

**DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK  
MULTILATERAL INVESTMENT FUND  
NOT AUTHORIZED FOR PUBLIC USE**

**REGIONAL**

**RISK ASSESSMENTS OF MICROFINANCE INSTITUTIONS**

(TC-99-08-006-RG)

**DONORS MEMORANDUM**

This document was prepared by the project team composed of Valnora Leister (LEG/OPR), Nobuyuki Otsuka (MIF), Kenroy Dowers (SDS/IFM), and Tor Jansson (SDS/MSM), Project Team Leader.

## CONTENTS

<b>I. COUNTRY AND PROJECT ELIGIBILITY.....</b>	<b>1</b>
<b>II. BACKGROUND .....</b>	<b>1</b>
<b>III. PROJECT OBJECTIVES, COMPONENTS AND ACTIVITIES .....</b>	<b>4</b>
A. OBJECTIVES .....	4
B. COMPONENTS AND ACTIVITIES.....	5
<i>Component I: MFI Risk Assessment Grant Facility (MIF: US\$1,107,000; Local: US\$923,000)</i> .....	5
<i>Component II: Information Exchange (MIF: US\$220,000; Local: US\$ 0)</i> .....	7
<b>IV. EXECUTING AGENCY AND EXECUTION MECHANISM, PROJECT READINESS, AND BENEFICIARIES.....</b>	<b>8</b>
A. EXECUTING AGENCY AND MECHANISM .....	8
B. PROJECT READINESS.....	9
C. BENEFICIARIES .....	9
<b>V. COST AND FINANCING DURING EXECUTION AND OPERATION PHASES.....</b>	<b>10</b>
<b>VI. PROJECT JUSTIFICATION AND RISKS .....</b>	<b>10</b>
A. PROJECT JUSTIFICATION .....	10
B. PROJECT RISKS .....	11
<b>VII. PROJECT PERFORMANCE CRITERIA AND EVALUATION OF RESULTS .....</b>	<b>11</b>
A. PROJECT PERFORMANCE INDICATORS .....	11
B. MONITORING AND EVALUATION .....	12
<b>VIII. EXCEPTION TO POLICIES AND PROCEDURES .....</b>	<b>12</b>
<b>IX. SPECIAL CONTRACTUAL CONDITIONS .....</b>	<b>12</b>

## ANNEXES

Annex I      Logical Framework

## APPENDICES

✓ Proposed Resolution

### **INFORMATION AVAILABLE IN SDS/MSM FILES**

- ✓ **Operating Regulations for Risk Assessment Grant Facility**
- ✓ **Detailed Project Budget**
- ✓ **Terms of Reference for Project Activities**

## **ACRONYMS AND ABBREVIATIONS**

<b>MFI</b>	<b>Microfinance Institution</b>
<b>CGAP</b>	<b>Consultative Group to Assist the Poorest</b>
<b>NGO</b>	<b>Non-Governmental Organization</b>
<b>CMAC</b>	<b>Caja Municipal de Ahorro y Crédito</b>

## RISK ASSESSMENTS OF MICROFINANCE INSTITUTIONS (TC99-08-006-RG)

### EXECUTIVE SUMMARY

<b>Executing Agency:</b>	Inter-American Development Bank, through contracted parties.
<b>Beneficiaries:</b>	Microfinance institutions in Latin America and the Caribbean.
<b>Project Cost and Financing:</b>	Modality No-reimbursable Facility III-A MIF: US\$1,470,000 Local Counterpart: US\$923,000 Total: US\$2,393,000
<b>Terms:</b>	Execution: 36 months Disbursement: 42 months
<b>Objectives:</b>	The general objective of the project is to contribute to the growth and sustainability of the Latin American and Caribbean microfinance industry through accelerated access to commercial sources funding. The specific objective of the project is to achieve an improvement in the amount and quality of information and transparency regarding the financial risk and performance of microfinance institutions.
<b>Components:</b>	The project will finance two components intended to improve the quality and availability of information on the financial health and performance of microfinance institutions (MFIs). First, the project will establish a <b>Risk Assessment Grant Facility</b> that will provide matching grants to assist MFIs to purchase risk assessment services. The use of a grant facility will enable the IDB/MIF to provide the support in a demand driven and market based fashion. Second, the project will establish a web-based <b>Information Exchange</b> to help disseminate information related to the risk assessments and the funding needs of MFIs. In essence, this web site will function as a marketplace where MFIs are paired with investors/creditors through access to timely and relevant information about one another. Combined, the Grant Facility and the Information Exchange will offer a significant increase in the amount, quality and availability of information on these institutions.
<b>Special Contractual Conditions:</b>	None.
<b>Exceptions to Bank Policies:</b>	None.
<b>Environmental and Social Review:</b>	The CESI reviewed the Project Abstract at its meeting on January 28, 2000, and recommended no changes or modifications to the project.

