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Microfinance Managers Consider Online Funding: Is It Finance, Marketing, or Something Else Entirely?

Online platforms are changing the way we engage with the world. Facebook links, eBay auctions, ePal chats, even Second Life avatars—these are all online platforms that connect people, ideas, products, and markets. These platforms shape **who** we connect with as well as **how** we connect. This concept extends to philanthropy: Online philanthropy is changing the nature of how and where people give.[1] An outgrowth of online philanthropy is online social investing.

Kiva.org is one of the best known online lending and investment platforms.[2] Since its launch in 2005, Kiva has grabbed the attention (and wallets) of over 350,000 online lenders, called "Kiva Lenders," who are eager to loan as little as $25 or $50 to microentrepreneurs through Kiva and its microfinance institution (MFI) partners.[3] Kiva has inspired many other new online lending platforms.

Not surprisingly, Kiva's success also has gained the attention of a growing number of MFIs that are searching for the capital and public awareness that the Kiva online lending platform often can provide. Kiva's marketing function is hard to quantify, but Kiva's widespread presence in the news and entertainment media, ranging from the *Wall Street Journal* to the Oprah Winfrey Show, makes Kiva and the MFIs whose clients are featured on Kiva.org important ambassadors for microfinance.[4]

This growth in online lending and investment platforms presents an opportunity and a challenge for MFIs intent on tapping the potential of online lenders or investors. This paper focuses on the demand side of the equation and highlights issues that MFIs may want to consider before signing up for a loan from an online lending platform.

This growth in online lending and investment platforms presents an opportunity and a challenge for MFIs intent on tapping the potential of online lenders or investors.

When Kiva launched in 2005, it listed seven Ugandan businesses, seeking a total of $3,500 for working capital needs (Aspen Institute Report 2008). As of November 2008, Kiva had raised, in aggregate, over $49 million from its Kiva Lenders. These funds are lent at 0 percent, with up to

Box 1. Kiva innovations

Kiva also has given rise to a new form of social networking and even a new kind of "currency." Kiva Lenders can use www.kivafriends.org, an independent Web site that is not sponsored by Kiva, to comment on their Kiva lending experience and to connect with each other, lender to lender.

Kiva coupons often are given as gifts, and sometimes traded as an instrument of barter for other goods and services. In a recent online auction even poetry was exchanged for Kiva coupons.

1 A recent study of the Aspen Institute (2008) defines the "online philanthropy market" as "an internet phenomenon through which individual citizens and institutions can engage with citizen-led organizations and micro-entrepreneurs all over the world to invest their money, time or expertise to improve human and environmental well-being." See Aspen Institute Report (2008).
2 "Kiva" is derived from the Swahili word for agreement.
3 The average amount loaned per Kiva Lender (including funds that are relent) is $136.87, according to www.kiva.org.
4 Kiva representatives estimate that as many as 36 percent of Kiva Lenders had never heard of microfinance before using Kiva. See USAID (2008).

36-month terms to MFIs that then onlend the proceeds of these loans to microentrepreneurs listed on Kiva.org.

New Online Lending Platforms

Kiva is not the only online lending platform operating in the microfinance sector. The number of online lending and investment platforms focusing on microfinance is growing.

Choosing among online lending or investing platforms can be tricky because they operate through many different business models, in varying legal forms, from a range of home country jurisdictions with varying regulatory and legal requirements, and with widely divergent business and social objectives. All of this can greatly impact the products, services, and nature of these platforms' funding patterns, costs, and partnerships. However, one thing all of the microfinance-focused online lending and investment platforms currently hold in common is that they make use of some form of intermediaries to identify borrowing microentrepreneurs in need of capital, and to handle the payment and repayments of the loans made to these borrowers. Yet this intermediation can take several forms.

