Debt and Equity

Neither clients' savings nor donor grants will provide the volume of funding that MFIs require. Today, these sources barely cover 5% of the existing needs. MFIs thus realise that access to the capital markets is essential in order to maintain their growth and expand the reach of their services to the poor. This recognition is driving MFIs to combine their social missions with managing their businesses for profit.

There are two principal ways MFIs can access commercial capital:

1. Debt

As well as deposit mobilisation, debt can take the form of the issuance of commercial loans. For example, Opportunity partner OMRO in Romania has taken out two loans from Oikocredit since 2002 for a total of 500,000 euros in order to expand its loan portfolio and open two new branches.

Ability to raise debt financing will largely depend on the type of MFI:

- Small, unregulated MFIs (usually NGOs) typically have the least ability to raise debt financing. Their challenges revolve around lack of experience, untested or poor capacity, lack of credit history and poor collateral – as well as their inability to provide guarantees for commercial bank loans. Examples include most of OI's partners in Latin America.
- Large, unregulated MFIs have the advantage of well developed funding networks. However, they are usually only able to access "development finance markets" for funding (e.g. development banks or specialty investment funds which are usually not entirely commercial). Examples include ASODENIC in Nicaragua.
- Newly regulated MFIs typically have well developed funding strategies from when they applied to transform into an FFI because this is required by financial regulators. Plans typically include a host of debt sources that will supply loan portfolios until deposit collection generates significant funding. Examples include OI-SASL in Ghana, OIBM in Malawi and FORUS Bank in Russia.
- Mature, regulated MFIs usually have well developed funding strategies based on long time funders and strong, or at least, predictable deposit operations. Unlike smaller MFIs, these institutions tend to actively manage liabilities to maximize profitability and minimize liquidity risk.

Note that the most well-known debt funds include the Calvert Foundation, Dexia Microcredit Fund, Hivos-Triodos Fund and Oikocredit.

2. Equity

In addition to debt, capital markets can be accessed through equity - the sale of shares of ownership of the MFI. In order for this to be possible, the institution must be structured as a commercial enterprise, with ownership held by individual persons or organisations. Examples includes OI-SASL, OIBM and OIBR.

These MFIs can raise equity by issuing and selling shares, or by reinvesting profits from their operations. For instance, with a grant of £100,000 from a UK donor, OIUK would be able to purchase a certain number of shares of OI-SASL through OMIL, our investment arm. We would thereby become an equity investor – in other words, we be part owners of OI-SASL and as such could control its ultimate purpose and direction.

Grants for equity can be of strategic importance in enabling MFIs such as OI-SASL to build a capital base. A sound equity position is important to generate investment income, build the loan portfolio, and leverage funds from commercial banks and capital markets. As such, they can be a catalyst and complement to domestic mobilisation of funds. Grants for equity can also help MFIs seeking to become FFIs to meet minimum capital requirements.

Note that other predominantly equity funds include Accion Gateway Fund, Africap, ProFund and OTI (the investment arm of OIUS).

What is the debt to equity ratio?

Both banking regulators and an MFI's lenders set limits in terms of the amount of debt that a MFI can have outstanding in proportion to the amount of equity they have built up on their balance sheet.

For example, if an OI-SASL wanted to borrow £1,000,000 from a commercial bank in Ghana, the lending bank might require £20 of equity for every £100 of loan it will provide to the MFI. This would be a 5-to-1 capital base requirement. In other words, OI-SASL would need £200,000 in equity or capital to borrow the requested £1,000,000.

As a result, sourcing and employing equity is fast becoming a critical challenge to the microfinance sector. Strategic equity investment is critical to the success of an institution, though rarely the largest source of MFI financing. NGO MFIs transforming into licensed financial institutions typically have the greatest equity investment needs and challenges of any type of MFI. They often face the dual problem of finding new investors to finance transformation and ensuring that new ownership maintains a focus on social mission.

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