## I. COUNTRY AND PROJECT ELIGIBILITY

- 1.1 The proposed project will promote the development of dedicated microfinance institutions<sup>1</sup> (MFIs) in all of the MIF eligible countries in Latin America and the Caribbean. The project is eligible for financing from the Small Enterprise Development Facility III-A of the MIF, and is consistent with the current MIF strategy, as it promotes increased levels of financing for MFIs, which in turn impact the growth of micro entrepreneurs throughout the region. Regional eligibility is requested for this project for the following reasons: (i) to obtain economies of scale to disseminate risk assessment methodologies; (ii) to strengthen the MFIs in the region through exchange of risk assessment methodologies and the results; and (iii) to leverage other MIF efforts in the region related to the capacity building and access to the capital market of MFIs.

## II. BACKGROUND

### *The Role and Importance of Transparency For MFIs*

- 2.1 By recent estimates, the Latin American microfinance industry has a combined portfolio of approximately US\$ 1.5 billion. It has taken about 20 years to arrive at this stage, starting with a limited number of small and fragile non-profit organizations scattered across the region. However, if the industry continues its current growth of about 25% per year, it will need this same amount - US\$ 1.5 billion – to finance its growth only over the *next three to four years*. While not much in relation to the sums circulating in international and domestic financial markets, it nevertheless constitutes an unprecedented flow of funds to MFIs in the region.
- 2.2 The Latin American microfinance industry is clearly in the midst of a fundamental transition characterized by a gradual integration into the formal financial sector. This integration promises to expand microfinance institutions' access to commercial sources of financing and capital; yet it also creates a new set of demands on the industry. In order to attract these new sources of capital and financing, MFIs must provide potential investors with a high level of informational transparency and an attractive risk/return profile.
- 2.3 Judging by available data on leading MFIs, financial returns should not be a problem in attracting creditors and investors. Many of the leading MFIs show profitability ratios (return on assets, financial margins etc.) well above those of commercial banks in their countries. Rather, the participation of commercial creditors and investors is held back by high transaction costs and the perception of large risks in financing MFIs. Transaction costs—expenses incurred in drafting the contract, transferring the funds and in third party management of commercial papers—are high due to a lack of standardization of

---

<sup>1</sup> There is no single definition of what constitutes a dedicated microfinance institution. However, the Micro, Small and Medium Enterprise Division generally characterizes microfinance institutions as those institutions (cooperatives, non-profit or incorporated) that primarily lend for business purposes and have an average outstanding loan of less than \$3,000.

instruments and processes as well as the relatively small amounts transacted. Risks are considered large, partly due to an incorrect estimation of the inherent risks of microfinance, and partly due to a fair assessment that the quality and availability of information (transparency) regarding the financial health and performance of MFIs is many times poor.

- 2.4 While the issue of transaction costs should not be underestimated, the most serious concern among investors is typically related to the ability to gain an accurate appreciation of the risk and performance of an investment object (in this case the MFIs). To make this assessment, they need information of high quality – that is, timely, relevant, reliable, impartial and detailed information– and they need to be able to access it at a reasonable cost. Without quality and availability, the information has little value to potential investors, creditors and, by extension, the MFIs themselves. In fact, this is what characterizes the current situation of most MFIs – they release information of relatively poor quality and, even if the quality of the information were good, they have few means of effectively distributing it to potential investors and creditors.
- 2.5 In financial markets, one way the issue of quality and availability of information has been addressed is through risk assessments, or ratings. The risk assessments, carried out by independent and specialized assessment firms, summarize all available information about an institution or firm in a single estimate, or grade. While risk assessments are widely used in developed markets and among large institutions/firms in developing markets, they are only beginning to be applied to microfinance institutions.
- 2.6 Risk assessments bring important benefits to financial markets in general and to MFIs in particular. The assessments provide strong incentives for financial discipline, transparency and performance among the rated institutions, in this case the MFIs. In return, the MFIs typically enjoy greater publicity (which helps attract individual clients) and much better access to potential investors and creditors. Risk assessments increase the reliability and availability of information in financial markets and thereby facilitate the due diligence required of investors and creditors. In fact, investors and creditors often use risk assessment reports to identify new investment ideas and, according to reports from Peru, they are typically very impressed by the high returns declared by leading MFIs. As a result of positive assessment reports, Peruvian commercial banks have taken a greater interest in the small and microenterprise market, thereby increasing competition and benefiting this clientele.

#### *Demand for Risk Assessments*

- 2.7 As the demand for commercial financing among microfinance institutions has grown, so has their interest in risk assessments. So far, however, very few Latin American microfinance institutions have undergone a risk assessment by an established rating firm. Only about 20 microfinance institutions in Latin America have received a widely

recognized rating, most of which are located in Peru and Bolivia<sup>2</sup>. These risk assessments have been carried by local and international rating firms, including Standard & Poor's which rated BancoSol, a Bolivian bank specializing in microfinance, in 2000.