Some online lending platforms use their Web sites as virtual money marketplaces for microentrepreneur borrowers. These platforms focus on the online lenders' experience as the platforms work to build a sense of connection between online lenders and individual microentrepreneur borrowers, not unlike "adopt a child" donation programs. Yet this is not quite how these platforms typically work; funding from the online lender first goes through MFI intermediaries before it reaches the borrowing microentrepreneur profiled on the online lending platform's Web site.[5] In this model, which is sometimes called the intermediary person-to-person (P2P) model,[6] it can be unclear as to where the credit risk of nonpayment really rests—is it with the borrowing microentrepreneur or with the intermediary MFI? To the online lender, it may appear that the risk of nonpayment is limited to that of the microentrepreneur borrower, but more often the risk of nonpayment is actually that of the intermediary MFI that has accepted/borrowed the financing from that online lender and then re-lent those funds to borrowing microentrepreneurs.

Box 2. Online lending sites

New lending or investment platforms from many different parts of the world quickly are coming online. Some use a business model similar to that of Kiva, where MFIs act as the intermediary between individual lenders/investors and microentrepreneurs. Others offer online investment opportunities, where registered brokers act as the intermediary between the individual investor and borrowing MFIs. The following are some of the online lending or investment platforms that focus on microfinance:

- Babyloan (www.babyloan.org)
- dhanaX (www.dhanax.com)
- GlobeFunder India (www.globefunder.in)
- Kiva (www.kiva.org)
- MicroPlace (www.microplace.com)
- MyC4 (www.myc4.com)
- myELEN (www.myelen.com)
- Rang De (www.rangde.org)
- United Prosperity (www.unitedprosperity.org)
- 51Give (www.51give.com)

5 In one variation of this model, the MFI may be using the online lending platform to find funding for an existing portfolio of borrowers; in another variation, the MFI (or similar partner organization) builds a new portfolio of borrowers whose loans will be funded through the online lending platform.

6 See USAID (2008), which characterizes the business models of Kiva, MyC4, dhanaX, RangDe, and Investors Without Borders as "intermediary P2P models."

MicroPlace, which was launched in 2007, offers a different model. It currently uses two layers of intermediaries—MFIs and third-party security issuers that have partnered with those MFIs. Online investors who come to MicroPlace do not pick individual microentrepreneurs to lend to; rather, the online investor chooses a third-party securities issuer, like Oikocredit or Calvert Foundation, in which to invest. The online investor then typically directs where his or her funding is to be placed among the intermediary MFIs profiled online by these securities issuers. Importantly, the credit risk of nonpayment is that of the securities issuer, not that of the intermediary MFI nor of its microentrepreneur borrowers.[7] MicroPlace has plans to profile on its Web site MFIs that are qualified to sell securities in the United States directly to the public. At that point, the credit risk of nonpayment would be that of the issuing MFI.[8]

Generally, when determining whether and where to borrow, an MFI is likely to consider the following basic questions:

- How much funding does it need?
- When does it need the funding?
- How will it use the funding?
- When will it be required to pay the funding back?
- How much does the funding cost?

The answers to these basic questions may make some online lending platforms seem like a terrific bet for an MFI in search of loan capital. Some of today's online lending platforms can direct significant amounts of funding to MFIs very quickly (sometimes in just hours, not weeks or months)[9] at highly subsidized interest rates (if any), and have, to date, a pattern of refinancing themselves (i.e., offering another new financing that can fund the MFI's principal payments on its prior online financing).

But MFIs need to probe deeper. Online lending platforms, like any other kind of financing, can expose MFIs to possible hidden costs and also to risks that the funder itself presents, such as the funder's stability, reputation, operational and management expertise, as well as regulatory risks. What makes these issues all the more pressing for an MFI when it contemplates online funding, however, is that the sheer number of "lenders" or "investors" involved can make these issues complex. In addition, many of these online platforms are very new so they do not have a meaningful track record of experience.

So MFIs need to go beyond the basic questions that are relevant for any financing. Additional considerations (some of which take on added significance in the current global financial crisis) include the following:

1. Which online platforms can be counted on to provide funding in the amount and at the time when needed, and what additional support do they offer to help the MFI?
2. What is the cost and currency of the online funding? And, if there were to be a significant foreign exchange event—either in the form of a devaluation or imposition of a currency control that made making payments in dollars very expensive or impossible—who will bear this risk?
3. How will the online lending or investment platform help its MFI partners manage abrupt and perhaps unpredictable shifts in the funding patterns of its online platform?

