

MANAGING THE FLOODGATES? MAKING THE MOST OF INTERNATIONAL FLOWS OF MICROFINANCE FUNDING

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The current community of microfinance funders comprises roughly 40 public agencies, 20 foundations, and 60 funds and other microfinance investment vehicles. International banks, private investors, international non-governmental organizations, and individual donors raise the numbers even higher. Perhaps surprisingly, however, there are no aggregate, reliable numbers on the amount of international funding for microfinance. Many of the largest microfinance funders, especially the public multilateral development agencies, know little about either the overall size or performance of their own microfinance portfolios. Various factors contribute to this situation, including the challenges of collecting and aggregating the data from decentralized operations, weak tracking systems, diffuse staff accountability, and misaligned incentives.

How can we know if aid is effective or ineffective if we do not even know how much we are spending? Assessing value for money or impact is impossible without the core baseline information on money actually invested, as well as the performance of the activities funded. Central aggregation and analysis of data on both the “how much money” and the “how well does the portfolio perform” questions seems to be a key driver of improved aid effectiveness in microfinance. Most importantly, calls for more money—or less money—are imprudent when little is known about what kind of money is available, let alone whether it is structured in the most useful way and the results achieved.

To examine the quantity, flows, and quality of funding for microfinance, CGAP launched a study of funding flows in the summer of 2005.¹ The

¹ The numbers presented in this report were collected from 2004 to 2006. The data available on microfinance investment vehicles dates from 2003, numbers on public bi- and multi-lateral agencies are from 2004, and for development investors from 2005. All data is self-reported.

research methodology combined a literature review, questionnaires and interviews. This note summarizes our and others' learning on the flows of international public and private funding to microfinance.

HOW MUCH MONEY IS AVAILABLE FROM WHICH TYPES OF FUNDERS?

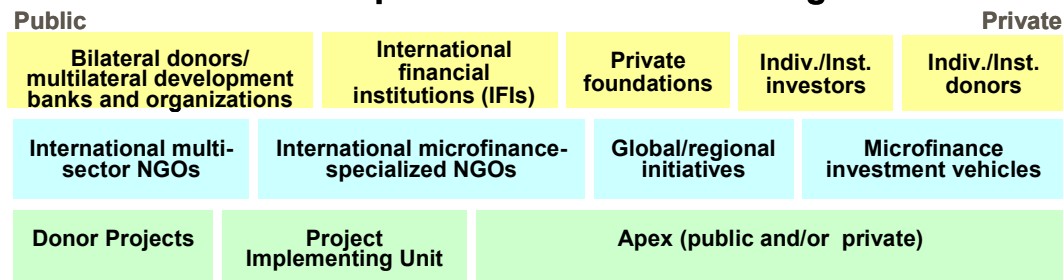
Microfinance funding flows from six types of primary funders—those with both ownership and decision-making over funds:

Types of Funders

- **Bilateral donors**—aid agencies and ministries of governments in developed countries [e.g., Swedish International Development Agency (Sida), United States Agency for International Development (USAID)]
- **Multilateral development banks and organizations**—agencies owned by multiple governments of the industrial and developing world (e.g., World Bank, the regional development banks), and UN agencies [e.g., the United Nations Program (UNDP), International Fund for Agricultural Development (IFAD)]
- **International financial institutions (IFIs)**—the subsidiaries of public bilateral and multilateral agencies that invest funds in private-sector activities [e.g., KfW Entwicklungsbank (KfW Development Bank), International Finance Corporation (IFC)]
- **Private foundations**—nonprofit corporations or charitable trusts typically funded by a private individual, a family or a corporation, with a principal purpose of making grants to unrelated organizations (e.g., Argidius, Bill and Melinda Gates, Ford, and Rockdale Foundations)
- **Private individual and institutional investors**—individuals, commercial banks, investment managers (e.g. pension and insurance funds such as TIAA-CREF), and other private entities that invest in microfinance, often with an expectation of return that is positive but below market
- **Private individual/institutional donors**—individuals and private organizations that make charitable contributions and grants.