- 2.8 The demand among MFIs for risk assessment services has so far been held back by certain factors. The small volume of assets of most MFIs makes a risk assessment relatively costly as the price of a rating amounts to \$8,000-\$25,000, depending on cost structure and pricing policy of rater. Also, in some cases, the continued availability of subsidized credit lines from donors also tend to reduce the incentives for MFIs to undergo a risk assessment since the need for commercial financing is less. The risk assessment could even conceivably undermine an institution's relationship with existing donors, creditors and investors, since it will expose any vulnerabilities and weaknesses of the institution.
- 2.9 In spite of these obstacles, the emerging trend is towards an increasing demand for risk assessment services among MFIs. The underlying driver of this demand is the explosive growth of many MFIs (20-30% per year), which forces them to increasingly seek commercial sources of funding. This, in turn, has lead to a growing awareness of the usefulness of risk assessments in establishing the initial contact with potential investors and creditors. As a result, MFIs have during the past few years expressed increasing interest in and demand for risk assessments.
- 2.10 The increased demand for risk assessment services among MFIs is also a response to factors outside their control. MFIs that operate as licensed and supervised financial entities are under increasing pressure from supervisory authorities to undergo risk assessments (as is the case in Bolivia and Peru). This trend, which is currently occurring among the largest and most advanced MFIs, will gradually reach the smaller and less mature MFIs, which typically operate as non-profit entities. While not required by banking authorities to undergo a formal risk assessment, these smaller MFIs will nevertheless see it as one of the necessary preparatory steps before entering the formal financial system. Additionally, due to the role of ratings in the new Basel Capital Accord, creditors will increasingly demand to see a recognized risk assessment before providing financing to any MFI. Social investors, which compose the vanguard in terms of MFI funding, already typically require the MFIs to show some sort of risk or performance assessment by, at a minimum, one of the smaller specialized MFI assessment firms, such as MicroRate (see paragraph 2.12).<sup>3</sup>

---

<sup>2</sup> **Bolivia:** Bancosol, Caja los Andes, FIE, Ecofuturo, Prodem; **Colombia:** FinaAmerica; **El Salvador:** Financiera Calpia; **Peru:** MiBanco, Caja Municipal de Ahorro y Crédito (CMAC) Sullana, CMAC Piura, CMAC Huancay, CMAC Arequipa, CMAC Cusco, CMAC Maynas, CMAC Ica, CMAC Paíta, CMAC Tacna, CMAC Trujillo, CMAC Pisco, CMAC Chinchá; **Uruguay:** Cooperativa FUCAC.

<sup>3</sup> The most significant difference between social and commercial investors is that social investors (such as the Dexia Fund and Calvert Fund for example) target industries and firms based on "social" considerations, including environmental record, development potential and other specific issues. However, while acting within their target market, most social investors behave much like commercial investors in that they try to achieve the highest return possible at the lowest risk available. They therefore react in much the same way as commercial investors to changes in the quality and availability of information regarding potential investments.

- 2.11 While consistent and accepted risk assessments of MFIs is a cornerstone in achieving increased transparency, it alone will not satisfy investors' demand for information. At a minimum, potential investors and creditors also need continual access to quarterly (and preferably monthly) information on the financial health and performance of these institutions. Without such information, they will be unable to effectively monitor their investments and loans. Currently, the flow of such information from and about most microfinance institutions is neither reliable nor frequent. Apart from the regulated and supervised institutions, most MFIs issue only yearly reports. Moreover, these reports rarely disclose financial information in sufficient detail to satisfy potential investors and creditors.

*Suppliers of Risk Assessment Services for MFIs*

- 2.12 The supply of risk assessment services for MFIs in Latin America is provided by three groups of institutions: (i) international and local professional rating firms, such as Standard & Poor's, Tomson Financial Bankwatch, Fitch IBCA, Pacific Credit Rating, Apoyo Asociados, and Equilibrium; (ii) small specialized microfinance assessment firms, such as MicroRate, PlanetRating and M-CRIL; and (iii) network operators such as Acción, Women's World Banking and Word Council of Credit Unions. Only firms in the first category currently provide domestically and internationally recognized ratings. The second and third category of firms/organizations, which represent the incipient and organic growth of a specialized microfinance assessment industry, provide risk and performance assessments that, while widely recognized among social investors, are only beginning to be known and accepted by commercial investors and creditors.
- 2.13 The firms in the second category — the small, specialized assessment firms — are quickly moving to become recognized "raters". Having realized that the risk assessment constitutes the crucial link between MFIs and investors/creditors, several of these assessment firms/organizations are in the process of developing rating scales of their own. Currently, however, their assessments tend to offer benchmarks and subjective analysis, but typically stop short of estimating the risk of default. While the assessments by the firms/organizations in this semi-professional group do not fully address the concerns and requirements of investors and creditors, many MFIs have nevertheless found them useful for benchmarking and management purposes.

