

Innovative blending in fragile contexts: Cordaid Investments in Myanmar

Background to Cordaid:

Cordaid Investment Management B.V. (CIMBV) is a responsible social impact investor, with currently EUR 63 million assets under management, spread over 23 developing countries in Asia, Africa and Latin America. CIMBV is the asset management branch of the Cordaid Foundation, who has worked for over a century with more than 600 partners in 38 countries to fight poverty and exclusion in the world's most fragile societies and conflict-stricken areas. CIMBV currently manages three funds: the Stability Impact Fund Africa supporting entrepreneurs in fragile countries, the Rural and Agricultural Fund supporting farmers and entrepreneurs in rural areas, and the Health Investment Fund targeting health institutions participating in Cordaid's Result Based Finance (RBF) system.

In a unique approach, at CIMBV we try to complement grant-based development aid with investments, as we believe that impact investing is the next stage in development aid. With this unique approach, we have directly benefited over 2 million people since our establishment in 1997. It is our aim to open markets to impact investing, trying to bridge the gap for organisations to develop themselves from being exclusively grant-based funded to a more financially sustainable investment-based funding.

Currently, we manage three funds, each with a specific focus, namely the Stability Impact Fund (focused on providing financing to stimulate economic development in fragile contexts), the Rural and Agricultural Fund (focused on boosting rural economies), and the Health Investment Fund (focused on improving the quality of African health centres). In each of these funds we actively seek cooperation with other departments of Cordaid, to provide a unique concept of blending to our clients. The majority of our portfolio consists of loans to so-called microfinance institutions (MFIs), which are socially oriented organisations focused on financial inclusion in developing nations. Other investees are impact-oriented funds, SMEs and, for the Health Investment Fund, health service providers.

Challenges:

As part of CIMBV's expansion into fragile contexts in Asia, we have been looking at Myanmar (also known as Burma) since 2012. As the country was under a military regime that ruled the country from 1988 until 2011, the country was fully closed-off economically before that time, and was only just starting to open up. Although the reforms under president U Thein Sein had been fuelling optimism, an understandable degree of scepticism about the scope and pace of reform, and an apprehension about potential risks and backlashes were still very strong amongst international investors (and still remain to date). This left the country devoid of foreign investments.

The microfinance sector was (and is) severely underdeveloped. Financial inclusion was extremely low, with only 20% of the adult population having access to financial services by 2013. Most of the private banks were unreachable for most of the inhabitants, mainly because they required extensive paperwork, collateral, and large loan sizes. This led to most people relying on the informal sector, borrowing against items such as gold and land from money lenders or pawnshops, often against exorbitant rates. The need for microfinance was therefore extremely high. Only a few institutions have successfully helped to bridge the gap between these formal institutions and the informal sector. In 2012, the unmet demand for microcredit was estimated to be close to a billion dollars. Microfinance is, however, more than just microcredit. The provision of other financial services, such as savings and insurance, often crucial in times of distress, were largely non-existent. Most institutions often limited themselves to the urban areas, whereas only the bigger ones such as PACT, Proximity and Gret mainly operate in rural areas. Outreach and distribution into the more remote rural areas, where an estimated 70 percent of the population resides (merely consisting of smallholder farmers), was simply too expensive, and the funding required to do this was lacking.

Therefore, there was a high demand for (international) funding for these microfinance institutions to grow and expand into the more remote areas. However, even impact-first investors were hesitant to provide financing to these MFIs, merely due to an inhibitory and complex regulatory context and several perceived high risks:

1. **Political instability:** before the national elections in November 2015, there were many doubts on how these elections would go. Not only was it a big question mark as to how peaceful and fair these elections would be and whether or not they would lead to political unrest and instability, but

also whether the outcome would mean a continuation of the progressive opening up of the country or rather a backlash into a protectionist military state.

2. Regulatory: the regulatory environment in Myanmar was (and remains) challenging and fragmented. In December 2011, the Government of Myanmar approved a new Law on Microfinance, which legalized the provision of microfinance and allowed foreign investors to establish MFIs in Myanmar. At the time, this law was seen as part of the transformation process from an isolated military regime to a democracy that adopts the principles of an open market economy. Since then, the government embarked on a series of reforms to improve the business and investment climate, facilitate financial sector development, and further liberalize trade and foreign direct investment. The first signs of these reforms became visible over the past few years. However, due to the upcoming elections, there was an increased skepticism towards these reforms and expectations that these would come to a grinding halt for at least 6-8 months. At the same time, the government posed several limitations upon the sector, which lead to additional challenges for investors and MFIs alike.
3. Ethnical: Myanmar is composed of an ethnically diverse population, with over 135 distinct ethnic groups. The majority consists of Burmese (over 60%), the rest is divided over many small groups, such as the Shan, Karen, Rakhine, Chinese, Indian and Mon. Apart from a diverse ethnical basis, there is also a diverse religious spread. Conflicts along the state borders are numerous and persistent.
4. Natural: Myanmar ranks as the 'most at risk' country for natural disasters according to the UN Risk Model and is exposed to a large number of natural hazards, some which have caused devastating damage in the recent past, for example Cyclone Nargis of 2008, leaving almost 140,000 people missing or dead. Coastal regions are at high risk for cyclones and tsunamis, whereas most of the country is also exposed to flooding and landslides during rainy season as well as to drought and fire during dry season. As Myanmar falls on one of the two main earthquake belts of the world, much of the country is prone to earthquake. As recent as July and August 2015, severe flooding and landslides in Myanmar displaced over 1.6 million people, damaging agriculture and infrastructure in the process.
5. Financial: The Myanmar Kyat (MMK) depreciated against the US dollar by 24% within one year, from MMK 965 in April 2014 to MMK 1,275 in early September 2015, largely the result of a widening current account deficit and a stronger US dollar. For investors who lend in local currency, such as CIMBV, this meant that reaching even a modest return on investment was under severe pressure, if not simply impossible.