7 For a comparison of the Kiva and MicroPlace business models, see Microfinance Gateway (2008).
8 MicroPlace can profile on its Web site any organization that complies with the listing requirements imposed under U.S. securities law, and that meets MicroPlace's due diligence process and reputational standards.
9 Kiva has been able to match funding to needs in as little as 25 hours.

4. How do other, more traditional, lenders to the MFI view the MFI's borrowing from online lending platforms to meet loan capital needs, particularly if the MFI faces times of distress?
5. What are the reporting requirements that the online platform will require from the MFI? And what are the operational and cost implications of these requirements for MFIs? Related, what management information system (MIS) is adequate to meet the online platform's microcredit portfolio reporting needs?
6. What customer privacy and consumer protection concerns does the posting of online stories about microentrepreneurs pose to the MFI?
7. What due diligence does the MFI need to conduct with respect to the online lending platform to satisfy concerns of regulatory authorities about money laundering and terrorist financing?

1. Which online platforms can be counted on to provide funding in the amount and at the time when needed, and what additional support do they offer to the MFI?

Online lending and investment platforms are proliferating worldwide. As with many online businesses, there is a strong first-mover's advantage as these platforms compete for funds and market share. Among microfinance-focused online lending and investment platforms, Kiva has enjoyed such an advantage. Moreover, it has devoted significant resources to protect that advantage by using creative ways to keep its Kiva Lenders engaged and connected—with Kiva, with their microentrepreneur borrowers, and with each other.

However it is not yet clear whether there is one market or several markets for online lending and investing platforms. Are online lenders who expect no return on their financing likely to act differently than those who are looking for a return? And, for those who do expect some financial return, does the expected amount of financial or social return result in different behaviors among online lenders and investors?

Why would understanding the motivations of online lenders matter to an MFI seeking to secure financing through an online lending platform? It matters because these motivations may impact the reliability and stability of the online lending or investing platform. For example, investors and lenders looking primarily for a financial return may be more fickle, shifting from microfinance to other types of investments or shifting among online platforms as they race after financial returns, than investors or lenders who are more socially motivated. This could negatively impact the stability of an online lending platform that cannot offer competitive financial returns. On the other hand, investors and lenders seeking a significant social return may turn out to be a much more dependable source of financing, provided that they have confidence in the reputation and transparency of the online lending platform that promises such a social return.

Varying appetites for financial and social returns are not the only differentiating motivations that could impact the stability of funding or type of products offered by an online lending or investment platform. The needs of online lenders and investors for liquid assets also can impact the stability of the online platform, both with respect to its ability to attract and its ability to retain financing. Online investors and lenders

who are uncomfortable holding illiquid assets (say, those with terms of longer than a year) may be more likely to use online lending platforms that offer loans and investments of short duration. Making this still more complicated is the challenge that online lenders and investors' needs and preferences may change over time.

An MFI about to borrow from a particular online lending or investment platform for the first time should conduct some due diligence of its own about the stability of the platform. Among questions that might be asked of the online platform (and other MFIs that have used that platform) are the following:

- Has this online platform consistently been able to provide funding in a timely manner and in expected amounts?
- How "loyal" to the platform are its online lenders and investors (another way to pose this question is to ask what percentage of its online lenders/investors reinvest funding that they originally made available through this platform)?
- Does the platform have all the required regulatory and government approvals from its host jurisdiction to raise funding online?[10]
- What other valued services does the online platform offer its partner MFIs (technical assistance, positive publicity, etc.)?

2. What is the cost and currency of the online funding? And, if there were a significant foreign exchange event—either in the form of a devaluation or imposition of a currency control that made making payments in dollars very expensive or impossible—who will bear the risk?

The cost of online funding to an MFI is not always easy to quantify. Even Kiva will tell you that the 0 percent loans it offers do not translate into an all-in 0 percent cost of funds for the borrowing MFI. So it is important for an MFI that is seeking loans from an online lending or investment platform to look at the cost of the reporting and other requirements that it may need to meet to secure such financing. Some online platforms are more transparent than others about defining all that is expected of their MFI partners to participate in the platform (e.g., the required scope of borrower profiles, the permission to participate, or not, in more than one online platform, etc.). Still others are actively engaging in measures to help lower the burden and costs their MFI partners incur to meet lending requirements.[11]

Another factor that can significantly (and perhaps unexpectedly) increase the cost of online borrowing is the currency in which that online funding is denominated. Many, but not all, online lending and investing platforms that are focused on microfinance lend in the currency of their online lending and investing community, not necessarily the currency of the borrowing MFI.