### **III. PROJECT OBJECTIVES, COMPONENTS AND ACTIVITIES**

#### **A. Objectives**

- 3.1 The general objective of the project is to contribute to the growth and sustainability of the Latin American and Caribbean microfinance industry through accelerated access to commercial sources funding. The specific objective of the project is to achieve an improvement in the amount and quality of information and transparency regarding the financial performance and risk of microfinance institutions.

## **B. Components and Activities**

- 3.2 The project will finance two components intended to improve the quality and availability of information on the financial health and performance of MFIs. First, the project will establish a “Risk Assessment Grant Facility” that will provide matching grants to assist MFIs to purchase risk assessment services. The use of a grant facility will enable the IDB/MIF to provide the support in a demand driven and market oriented fashion. Second, the project will establish a web-based “Information Exchange” to help disseminate information related to the risk assessments and the funding needs of MFIs. In essence, this web site will function as a marketplace where MFIs can identify risk assessment firms and be paired with investors/creditors through access to timely and relevant information. Combined, the Grant Facility and the Information Exchange will offer a significant increase in transparency regarding Latin American microfinance institutions.
- 3.3 To achieve wide awareness of the Risk Assessment Grant Facility and the Information Exchange, the project will make extensive use of free electronic means of promotion and dissemination by systematically compiling and using e-mail lists of investors, donors, MFIs and raters, as well as by swapping advertisements and links with other related web-sites. This strategy will enable a low-cost, continuous, timely and targeted dissemination of information. It is particularly crucial to undertake these promotional activities during the first year of implementation of the project. The Bank will use its extensive network established in the region and promote the project through as many fora as possible, including the yearly Inter-American Microenterprise Forum, which is organized by the Bank.

### **Component I: MFI Risk Assessment Grant Facility (MIF: US\$1,107,000; Local: US\$923,000)**

- 3.4 The project will finance a Grant Facility that enables the partial financing of 140 risk assessments for an estimated 80 Latin American and Caribbean institutions over a period of 3 years (a significant number of institutions are expected to request repeat assessments). The multi-year nature of the grant facility is deemed necessary to encourage a permanent improvement in the information available on financial institutions that serve the microenterprise sector and, by extension, a greater permanent interest among social and commercial investors and creditors. It is expected that most of the supported institutions will continue to pay for risk assessments after the life of the Grant Facility.
- 3.5 The matching grant provided by the Grant Facility to any specific institution will vary between \$3,000 and \$8,000, depending on the asset size (i.e. payment capacity) of the institution and whether it is a first or repeat assessment (repeat assessments are less expensive and will receive a smaller matching grant). The matching grant will be paid out to the institution after the assessment has taken place and against the invoice from the risk assessment firm. In exchange for the matching grant, participating MFIs will be required to submit, at a minimum, quarterly financial statements for one year subsequent to each
-

risk assessment. These reports, along with the risk assessment itself (or the summary thereof), will be made available to potential investors and creditors through the Information Exchange (see Component II).

- 3.6 The Grant Facility will target specialized microfinance institutions with assets between US\$1 million and US\$10 million. It will also allow the participation of financial cooperatives within the same size range. It is typically in this range that these institutions start accessing commercial sources of financing and, consequently, where IDB support can have the largest impact. There are at least 90 specialized microfinance institutions and about 800 financial cooperatives within the US\$1-10 million range in Latin America and the Caribbean. In addition to the asset size limitations, only institutions with an average loan size of less than US\$3,000 and more than 25% of its portfolio in enterprise loans (as opposed to consumer or mortgage loans) will be eligible for matching grants from the Grant Facility. Finally, eligibility will be granted only to those institutions that have subjected themselves to external audits.
- 3.7 In terms of *what* is financed, the Grant Facility will primarily support the purchase of institutional risk assessments. The Grant Facility will also have some flexibility in providing matching grants for other products with a similar purpose, for example portfolio risk assessments and risk assessments related to the issuance of specific debt or equity instruments. However, the facility will *not* directly assist MFIs in the issuance of any financial instruments, such as equity or debt.
- 3.8 In order to assure some minimum quality standards of the risk assessments, the Grant Facility will offer a list of pre-approved risk assessment firms among which MFIs can choose. Only assessment firms that are (a) recognized by a country's relevant authorities, (b) associated with an internationally recognized rating agency, or (c) specifically approved by the project's Steering Group (see paragraph 4.1) will be qualified to participate. The purpose of having pre-qualified firms is not to restrict choice or supply for MFIs, but to achieve a reasonable assurance that participating assessment firms possess the minimum skills needed to effectively assess microfinance institutions. Having a list of pre-qualified firms will also help creating a market in microfinance assessment services by giving raters a platform to present themselves and their services, as well as by giving MFIs the opportunity to choose among them. This way, MFIs can easily identify and select the risk assessment firm that best fits their particular needs and constraints. In order to assure that the Grant Facility is not dominated by any single risk assessment firm, no such firm may receive more than 35% of the Grant Facility's funds. A detailed description of the Grant Facility's operating regulations is available in the technical files of SDS/MSM.
- 3.9 The project will include financing to undertake a review and comparison of the methodologies used by the different risk assessment firms. Such a review will be an important input in fostering a greater cohesion and comparability of various risk assessment methodologies as they relate to microfinance, something which ultimately improves transparency in the financial markets in relation to this sector. The review will

