, including private finance companies, private investors, and commercial banks. For example, the fund has directly assisted mainstream financial institutions, such as SOGESOL in Haiti and Visión in Paraguay, to enter the microfinance market.

> "Our investment, in many cases, completed the financial plan of potential MFIs and thus allowed other potential participants to co-invest."

*Alex Silva, Manager, ProFund*

- **Demonstration effect for other investment funds.** Finally, the success of ProFund spearheaded the emergence of similarly structured specialized investment funds, such as the ACCIÓN Gateway Fund (1996) and AfriCap Microfinance Fund for Africa (2002), to name but two. A recent CGAP survey identified 22 funds that lend to and make equity investments in MFIs. In 2003 alone, 10 such funds were created or began operations. 19 funds are now members of the Council of Microfinance Equity Funds, launched in 2003 to collaborate on a strategy for effective investment in microfinance.

### How ProFund Benefits MFIs and Their Clients

In 1999, the financial sector in Ecuador underwent a serious crisis. “Nearly all the banks were in severe difficulty, and no one could secure any loans,” recalls Maria Elena Perez of Banco Solidario. ProFund, a shareholder in Banco Solidario, led an effort to secure funds for the bank via a US$ 2 million syndicated loan with Calvert, Triodos, and ACCIÓN. In only three months time, Banco Solidario received the loan. The boost in liquidity not only allowed the bank to continue lending to microentrepreneurs, it also gave confidence to Banco Solidario’s international and national investors, which continued to provide the bank financial and technical support at a time when no other bank in Ecuador had access to funds.

> “After the week-long national bank holiday, when there were bank runs across the country, Banco Solidario had microentrepreneurs lined up to pay their debts rather than withdraw their money," adds Perez. "We were the only bank in that situation."

*Maria Elena Pérez, Soledad Burbano, and Mónica Hernández, Case Study Banco Solidario: Strategy during Ecuador’s Financial Crisis.*

### Lessons for Other Donors on Support for Specialized Investment Funds

IDB’s experience with ProFund offers the following lessons for other donors considering supporting specialized investment funds:

- **Be careful not to crowd out genuine investors.** When considering specialized funds, donors should carefully evaluate whether their participation is truly essential. Is donor involvement indispensable or are private sector investors willing to invest? Leaving well-established MFIs to work with commercial investors, donors can use their resources more effectively by supporting riskier MFIs.

- **Beware of conflicts of interest within donor agencies.** Specialized funds are usually intended to help stronger MFIs tap formal financial markets. Donors should not undermine this objective by also offering soft loans to these same institutions. Agency policies should make a clear distinction between MFIs that are mature enough to use market-priced investment instruments and those that still need concessionary funds (see “Challenges” on page 2).
Avoid investment conditions. Specialized funds are market instruments and must function in a market environment. Donors should avoid disbursement conditions and leave fund managers free to make market investment decisions without constraints.

Consider introducing procedural changes to support market instruments. Development agency procedures are often ill-suited for brokering deals with professional investment funds; the review processes of agency legal departments are particularly time consuming. Donors should streamline their legal documentation and procedures when investing in equity funds.

Ensure the selection of a top-notch fund manager who will 1) have presence in the target market, 2) maintain an independent vision for the fund, and 3) rigorously adhere to the specific objectives defined for the fund.

Conclusion

IDB contributed to the effectiveness of ProFund in three principal ways. First, it gave ProFund credibility. As the first major investor in the fund, IDB gave ProFund the seal of approval of the chief development finance institution in Latin America. Second, IDB investment gave ProFund the flexibility to take risks. IDB’s Multilateral Investment Fund was not bound by profit margins, so the development bank could absorb potential losses. Third, it provided the fund the added value of Board membership. Tomás Miller, the IDB-MIF representative on the ProFund Board of Directors, remarks that, “IDB-MIF has sought to support ProFund not just with money, but also by participating in the strategic definition of the fund.” This has meant ensuring that the corporate governance structure, financial incentives, and investment/divestment decisions of the fund are designed to promote sound financial returns.

ProFund in turn allowed IDB to streamline its investments in microfinance and take advantage of the knowledge and speed that comes with a fund manager based in the region. “ProFund offers a very agile way to conduct operations...in a direct way. We have been able to invest in MFIs more efficiently,” comments Miller. ProFund is an example of how innovative donor support at the right time and place can build bridges between microfinance institutions and traditional financial markets. The ultimate success of ProFund is the diminishing role of donors in specialized funds in Latin America, “which is one of the reasons why there will be no ProFund II,” notes Alex Silva. Private investors in the region are waking up to microfinance, and donors must now make way for them.

References


Contacts and Web sites

IDB-MIF: www.iadb.org/mif/v2/index.html
ProFund: www.profundinternacional.com

Bonnie Brusky is a microfinance consultant. This case study draws on the above references, as well as valuable input from Sandra Darville (IDB-MIF); Todd Farrington (MicroRate); Tor Jansson (IFC); Tomás Miller (IDB-MIF); Maria Otero (ACCIION); Soledad Burbano, Monica Hernandez, and Maria Elena Perez (BancoSolidario, Ecuador); Alex Silva (ProFund); and Damian von Stauffenberg (MicroRate). The author thanks them for their time, patience, and insights.

ProFund Shareholders

SECO: State Secretariat for Economic Affairs, Switzerland
CDC: Commonwealth Development Corporation Group (owned by DFID)
CABEI: Central American Bank for Economic Integration
IDB/MIF: Inter-American Development Bank/Multilateral Investment Fund
CAF: Corporación Andina de Fomento
FUNDES: Fundación para el Desarrollo Sostenible en América Latina
SIDI: Société d'Investissement et de Développement International