The global financial and economic crisis has led to some quite large swings in many currencies. This potential currency mismatch raises the question of who is best equipped to manage the resulting foreign exchange risk. In a typical cross-border financing, one might suggest that the bank making the cross-border loan has more expertise in managing this kind of risk than any of the other parties, and thus should

10 In late November 2008, the U.S. Securities and Exchange Commission (SEC) imposed a cease-and-desist order on Prosper.com (an online lending platform based in the United States that claims on its Web site to be America's largest people-to-people lending marketplace) upon finding that Prosper had violated the provisions of the U.S. Securities Act of 1933 that prohibit the offer or sale of securities without an effective registration statement or valid exemption from registration. See SEC Order (2008).

11 Kiva has taken a number of steps to reduce these costs to the MFI. For example, where possible, Kiva tries to use data already being collected by the MFI. It allows MFIs to post borrower profiles in the local language of the MFI and then turns to volunteers to help translate such profiles. It has also, for some MFIs, sent teams of volunteers to the MFI to help with meeting Kiva's reporting requirements.

assume at least some of this burden. But is this true when the online lender is a retired school teacher in Iowa? What does he or she know of the likely movement of the Kyrgyz som against the dollar or of the currency controls that have been imposed from time to time by some Latin American countries on the repayment of foreign currency debt by local borrowers?

Some have suggested that online lenders should be willing to assume this foreign exchange risk. According to Ben Elberger of Kiva, Kiva Lenders "… are more interested in learning what happened to the entrepreneur than they are in getting their money back." (Aspen Institute Report 2008). But one might ask whether online lenders will continue to make loans or investments in microfinance if they experience a series of losses due to foreign exchange risks.

So to answer the question, which party—the microentrepreneur, MFI, online individual lender or investor, online lending platform—is best equipped to manage foreign exchange risks, the online lending platform might seem the obvious option. But few online lending platforms appear to have come to this conclusion. Until they do, the borrowing MFI should take concrete actions, such as setting aside reserves or acquiring a foreign exchange hedging product, to mitigate these risks.[12] And those actions are likely to increase the costs of such funding to the MFI.

3. How will the online lending or investment platform help its MFI partners manage abrupt and perhaps unpredictable shifts in the funding patterns of its online platform?

To date, the amount of online financing that is available to the microfinance sector as a whole is growing fast, with organizations like Kiva raising as much as $1 million every 10–12 days to be onlent to microentrepreneurs. This does not mean, however, that the amounts of online funding available to an individual MFI also are unlimited. In fact, some online lending platforms are developing lending limit policies to avoid overexposure to any single MFI.[13]

What is not known is whether these online lending platforms themselves are dependable, recurring sources of funding. Evidence to date suggests that they could be.[14] But as financing and economic growth contract in the world in general, online lenders could find themselves with less financial resources to dedicate to microfinance. This, in turn, could require shifts in the funding patterns of these platforms. In the worst case, all of this could come at a time when microfinance providers find other more traditional sources of funding also drying up.

On the other hand, it also is possible that far from exacerbating a deleveraging of microfinance, online lending and investment platforms, because of the diversity and number of online lenders and investors attracted to such platforms, could provide countercyclical stability. They may serve as a type of "lender of last resort" for the microfinance sector, making credit available when other local or international sources of finance are less accessible and attractive. At least two online platforms, Kiva and MicroPlace, are now performing this important countercyclical function in providing finance to MFIs, proving that their online lenders and investors are

12 The good news is there are now several organizations focused on offering hedging products to MFIs and investors in microfinance to minimize or reduce the foreign exchange risks triggered when an MFI borrows in a currency that is different than the currency in which its microcredit portfolio is denominated. MFX Solutions is one new entrant (www.mfxsolutions.com).

13 Kiva now limits its exposure to any given MFI to an outstanding principal balance of no more than 30 percent of the MFI's gross loan portfolio.