be carried out towards the end of the project or as soon as sufficient information is deemed to exist to support such an undertaking.

**Component II: Information Exchange (MIF: US\$220,000; Local: US\$ 0)**

- 3.10 The project will finance consultancies to create and maintain a web-based “Information Exchange” meant to facilitate access to information for investors, raters and microfinance institutions. This platform will function as a virtual marketplace where information is gathered, structured and channeled in a fashion that allows MFIs, raters and investors/creditors to evaluate and initiate business contacts between one another. This site is essential not only in making the Grant Facility work properly, but also in creating additional value for the MFIs that choose to purchase risk assessments.
- 3.11 The Information Exchange will offer a wide range of information that promotes transparency and helps match the needs of MFIs with the resources of investors/creditors. Among the information that users of the site will be able to access are the risk assessments, financial statements and performance data of MFIs; the characteristics and contact information for social and commercial creditors/investors; and all aspects pertaining to the Risk Assessment Grant Facility, including application and reimbursement instructions for MFIs, the names, characteristics and contact information of pre-qualified raters, and the assessments financed to date. To provide the incentives for risk assessment firms to do a good job, the Information Exchange will also actively solicit and publish feedback information from both MFIs and investors/creditors on the quality and usefulness of the risk assessments.
- 3.12 The Information Exchange will offer all information previously mentioned for free to MFIs, investors, creditors, donors and assessment firms during the execution of the project. At the end of the project, the management of the site will be assumed by a party with appropriate incentives to maintain the site over the long run (including possibly the entity that managed the site during the execution of the project). At that time, the site may start charging for any and all information it provides in order to sustain itself. During the design of the project, the team established contact with other multilateral organizations and private social investors that have demonstrated interest in promoting the access of MFIs to commercial sources of funding. As a result, UNCTAD, CGAP<sup>4</sup> and some private social investors have indicated that they would be willing to explore collaborative arrangements by which a more complex and extensive web-based Information Exchange could be mounted. Such a site, with its greater informational depth and potential financial backing, would have a better chance of becoming self-sustainable after the project ends. Consequently, the project team will continue to explore possible collaborative arrangements during the execution of the project. The proposed terms of reference for the Information Exchange are available in the technical files of SDS/MSM.

---

<sup>4</sup>The Consultative Group to Assist the Poorest (CGAP) is a 27-member donor consortium whose mission is to improve the capacity of microfinance institutions to deliver flexible, high-quality financial services to the very poor on a sustainable basis. CGAP was created in 1995 and today employs 8 technical staff and an equal number of consultants in its secretariat located in Washington D.C.

## **IV. EXECUTING AGENCY AND EXECUTION MECHANISM, PROJECT READINESS, AND BENEFICIARIES**

### **A. Executing Agency and Mechanism**

- 4.1 The IDB will be the executing agency responsible for basic oversight and project implementation. A Steering Group composed of the project team members will act as the basic unit of responsibility, though most of administrative work will be delegated to a consulting firm or individual to be hired for each component ("contracted party"). The Deputy Manager of the Private Enterprise and Financial Markets Sub-Department of the Sustainable Development Department will head the Steering Group and will invite staff from the Regional Departments to participate. The Steering Group will be responsible for the strategic direction of project components, the technical issues associated with them, and the selection of consultants and/or consultant firms to be contracted with funds from the project. The Steering Group will meet periodically (at least each quarter) to review the operational issues on an as-needed basis. The Group will also coordinate the mid-term and final evaluation of the project, which will have a duration of 36 months from the moment it is approved.
- 4.2 For the implementation of the project, a qualified firm/organization will be contracted through international competitive bidding. The project team will identify and invite 5-10 firms/organizations that are deemed qualified to implement the project. Given the diverse nature of the activities under Component I and II, the contracted party may choose to outsource some of these (for example web design). Any major controversies or difficulties in the implementation of the project's activities should be referred to the Steering Group, particularly if they relate to the eligibility of MFIs and risk assessment firms.
- 4.3 In terms of the Risk Assessment Grant Facility, the contracted party will be expected to assure its timely and proper management. Specifically, the contracted party will carry out the following tasks on an on-going basis: (i) respond to general inquiries from MFIs, investors and donors; (ii) receive and screen applications by MFIs; (iii) contact and pre-qualify raters to participate in the Grant Facility; (iii) issue the pledge of financing to approved MFIs; (iv) make/request disbursements of matching grants to the MFIs upon invoice for the risk assessment; (v) review and structure information received and collected from MFIs, investors and raters (for example the financial statements of MFIs.); (vi) submit analyzed and structured information on risk assessments, raters, MFIs and investors to the Information Exchange on a timely basis; (vi) compile extensive e-mail lists on investors, MFIs, raters and donors; (vii) continually use the e-mail lists to inform investors, MFIs, raters and donors about the activities of the Grant Facility and its results.
- 4.4 For the management of the web-based Information Exchange, the contracted party will be expected to carry out the following tasks: (i) arrange for the hosting of the web-site on an appropriate server; (ii) design a web-site that will host all information related to the Grant

