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By Hans DieterSeibel

1. Equity participation: the need for a new IFAD instrument in rural finance

The IFAD Rural Finance Policy lists among the initiatives to be supported *commercially-operated apex organizations for refinancing MFIs* (para. 20) and stipulates that,

> *Equity financing through appropriate apex institutions may be developed by IFAD as a new instrument, which would provide the much-needed external capital and leverage multiples of domestic capital.* (para. 32)
>
> *Equity participation, which avoids some of the pitfalls of credit lines, strengthens the capital base of apex funds and rural financial institutions and leverages additional domestic resources in the form of savings deposits or additional equity. It may also be used to fulfil legal minimum capital requirement when transforming non-formal institutions into formal entities. (para. 44)*

Examples given of autonomous apex funds are the Social Capital Fund in Argentina, the Palli Karma-Sahayak Foundation in Bangladesh, and the People's Credit and Finance Corporation in The Philippines (para.32).

IFAD may also invest in larger-size financial intermediaries, among them microenterprise banks and rural banks as well as agricultural development banks and some commercial banks, which either refinance smaller rural financial institutions or lend directly to IFAD's target group.

2. Sources of information

Discussions were held with:

- ✓ DEG – Deutsche Investitions- und Entwicklungsgesellschaft mbH (*German investment and development corporation,* Cologne, 23 June 2000

- ✓ AFRICAP Fund, An African Microfinance Investment Fund (being newly issued in 2000): during the CGAP meetings in Edinburgh, 20-22 June 2000

- ✓ Hivos-Triodos Fund, a joint fund of the Humanist Institute for Development Cooperation (Hivos) and Triodos Bank in the Netherlands, founded in 1994: during the CGAP meetings in Edinburgh, 20-22 June 2000

- ✓ IMI, Internationale Micro Investitionen AG, a microbanking fund initiated in 1998 by Internationale Projekt Consult (IPC GmbH and IPC-Invest) Frankfurt, together with DEG, DOEN and ProCrédito:

3. Requirements for commercially operating financial apex institutions and other financial intermediaries

(1) The political will to establish a truly autonomous and viable financial intermediary
(2) Real ownership with a commercial interest in the viability and profitability of the intermediary
(3) An exit option for the intermediary's equity owners
(4) Autonomous management
(5) A qualified fund or bank manager
(6) A proven market potential, defined as the probability of earning positive real returns adjusted for inflation
(7) An appropriate legal and regulatory framework, including the definition and enforcement of prudential (bank) norms (with effective supervision by the central bank or bank superintendency)
(8) A clientele of viable and sustainable MFIs, which on principle mobilize their own resources domestically (particularly through savings deposits) and cover their costs from their operational income.
(9) *Among apex institutions:* Appropriate financial products for investing in, refinancing, reinsuring, or providing credit guarantees for, MFIs owned or used by IFAD's target group
(10) *Among other financial intermediaries (banks, finance companies):* Appropriate deposit, loan and other financial products for IFAD's target group or MFIs.

4. Options for IFAD

The following options have emerged from the discussions (in the order of magnitude of engagement):

(1) **Equity participation in financial intermediaries** (with or without sovereign government guarantees), such as Micro Enterprise Bank in Bosnia & Herzegovina, Caja Los Andes in La Paz/Bolivia, Centenary Bank in Uganda, cooperative and community banks in Tanzania, and Himalaya Finance & Savings Company in Nepal – in the framework of IFAD projects.

(2) **Investment in existing or new funds**, eg, AFRICAP Fund (Annex 1), IMI (Annex 2), Hivos-Triodos Fund. A seat on the board would give IFAD the opportunity to take an influence on all investments by the fund. Minimum investment that would give IFAD a seat on the board in the case of AFRICAP fund: $2m. The first such investment might be funded through a technical assistance grant (TAG).

(3) **Agency line with a development finance institution (DFI)**, which carries out all investment preparations (including a due-diligence study), but leaves contractual arrangements and financial transfers to IFAD.

(4) **Subsidiary agreement or trust deed with a development finance institution (DFI)** like DEG (Germany), FMO (Netherlands), IFC (multilateral), which invests, in consultation with IFAD, on IFAD's behalf.

(5) **Establishing an investment fund,** either as an IFAD subsidiary, or as a special program, mandated to invest in regional or national funds, microfinance banks and non-bank financial institutions (NBFIs) with outreach to the rural poor. The fund would be a separate, professionally run entity with a commercial orientation, with or without a legal personality of its own, but accountable to IFAD. Its principal operations would be investments in, and loans to, regulated financial intermediaries and to non-formal institutions in the process of transformation into regulated ones. Co-funding with bilateral and other multilateral development finance institutions as well as private sector banks would be possible. All risks would be borne by the investment fund (sovereign government guarantees may stifle a commercial orientation).
(6)

5. Recommended action

(1) Carry out a study of the various options of an IFAD equity participation instrument to enable IFAD to invest at its own risk in microfinance investment funds and in rural microfinance banks and non-bank financial institutions. Particular emphasis should be placed on options 1 and 2, which will allow IFAD to gain experience with the new instrument. One of the agencies listed above may assist in the preparation of the TOR for such a study and its supervision.

(2) Examine the feasibility of an equity component in the planning of IFAD rural finance projects during an early phase of the project cycle; and assist the regional divisions in the preparation of such components.