Further complicating the picture, myriad possibilities for channeling funds exist. The diagram below shows the levels through which microfinance funding flows down from the primary funders described above through diverse intermediaries, which receive the funds and program them in turn to financial institutions serving the poor.

Landscape of Microfinance Funding



An educated guesstimate. Keeping in mind poor data availability, serious methodological challenges and the complexity of funding flows, a rough estimate of international public funding for microfinance is \$1.5 billion in annual commitments. Of this, we estimate that bilateral and multilateral agencies commit \$800 million to \$1 billion annually and have a combined microfinance portfolio valued at roughly \$7 billion. Initial results from our survey show that IFIs have a total outstanding portfolio of \$2.3 billion.² Microfinance investment vehicles are reported to have \$1.5 billion in portfolio, of which about \$0.8 billion comes from IFIs. (Note that these figures do not include funding from private foundations, banks, investors, or individuals.) Table 1 below provides more detail.

Table 1: Microfinance by the numbers—Public international funding commitments		
Funding source	Funding amount	Funders included
Bilateral agencies	Outstanding portfolio as of 2004: \$1.3 bn	AusAid, CIDA, DANIDA, Finland, GTZ, JBIC, Netherlands, SDC, Sida, USAID
	Committed in 2004: \$0.2 bn	
Multilateral development banks	Outstanding portfolio as of 2004: \$5.8 bn	AfDB, AsDB, EC, IADB, IFAD, UNCDF/UNDP, World Bank
	Committed in 2004: \$0.6 bn	
IFIs³	Outstanding portfolio as of Dec 2005: \$2.3 bn	AECI, AFD/Proparco, BIO, CAF, DCA/USAID, EBRD, EIB, Finnfund, FMO, IFC, KfW, MIF/IADB, SECO, Swedfund

² The portfolio figures include disbursements plus funds that have been committed but not yet disbursed.

³ Committed figures were not available.

Intuitively, these estimates for bilaterals and multilaterals seem high and it is safe to assume that annual *committed* numbers do not translate neatly to *disbursed* funds for microfinance. Many multilaterals report that only a fraction of funds—anywhere between 20 and 70 percent—committed to microfinance actually get disbursed. Moreover, significant chunks of money disbursed by agencies get stuck in local government on-lending institutions with their own poor disbursement records. This stark difference between committed funding for microfinance and actual disbursed spending, often distorts the picture by not providing a clear view of how much money actually reaches the intended countries and institutions.

As noted, these estimates cover only the public donors, i.e., the first three categories listed above. Comparable data for private foundations and individual or institutional donors and investors is not currently available. Although an aggregate number for funding is not possible, CGAP's research suggests that all types of public and private microfinance funding are increasing. While flows from bi- and multi-lateral public donors continue to play a significant role, the big news is the recent entry of private and semi-private funders (new foundations, investment vehicles, international banks, institutional investors, and individual givers).

Why Is The Funding Data So Incomplete?

Three important factors contribute to the uncertainty surrounding the levels, composition and performance of microfinance funding:

Weak tracking systems. Many public bilateral and multilateral development agencies—do not have good systems for tracking the size or performance of their portfolio. While tracking at the project level generally is a bit better, few agencies have easily accessible information on funding levels and performance at the central level. Weak tracking systems have special difficulty capturing the estimated 60 percent of microfinance funding that is channeled through credit components as part of larger multi-sector projects (including lines of credit)⁴ Since credit is typically a smaller component, sometimes as little as 4 percent of the overall program budget, it is often invisible. The lack of visibility makes it difficult to accurately estimate the size of a funder's microfinance portfolio. It can also mean that credit components do not receive adequate financial expertise during the design phase or oversight and management during implementation. Often repayment is not enforced, funds do not revolve and the capital disappears. At best, this means waste. At worst, it means

⁴ This number is estimated based on information gathered during Microfinance Donor Peer Reviews of 17 agencies. CGAP's research on public funding flows in July 2005 corroborates this estimation.

harming the repayment culture so that it is more difficult for others to provide sustainable microfinance services.

Diffuse staff accountability and misaligned incentives. Donor staff often have incentives that encourage spending money but do not reward clear reporting and good project performance over time. Development agencies are accountable to numerous and sometimes competing stakeholders, both in their own countries and in developing countries. Parliaments and the public may expect agencies to respond rapidly and generously with commitments of microfinance funds to address diverse development challenges.