Facility; (iii) continually post all information received from the Grant Facility, plus other information relevant to the objective of creating more transparency about and for microfinance institutions and potential investors/creditors; (iv) provide on-going technical maintenance and calibration of the web-site.

## **B. Project Readiness**

- 4.5 The project team has undertaken significant consultations with MFIs, investors, professional raters and specialized MFI assessment firms during the preparation of this project. The enthusiasm demonstrated in these consultations led the IDB and the Consultative Group to Assist the Poorest (CGAP) to jointly launch a small worldwide pilot facility on May 1, 2001, to assess the demand for these services, as well as to preempt the proliferation of a multitude of supply-driven donor initiatives in this new and innovative area<sup>5</sup>. The joint pilot facility is financed by CGAP (\$225,000) but its operating regulations have been developed largely by staff from SDS/MSM. It is managed in close collaboration between IDB and CGAP staff, and all significant decisions are taken subsequent to informal consultations
- 4.6 The work carried out during the preparation and implementation of the pilot facility has given SDS/MSM the information and knowledge useful for the design of the larger facility to be financed through this project. The pilot facility has demonstrated that there is a strong demand for these services among Latin American microfinance institutions and that they are very interested in achieving greater transparency regarding their financial health and performance. The pilot facility has also allowed the project team to test some basic operating regulations as well as to estimate the cost of managing the larger Risk Assessment Grant Facility. Finally, it has begun creating a basic awareness among MFI regarding this funding mechanism, which will considerably facilitate the initial stages of the larger facility to be financed by this project.

## **C. Beneficiaries**

- 4.7 This project will directly benefit approximately 80 Latin American and Caribbean microfinance institutions and financial cooperatives that serve approximately 550,000 low-income entrepreneurs in the region. It will also benefit other MFIs that, while not receiving reimbursements for risk assessments, benefit from the project's attempt to increase transparency and investor interest in the sector, as they are expected to realize the importance of such assessment to obtain commercial financing and achieving financial sustainability in the long run

---

<sup>5</sup> The response was overwhelming – within two weeks, the pilot fund received more than 30 declarations of interest from MFIs, social investors and potential raters.

## V. COST AND FINANCING DURING EXECUTION AND OPERATION PHASES

- 5.1 The cost of the project is estimated to be US\$2,393,000. The MIF will provide US\$1,470,000 on a non-reimbursable basis; individual microfinance institutions will contribute US\$923,000. The counterpart amounts to 38.6% of the total project costs and is all in cash. A detailed budget is available in the files of SDS/MSM.

	IDB (US\$)	MFI Counterpart (US\$)	Total (US\$)
<b>Component I: Grant Facility</b>	<b>1,107,000</b>	<b>923,000</b>	<b>2,030,000</b>
Set-up & Management of Facility	230,000	-	230,000
LAC Matching Grants (140)	877,000	923,000	1,800,000
<b>Component II: Information Exchange</b>	<b>220,000</b>	<b>-</b>	<b>220,000</b>
Initial Design	60,000		60,000
On-Going Technical Maintenance	160,000		160,000
			-
<b>Other</b>	<b>143,000</b>	<b>-</b>	<b>143,000</b>
Best Practice Review of Assessment Methodologies	30,000		30,000
Evaluations	40,000		40,000
Contingencies	73,000		73,000
<b>Total</b>	<b>1,470,000</b>	<b>923,000</b>	<b>2,393,000</b>