14 For example, Kiva Lenders who are fully repaid are relending approximately 60–65 percent of their loan reflows.

prepared to lend to and invest in microfinance even when confronted with a severe economic downturn. More specifically, in the last quarter of 2008, both Kiva and MicroPlace tapped larger amounts of funding from online lenders and investors than in the past, even as flows of more conventional sources of funding for microfinance slowed.[15]

To date, there are no clear answers to questions about how online lenders and investors might behave in the current financial crisis. However, this does suggest another question MFIs may want to ask in conducting due diligence of an online lending or investment platform: What does the platform do to keep its online community of lenders and investors engaged and interested in microfinance in general, and in this platform in particular?

If the online investing community, as individuals or as a group, changes its perception about the efficacy of microfinance or, perhaps more likely, if it begins to question the reputation of an online lending platform, then there could be a precipitous drop in online investing for all online lending platforms that focus on microfinance. For an MFI (especially a smaller or less well-known one) that expects to enjoy recurring funding from its online lenders, an abrupt shift or slowdown in this funding could be a rude awakening—rude enough to trigger a liquidity problem. At this point it is worth remembering the old adage, well-known in banking circles, that bank failures often can be traced to liquidity, rather than insolvency, problems. This is likely to hold true for MFIs, too.

So another question worth investigating is what is the online platform's reputation for the accountability and transparency with which it treats its online community of lenders and investors. Is its online community generally satisfied with its lending/investing experiences? Social networking has helped "crowd in" online lenders and investors to today's online lending and investment platforms. It is critical that the platforms take appropriate care that this same social networking phenomenon does not one day trigger a rush for the exit, too.

4. How do other, more traditional, lenders to the MFI view the MFI's borrowing from online lending platforms to meet loan capital needs, particularly if the MFI faces times of distress?

Due in part to the newness of many online lending platforms and also to the lending limit policies being adopted by some online lending platforms, few (if any) MFIs now source, or are likely to source, a significant amount of their funding needs with online borrowing. MFIs that borrow from online platforms are likely to tap other, more traditional sources of financing, too.[16] Accordingly, an MFI that is considering borrowing from an online lending platform should ask how do the MFI's other lenders, current and potential, view online platforms as a source of financing? And, importantly, are these other lenders willing to lend alongside these online lending platforms?[17]

Few of today's traditional lenders to microfinance appear to be developing a coherent strategy or policy on this point, but that is likely to change as

15 According to a Kiva press release dated 11 November 2008, in October 2008, Kiva Lenders loaned a record $3.6 million, the highest loan volume attracted by Kiva in any given month. According to correspondence with MicroPlace representatives, in the fourth quarter of 2008, MicroPlace doubled both the number of investors and the amount of investments it attracted compared to the amounts raised in the third quarter of 2008.

16 Kiva intends to "graduate" its microfinance partners over time so that Kiva loans become a less important source of funding for these MFIs.

17 The MFI also should consult with its legal counsel to make sure the contemplated online borrowing is on terms and conditions and in amounts that do not violate any of the MFI's existing loan agreements.

more of the debt available to the microfinance sector is channeled via online lending platforms. Lenders may have concerns that arise about the currency, short duration, and refinancing risks inherent in many current online lending products. In addition, traditional lenders that have significant exposure to one or more MFIs borrowing online are likely to begin to evaluate the soundness and debt management expertise of the online lending platform itself. Traditional lenders may need to consider how much they would be willing to lend side-by-side with an online lender. The concern that they are all likely to share is how well online lending platforms will cooperate and negotiate with other lenders when an MFI faces repayment or other financial difficulties.

It is not unusual for lenders, particularly international lenders, to join together to negotiate jointly to resolve and respond to weakening MFIs. How does this work when there are perhaps hundreds of individuals that have lent to one MFI via an online lending platform? Presumably the online lending platform will have the authority to negotiate on behalf of all of its individual lenders and investors if a restructuring or refinancing of its debt to an MFI were to take place. However, how would an online lending platform raise additional capital from its lenders to bolster the capital structure of a weakening MFI? If the platform itself does not have the capacity to mobilize additional financing, does it have sufficient connections to other types of lenders and investors that would help the MFI secure the necessary funding?

