

# **Financing Microfinance For Poverty Reduction**

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There is no doubt that strong demand exists for microfinance services, among the poor. More than nineteen million of the poorest households around the world now have access. That is encouraging because the number has increased substantially since 1997 when the Microcredit Summit Campaign (MSC) was launched. But it is daunting that there are still 81 million poorest families to be reached before the Campaign target of 100 million is achieved.

There is no dearth of microfinance institutions (MFIs), but most of them are small. If only 10% of the 1,580 MFIs that have reported to the MSC and are serving the poorest could be scaled-up to serve an average of 500,000 very poor households each, then the shortfall of 81 million could be overcome.

A lot of effort is being put into institutional capacity building for MFIs that have the vision and willingness to provide micro finance services to large numbers of poor households. New effective management tools are being created and disseminated to microfinance institutions. Training is being provided from the Consultative Group to Assist the Poorest (CGAP) training hubs around the world, and by networks of MFIs.

Much less thought and effort has been put into sourcing the amounts and the right kinds of capital which will be required to scale up the next generation of microfinance leaders. The issue is not a lack of on lending funds, but the equity with which to leverage them – and financing to meet the inevitable operating deficits that arise with rapid scaling-up.

To overcome this major hurdle, a new Financing Paradigm is needed. First, alternatives to traditional equity must be identified. Equity-like financial instruments, or quasi-equity, such as subordinated debt, convertible debt, preferred stock, and Special Drawing Rights (SDRs), likely more acceptable alternatives to traditional equity financing for many funders, may be a large part of the answer.

Second, MFIs must adjust their balance sheets to present a truer and fairer picture of their financial health. Marking below-market rate borrowings, or soft loans, to market to capture the implicit subsidy inherent in its lower interest rates, and capitalizing that subsidy as a “grant” on the balance sheet as equity, is an important part of this solution. Finally, the prevailing microfinance standards on capital adequacy, that inflate the amount of equity (already in limited supply) MFIs should hold on their balance sheets, must be challenged.

Readers should understand that this is not a call for the kind of "creative" accounting that is getting big business into difficulty these days. Rather it is a proposal for analysis of already audited financial statements, so as to present a truer and fairer picture of the financial health and capital adequacy of MFIs.

**The combined effect of these three initiatives is to: i) increase the availability of funds to meet operating deficits through quasi-equity; ii) minimize the amount of equity and equity-like financing MFIs must raise; and iii) maximize their ability to leverage onlending funds from banks and other commercial and semi-commercial sources. The bottom line – the equity hurdle can be overcome, allowing for more rapid scaling-up of outreach to the poor.**

CASHPOR Financial & Technical Services Limited (CFTS) has been working among the poor and poorest rural households in Mirzapur District eastern UP India, for the past 5 years. Institutional financial break-even has been reached by providing financial services to 25,000 of the poor and the poorest rural women. Loan portfolio quality is good, with less than 2% at risk. Most importantly, the deficits of CFTS prior to break-even were financed almost entirely by quasi-equity, which CFTS was able to leverage significantly in order to achieve its targets. The impact of marking soft loans to market to present a fairer picture of financial health moved CFTS's capital adequacy from negative territory to 10%, well in line with international standards. While CFTS may be an extreme case, financing its deficits exclusively with quasi-equity, it shows that that the three steps outlined above are a feasible approach to financing scaling-up.

CGAP, as the leader in organizing support services for the micro finance industry, is asked to take the lead in mobilizing quasi-equity from its member-donors, perhaps channeled through national and regional quasi-equity funds, for MFIs with the vision and will to build the necessary institutional capacity, including the necessary transparency, to reach large numbers of the poorest.