## VI. PROJECT JUSTIFICATION AND RISKS

### A. Project Justification

- 6.1 The project is innovative as it will finance the launching of the very first Latin American risk assessment facility of this nature and promises, as structured in such a demand-driven way, to have a catalytic impact on the development of the microfinance industry in Latin America and the Caribbean. Also, through its emphasis on transparency the project will benefit not only the institutions that undergo a risk assessment but all MFIs and financial cooperatives interested in accessing the commercial sources of financing.
- 6.2 The project is consistent and complementary with the Bank's current efforts to support the microenterprise sector. It addresses a specific need that corresponds to a crucial step in the evolution of institutions that provide financial services to this sector. Furthermore, the particular type of support provided through the proposed Grant Facility is not offered through the Bank's existing projects or programs.
- 6.3 The project is consistent with the IDB's *Microenterprise Development Strategy* (GN-1938), which states that the Bank's activities should facilitate the access of microfinance institution to capital and financial markets "in order to enable them to mobilize resources

in a sustainable manner”. Further, the project is compatible with the Bank’s *Financial Market Strategy* (GN-1948-3), which states that information on the performance of financial institutions generates confidence among investors and promotes the appropriate pricing of financial resources. In addition, the document states that risk assessment firms can play an important role in promoting such transparency of information.

## **B. Project Risks**

- 6.4 The project exhibits three risks. First, there exists a possibility that the demand-driven mechanism of the Grant Facility could be (partially) subverted by the risk assessment firms if MFIs are not adequately informed of the Grant Facility. A lack of awareness among MFIs would give the raters the opportunity to form an agreement with MFIs *before* these institutions approach the Grant Facility, which would diminish its effectiveness in creating a market for risk assessment services (since MFIs would be precluded from choosing among the various pre-qualified raters). This risk will be addressed by having the contracted party undertake significant outreach efforts, by electronic means, to MFIs before and during the operation of the Grant Facility.
- 6.5 Second, there is a risk that other private, bilateral and multilateral donors may offer sole-source funding directly to raters or specialized microfinance assessment firms to assess a certain number of microfinance institutions in a particular region or country. This could not only affect the demand for services through the Risk Assessment Grant Facility, but such initiatives could also create unintentional duplicative funding. To mitigate this risk, the Steering Group will actively seek coordination and collaboration with other bilateral and multilateral donors, particularly with CGAP.
- 6.6 Third, there is a risk that Information Exchange does not achieve its potential as an effectively market place and source of information for MFIs, investors and risk assessment firms. For the Exchange to work, these actors have to be willing to share basic information on their operations, funding strategies/preferences and assessment methodologies. Although it should be in their interest to share such information, there is always a possibility that they may choose not to. To mitigate this risk, MFIs and risk assessment firms will be required to commit in writing (at the time of applying to the Grant Facility) to disseminating the risk assessment reports (or summaries thereof), quarterly financial statements, and a reasonable explanation of their risk assessment methodologies.

## **VII. PROJECT PERFORMANCE CRITERIA AND EVALUATION OF RESULTS**

### **A. Project Performance Indicators**

- 7.1 To measure the performance of the project, several indicators related to the implementation of activities as well as the attainment of the project’s objectives will be monitored. These indicators, the most important of which appear in the simplified logical

framework in Annex I, include: (i) the number of microfinance institutions, raters and investors/creditors contacted and informed about the Risk Assessment Grant Facility and the Information Exchange; (ii) the number of risk assessments performed during each year of the project; (iii) the timeliness of matching grant disbursements to MFIs by the executing agency subsequent to receiving the invoice from the raters; (iv) the extent to which assessed institutions continue to issue quarterly reports subsequent to the risk assessments; (v) the month at which the Information Exchange goes live on the web and the amount of down-time during the execution of the project; (vi) the number of monthly unique users at the Information Exchange; (vii) the extent to which assessed institutions continue to purchase risk assessments on their own after the life of the Grant Facility.

## **B. Monitoring and Evaluation**

- 7.2 The Steering Group will submit semi-annual progress reports to the MIF within 60 days of the closing of each semester. The reports will detail the status of the project, identify any problems and delays, and describe the corrective actions that have been or will be taken. The reports of the Steering Group will rely on information from the contracted party, who will be required to submit semi-annual progress reports within 30 days of the closing of each semester. The progress reports of the contracted party should provide information on the activities carried out under the project, including subcontracts entered into, dissemination efforts, the number and dollar amount of grants disbursed, names of the MFIs supported, and a current list of pre-qualified risk assessment firms and the business they have generated through the Grant Facility. The progress reports should also identify and explain any problems or delays in the implementation of the project.
- 7.3 There will be two external evaluations of the project: a mid-term review at month 18, or when 50% of funds are disbursed, and a final evaluation within three months of the project's completion. The mid-term evaluation will review the results achieved up to that point and recommend appropriate changes or modifications in the approach to follow for the remainder of the project. Specifically, it will assess the performance of the project according to indicators mentioned previously in paragraph 7.1. It will also seek the opinion and input of MFIs, investors/creditors and risk assessment firms to clarify how well the Grant Facility has worked and to what extent the Information Exchange measure up the standards of informational depth and ease of use needed to attract investors/creditors and MFIs. The final evaluation will review the same aspects as the mid-term evaluation, plus any additional aspects identified in the mid-term evaluation.