To date it appears that most traditional lenders are likely to be comfortable with lending alongside an online lending platform. However, this comfort level may not extend equally to all online lending or investing platforms. Accordingly, any MFI considering borrowing a sizeable amount of funding from such a platform should find out if that particular platform (*i*) has a positive reputation for collaborating with other types of investors, and (*ii*) regularly engages in industry-wide discussions with other investors in microfinance.

5. What are the reporting requirements that online platforms will require from the MFI? And what are the operational and cost implications of these reporting requirements for MFIs? What management information system (MIS) is adequate to meet the online platform's microcredit portfolio reporting needs?

Some, but not all, online lending platforms prize the personal connections that can be made between "borrowers" and "lenders" through the profiling of microentrepreneurs on the platforms' Web sites. But these microentrepreneurs' stories do not tell themselves. MFI staff or outside consultants hired by the MFI need to develop and update these profiles regularly.

In a recent informal survey of four MFIs currently borrowing from Kiva, the MFIs described how they each staffed to meet Kiva's reporting requirements. One MFI engaged three volunteers and one staff person, all of whom were exclusively dedicated to managing the reports required to profile microentrepreneurs on Kiva.org. Another MFI dedicated one staff member to gather microentrepreneur stories from the field; another part-time hire prepared the information so that

it could be used on Kiva.org. A third MFI hired a temporary staff person who was paid a sliding fee based on the number of microentrepreneur stories that were available for uploading to Kiva.org each day. This staff person writes and uploads approximately 10 stories a day. A fourth MFI dedicated a full-time staff member to gather and upload microentrepreneur stories to Kiva.org.

This is not to overstate the burden of reporting and profiling microentrepreneurs, something that many MFIs do as a matter of course to satisfy and garner philanthropic dollars. However, it is unusual for MFIs to spend this amount of time and resources gathering stories on specific clients from the field to satisfy a lender, rather than a donor. Moreover, the sheer number of microentrepreneur stories required to elicit funding by some online lending platforms is on a scale that is dramatically larger than has ever been experienced by the microfinance sector.[18]

As with any financing, the MFI will need to evaluate how easily it can meet the day-to-day reporting requirements required by its online lenders or investors. This likely will require an adequate MIS that captures, on a timely basis, information about the microcredit portfolio's health—particularly that portion of the portfolio that is being funded with online financing. Some MFIs may find it more problematic than others to segregate the microcredits funded by online platforms from those microcredits that are more generally funded out of other MFI resources. Before seeking financing from an online platform, an MFI should assess its own technology capabilities to meet and manage the data needs of that platform. For MFIs that have not yet invested in an MIS that can meet this challenge, it may be wise to think twice about trying to tap an online lending or investment platform for funding.

6. What customer privacy and consumer protection concerns with respect to the online lending platform should MFIs have about posting online stories on microentrepreneurs?

Anytime a photo and story of a microentrepreneur is posted on the Internet, be it to capture donations or to capture financings, customer privacy and consumer protection issues should be of concern to the MFI that serves that customer. This concern can become particularly acute when an online lending platform shares data with the public about a particular microentrepreneur's credit and repayment history. Not enough attention was paid to these issues in the early days of online lending to the microfinance sector, but increasingly online lending platforms are aligning themselves with MFIs to find solutions that balance the information needs of the lending public with privacy needs of borrowing microentrepreneurs. As new online lending platforms are launched, MFIs would be well advised to help inform these platforms of the growing body of "best practice" or even "minimum practice" in this area and to avoid borrowing from any online lending platform that encourages information sharing with the public to the detriment of the privacy and protection of borrowing microentrepreneurs. So, for example, as more microfinance investors adopt responsible finance principles aimed at, among other things, protecting the privacy of

18 It should be noted, however, that not every online lending or investing platform requires numerous microentrepreneur stories. Platforms that are less intent on delivering a personal connection between online lenders/investors and individual microentrepreneurs, such as MicroPlace, require only a few "representative" photographs and stories about microentrepreneurs to profile a borrowing MFI on their Web sites.

customer data, so too should online lending platforms—even if addressing such privacy concerns could potentially interfere with the personal connection sought by online lenders with the end-user of their funds (e.g., the borrowing microentrepreneurs). So far, only three online lending and investment platforms—Kiva, MicroPlace, and MyC4—have endorsed the Client Protection Principles recently agreed by more than 40 of the world's largest microfinance investors.[19]

7. What due diligence does the MFI need to conduct to satisfy concerns of regulatory authorities about money laundering and terrorist financing?