Although there were many obstacles for international investors in Myanmar, for CIMBV as an impact-first investor, there was also an important opportunity to make a difference for the over 50 million people in the country. Myanmar is one of the poorest countries in Southeast Asia, with a per capita income of USD 821 (World Bank, 2011) and with over 25% of the population living below the poverty line, 85% of which live in rural areas (ADB, 2015). It was ranked 148 out of 188 in the 2015 UNDP Human Development Index. In addition, as mentioned before, it has one of the world's most underdeveloped financial services industries as a result of the country's decades of isolation

Options available:

After a careful evaluation of both the risks and the potential for impact, CIMBV decided to move forward with the first investment, despite the risks. It is one of the cornerstones of our organizational policy that we will try to lend in local currency whenever possible. This means that CIMBV bears the currency risk, thus not transferring it to local MFIs, and potentially the end-client at the bottom of the pyramid. In the case of Myanmar, this was a challenge to begin with. In sight of the elections and the potential accompanying political instability, the performance of the Myanmar Kyat was insecure, to say the least. There is no benchmark for any market rate available. After careful evaluation of the past performance of the currency, and taking into account the capacity of the MFI to bear the interest rate, we decided to set an interest rate for our first loan that seemed to be sustainable and fair to both CIMBV (the financial return of our fund being equal to the euro-inflation rate) and the MFI.

However, at that exact time, the government of Myanmar decided to place a cap on the interest rate that foreign investors were allowed to charge, which was above the interest rate that we had set. With the expected devaluation of the MMK being largely above the cap at the time, we would be fairly sure to lose money on the investment.

This cap on the rate in MMK meant a near stand-still of foreign investment into the Myanmar microfinance market. No foreign investor would risk lending at this rate. As CIMBV was already in the final stages of a potential investment, this posed a dilemma to us. On the one hand, our partner MFI in Myanmar was counting on the funds coming in. As funding was the major impediment to growth at the time, they had started to gear up for growth, counting on our investment funds coming in within the next few months. They had started hiring additional staff, building a pipeline of smallholder farmers that needed loans, and investing in capacity building and strengthening the organisation. On the other side of the dilemma, we realised that the cap would not only impose a financial risk to us, but meeting the cap would also dis-incentivize the government to raise the cap to more realistic and market based levels.

At the same time, CIMBV would also need to consider the longer-term. If we would lend to our partner, what would happen in a year's time, when the loan would have to be renewed or repaid? If the cap wouldn't be lifted and the MMK would not have stabilized, no follow up financing from ourselves or other investors would be possible and the partner would struggle to not only to repay the loan, but also to achieve the much-needed growth to flourish in a difficult and complex environment. Thus not only the short-term future of the MFI was at stake, but also their long-term prospects.

All in all, CIMBV had to make a difficult choice amongst the following options:

1. Lend in MMK, and running the risk of a financial loss as well as indirectly supporting the cap.
2. Lend in USD, and transferring the currency risk to the local MFI.
3. Not invest and try to support an industry-wide movement to persuade the government to lift the cap, which would negatively affect both the MFI and the smallholder end-clients.

Unfortunately, hedging was not an option at the time. Not only was hedging not yet available in the short-term, but understandably, with the volatility of the MMK, it was simply too expensive for either us or the MFI to bear the cost. As for the longer-term, there was no clear sight (yet) of the outcome of the elections and the development of the MMK. And, with elections in sight, there was no expectation for the government to lift the cap or for other investors to step in. Even if CIMBV would be able to make a loan to our partner in the short-term, the long-term would still be an important risk factor, to both us and the MFI.

Role of Cordaid:

After careful and extensive deliberation CIMBV decided to lend in MMK. Although giving the loan in USD would benefit us financially, we felt that as an impact-first investor it was irresponsible to leave our partner (and probably their end-clients) with the currency risk against the MMK.