## **VIII. EXCEPTION TO POLICIES AND PROCEDURES**

None.

## **IX. SPECIAL CONTRACTUAL CONDITIONS**

None.

## Annex I: Logical Framework

SUMMARY	INDICATORS	MEANS OF VERIFICATION	ASSUMPTION
<b>OVERALL OBJECTIVE</b>			
The general objective of the project is to contribute to the growth and sustainability of the Latin American microfinance industry through accelerated access to commercial sources funding.	[keep empty]	[keep empty]	[keep empty]
<b>SPECIFIC OBJECTIVE</b>			
An increase in the amount and quality of information and transparency regarding the financial performance and risk of microfinance institutions.	<ul style="list-style-type: none"> <li>✓ By month 36, comprehensive and detailed information on the risk and financial performance of 80 Latin American and Caribbean MFIs available to investors and creditors in a format that meets their needs</li> <li>✓ By month 36, a minimum of 60 institutions that intend to continue to purchase risk assessment entirely on their own.</li> </ul>	<ul style="list-style-type: none"> <li>✓ Survey of MFIs, investors and creditors</li> </ul>	<ul style="list-style-type: none"> <li>✓ Current availability and quality of information on the performance and risk of MFIs are improved for the users of this information</li> <li>✓ There is a demand for better information on performance and risk among investors and creditors</li> </ul>
<b>COMPONENTS</b>			
<p><b>Risk Assessment Grant Facility:</b> A grant facility established that provide partial financing for ratings and assessment of Latin American microfinance institutions.</p> <p><b>Information Exchange:</b> An information exchange established where all information regarding the project and the grant facility is available to MFIs, investors, donors and raters.</p>	<ol style="list-style-type: none"> <li>1. By month 36, 140 assessments financed for the benefit of at least 80 MFIs.</li> <li>2. By month 6, an interactive web-site that provides information on how to access the Grant Facility, publishes assessment reports, and gives participants a chance to provide feedback on one another. The site should offer a means for MFIs and investors to evaluate the work of the risk assessment firms.</li> <li>3. By month 36, 250 monthly unique users to the Information Exchange.</li> </ol>	<ol style="list-style-type: none"> <li>1. Project progress reports and evaluations of the Risk Assessment Grant Facility and the Information Exchange.</li> </ol>	<ol style="list-style-type: none"> <li>1. MFIs will find the terms of the Risk Assessment Grant Facility attractive enough for them to purchase rating/assessment services.</li> <li>2. Prospective and actual participants (MFIs, raters, investors/creditors-do not) of the Information Exchange are able to obtain the information they need from it.</li> </ol>

ACTIVITIES			
<p><b>Risk Assessment Grant Facility:</b></p> <p>Respond to general inquiries from MFIs, investors and donors</p> <p>Screen of applications by MFIs</p> <p>Pre-qualify risk assessment firms to participate in the Grant Facility.</p> <p>Issue pledge of financing to approved MFIs</p> <p>Disburse requests of matching grants to the MFIs upon invoice for the risk assessment</p> <p>Review and structure information received and collected from MFIs, investors and raters.</p> <p>Submit analyzed and structured information on risk assessments, raters, MFIs and investors to the Information Exchange on a timely basis.</p> <p>Compile extensive e-mail lists on investors, MFIs, raters and donors</p> <p>Disseminate the activities of the Grant Facility and its results to investors, MFIs, raters and donors.</p>	Budget		
<p><b>Information Exchange:</b></p> <ul style="list-style-type: none"> <li>Design an Information Exchange web-site to host all information related to the rating Grant Facility.</li> <li>Arrange for hosting of Information Exchange web-site on appropriate server.</li> <li>Continuously post all information received from the Grant Facility, plus other information relevant to the objective of creating more transparency about and for microfinance institutions and potential investors/creditors</li> <li>Provide on-going technical maintenance and calibration of the web-site.</li> </ul>	Budget		

## PROPOSED RESOLUTION

### REGIONAL. NONREIMBURSABLE TECHNICAL COOPERATION FOR THE RISK ASSESSMENTS OF MICROFINANCE INSTITUTIONS PROGRAM

The Donors Committee of the Multilateral Investment Fund

#### RESOLVES:

1. That the President of the Inter-American Development Bank or such representative as he shall designate is authorized, in the name and on behalf of the Bank, as Administrator of the Multilateral Investment Fund, to enter into such agreements as may be necessary and to take such additional measures as may be pertinent for the execution of the project proposal contained in Document MIF/AT-\_\_\_\_ with respect to a technical cooperation for the Risk Assessment of Microfinance Institutions program.
2. That up to the amount of US\$1,470,000, or its equivalent in other convertible currencies, shall be authorized for the purpose of this resolution, chargeable to resources of the Small Enterprise Development Facility of the Multilateral Investment Fund.
3. That the above-mentioned sum is to be provided on a nonreimbursable basis.