In this world of increasing regulation and concern over the deliberate misuse of funding to finance the conduct of illegal or terrorist activities, MFIs are facing increasing requirements to perform their own due diligence of their respective funders as well as of their microentrepreneur customers. These regulations are often found under the rubric of anti-money laundering and combating the financing of terrorism (AML/CFT) regulation. MFIs that are subject to AML/CFT rules must be sure that they are not exposed to any suspect sources of funding when they tap online lenders or online investors.

Online lending platforms can present an interesting challenge to MFIs in this regard because the precise source of the funds is not always evident when many individual lenders/investors are coming together via an online platform to provide financing to an MFI. In this case, the MFI needs to be able to rely on its online platform, which has greater information about the individual lenders/investors, to conduct adequate due diligence much as it would rely on a microfinance investment vehicle to conduct this kind of due diligence on the various investors that invest in the microfinance investment vehicle.

Conclusion

The promise of online lending platforms as a source of learning as well as financing for the microfinance sector is significant. Importantly, online lending platforms can contribute to growing the next generation of socially responsible investors by showing the small investor/lender how his and her money can be used to do good in the world while returning the principal amount of that financing to the investor/lender and perhaps even generating a financial return on this principal. And, while some MFIs clearly see the use of online lending platforms more as an opportunity to spread news of their operations to the general public, the scale of online lending platforms is likely to make these platforms first and foremost a source of funding, not marketing. Therefore, MFIs need to manage this source as carefully as that derived from any other investor. MFIs that borrow significant amounts from online lending platforms, but treat this funding as primarily a marketing strategy rather than as a serious debt obligation, do so at their own peril, and run the risk of damaging their entire capital structure.

The good news is that the well-publicized successes of online platforms like Kiva and MicroPlace are likely to generate a surge of still more online lending platforms aimed at microfinance. This has obvious potential

19 See Press Release: Microfinance Investors Institutions Signed on to the Client Protection Principles, October 22, 2008 (www.cgap.org).

benefits, but some potential minuses as well. Online lending is likely to attract a multitude of players with very different agendas, missions, and business models. Some will be more attuned to the needs of MFIs than others. And these models are likely to shift as online platforms compete with each other to elicit more online funding (gain market share) or to differentiate themselves from each other (in part, to avoid the risk that one "bad actor" might contaminate or damage the reputation of all online lending and investment platforms). This competition and differentiation may be aimed at improving the "quality" of the interactive experience between online lenders and microentrepreneurs, thereby allowing online investors to see the social impact of their investments on the lives of those microentrepreneurs who receive their funding. Other platforms, however, are likely to compete by offering sweeter financial, rather than social, returns to their online investors, which in turn will likely raise the cost of online funds to borrowing MFIs.

Accordingly, in the not too distant future, MFIs contemplating borrowing from an online platform will face a variety of online platforms with very different business models. Some of these online platforms are already experimenting with a much broader range of financial products, allowing online investors to use their funding to guarantee borrowings or even to make equity or equity-like investments. Others are combining funding with technical assistance to support the MFI and/or its microentrepreneurs. In some cases, this technical assistance is coming from the online platform itself, but in other cases, online lenders and investors themselves are offering their knowledge and business expertise.

As online platforms and products proliferate, some MFIs are likely to end up asking themselves if the scale of financing being made available via these platforms is worth the risks that their unique funding patterns and often untested business models engender. Sometimes the answer to this question will be, and should be, no. However, if the experiences of online lending platforms over the last year are a guide, more often the MFIs' answer will be yes. That calls for developing a more discerning microfinance sector so that MFIs can differentiate among these online platforms and, consequently, make funding decisions that are most appropriately geared to their funding needs and desired capital structures. It also calls for making the business operations and risks of these online platforms as clear and transparent as possible to the individual online lenders/investors, to the MFIs that accept this form of financing, and to more traditional lenders and investors.

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