As mentioned, our partner MFI had fully geared up for growth, and a last-minute drawback of our funds would not only leave them in trouble, but also the 8,000 smallholder end-clients who were counting on the money to buy seeds and machinery for their crops. Although there was a significant risk that the MMK would devalue by (much) more than the capped interest rate, and CIMBV would end up losing money on the investment, we tried to mitigate this by shortening the original period of the loan from 3 years to a mere 9 months. This short-term solution would give us time to support the industry lobby to raise the cap, while giving our partner the opportunity to help their clients. It was a difficult decision, not only due to the financial risk, but mainly because we realised we would potentially distort the market by providing the loan at what was considered a subsidized rate.

In the end we felt that the wellbeing of the bottom-of-the-pyramid end-clients was our uttermost priority. Without the loan they were promised, a substantial amount of smallholder farmers would not have been able to gather the financial means to make the maximum use of the planting season. Timing was therefore of the essence. Our partner MFI lived up to their promise; within days after the disbursement of the funds, we received the positive news that all the money had been distributed to the smallholders in the field; just in time for the planting season.

However, as mentioned, this was only a short-term solution. The cap stayed in place, and the Myanmar Kyat devaluated substantially, so that in the end we indeed lost money on our first loan in Myanmar. The situation hadn't changed and due to the elections it was unlikely that it would any time soon.

It was around that time that, LIFT, a consortium of international donors in Myanmar, announced their call for financial inclusion. A substantial amount was available to improve access to financial services

for the rural population of Myanmar. This call for financial inclusion turned out to be the much needed innovative solution to the problem at hand. It included a section on guarantees, and we decided to focus our proposal on this section, in particular on a guarantee to cover currency risk.

Our first proposal consisted of a plea for a grant to cover a certain percentage in the devaluation loss of the MMK to cover the gap between our original interest rate and the allowed cap. In return for this limitation of currency risk, CIMBV would commit a total of EUR 10 million of investment funds to support microfinance institutions in Myanmar. Later on, however, we realised that the devaluation of the MMK was steeper than expected and even the requested grant would not be able to cover the losses. At the same time, however, TCX was looking to step into the market and provide hedging facilities that were previously non-existent.

These two circumstances lead to a change in the proposal to LIFT, namely to use the grant funding exclusively for the establishment of a hedging facility with TCX. Partnership with TCX was sought and eventually an agreement between LIFT, TCX and CIMBV was reached. This took willingness, open-mindedness and creativity from all sides. It was a steep learning curve, as for CIMBV it was the first time to approach a donor for this purpose or to engage in a hedge, as this was usually too expensive and not available for the relatively small ticket sizes of our investments. In the end, however, CIMBV not only received a hedge for the investments, but also a generous additional amount in technical assistance funds to provide to the MFI partners for capacity building and development, making this case an excellent example of the blending approach to impact investment.

Results and impact:

As a result of this case, eventually a unique partnership was created between CIMBV (the impact-first investor), LIFT (the donor) and TCX (the private sector), in which financial security was combined with social impact in Myanmar. LIFT generously provided the funding for covering the largest risk facing an impact investor, namely the currency risk, in addition to reducing credit risk by providing a grant for additional capacity building to strengthen the microfinance institutions. TCX provided the financial mechanism and expertise for the hedge, and as a result, CIMBV was able to commit funding for investments to the development and strengthening of the Myanmar microfinance sector.

This makes it an innovative blending solution, providing some much-needed funds into an underfinanced sector. At the same time, the long-term perspective still needs to be considered, as, after three years CIMBV's investments will expire, and a new solution needs to be sought. Continued efforts to support the Central Bank in their knowledge and decision making are therefore still ongoing. Hopefully this intervention proves to be a critical step for the development of the microfinance sector in Myanmar.

In Myanmar, as in many fragile and development countries, foreign exchange risk is a major hurdle for international (impact) investors. Whereas many investors shift the currency risk onto their end-clients, CIMBV believes that as impact investors we are responsible to take this risk, wherever possible, and to seek alternative solutions if not.

The case of Myanmar is a unique example of an innovative solution to solve the exchange risk issue, where cooperation with a donor and a private sector finance provider was sought to be able to come to a sizeable investment impact. This is an interesting case study about the use of blending to solve a problem that is inherent to investing in fragile countries. As such it could potentially be copied to other environments. Using grant funding or approaching donors for first-loss positions and/or to provide hedging could be an important step forward in persuading (impact) investors to invest in fragile contexts. Education and knowledge are essential, as the risk is often underestimated or unknown to donors, but at the same time an unsurmountable hurdle for investors.

As for the Myanmar microfinance market, things are looking up. TCX and LIFT have come to an agreement at larger scale, to provide a hedging facility for other impact investors. This is hopefully a large catalyst for further investment into the sector.

Key words: blending, currency risk, fragility, innovative financing, responsible impact investment, Myanmar, Cordaid

Industry: Investors