Parliaments tend to focus on overall spending levels and are less likely to ask for detailed portfolio quality information. Similarly, the public opinion in donor countries is more interested in overall funding amounts or highlights of individual impact stories than details about portfolio performance. IFIs, foundations, and private investors, however, typically have a stronger culture of and interest in portfolio management and better performance tracking systems.

Methodological challenges. As illustrated by credit components, defining “microfinance” in the context of larger, broader development programs can itself be difficult. Another barrier to accurate estimates of total microfinance funding is the often yawning gap between the amount of funding committed and that actually disbursed, compounded by the long time horizon of some microfinance funding. When IFAD, for example, commits a new 10- to 30-year loan, the whole amount will appear in the portfolio. Some funders are unable to report on both categories, and for many, the value of funding programmed into actual support for MFIs and other microfinance industry-building activities is a small fraction of that committed. Figuring out how to compare different funding instruments (e.g., grants, loans, equity investments, guarantees) further confounds efforts to add up all the funding for microfinance. In the case of guarantees, for example, some funders report only the cash cost of the guarantee to the funder, others report the guaranteed portion only, and still others report the full amount leveraged by the guarantee. For loans, should long-term loans with low interest rates be equated with short-term term, higher-cost financing? In sum, the goal of “comparing apples to apples and oranges to oranges” in microfinance funding is very challenging indeed.

TRENDS IN MICROFINANCE FUNDING AND IMPLICATIONS

The supply of funding for microfinance today is radically different from 10 years ago. There are far more funders now than ever before. The development agencies that propelled much of the early development and subsequent commercialization of microfinance now confront changing roles in the new landscape. Many observers expect that the arrival of new entrants—often funders that bring not just fresh funding options and greater flexibility but a private sector ethos and experience—could fundamentally alter the course of microfinance.

Ultimately, the role of international funds should be to create sustainable microfinance providers and services in local financial markets. This means building them into effective intermediaries between domestic savers and borrowers. *Local* deposits can be a more stable, plentiful and cost-effective source of financing than *cross-border* funding.⁵ And providing secure deposit services to poor clients is one of the most useful services an MFI can provide. Too much subsidized money from international socially motivated investors and donors can serve as a major disincentive for deposit mobilization, crowd out local and international commercial sources, and mask operational inefficiencies of microfinance providers.

Too little external funding, on the other hand, can hinder an institution's growth and delay poor people's access to financial services (especially where local funding markets are not developed). MFIs often value international funding because it is available on longer terms than local resources, confers prestige, and can provide political "risk insurance." Yet, many MFIs are not able to raise enough funds from international donors because they are too small, too young or are in a country that is not politically important. Others MFIs that receive more funding, however, may spend too much energy managing relationships with many funders that provide tiny tranches of funds. In either case, the market is inefficient.

In many places, developing a *local* financial market that can support microfinance is a long term, extremely difficult task. It will require good policy decisions at the macroeconomic level. It will require investments in market infrastructure, such as payment systems to support a high volume of diverse financial transactions, supervisory capacity and reporting standards. And it will require MFIs that are financially sound enough to mobilize deposits and issue local debt. So, while the long-term, end-goal is building domestic

⁵ Ivatury, G. and Julie Abrams. The Market for Foreign Investment in Microfinance: Opportunities and Challenges, 10

institutions and the market infrastructure that supports them, in the medium-term there is a funding gap to fill.

Where are all the microfinance funds currently flowing? What are the priorities for the different funding sources? CGAP's research on funding flows from bilateral donors, multilateral development banks, foundations, and IFIs, on microfinance investment vehicles (MIVs) and apexes, as well as its experience working with development agencies on aid effectiveness,, uncovered the following trends.

Private flows from foundations and social and commercial investors are increasing. In the past few years, more and more foundations entered the market, joining early pioneers like the Ford Foundation, which provided its first grant for microfinance in 1976. Since 2005, the Bill and Melinda Gates Foundation, the Michael and Susan Dell Foundation and the Mastercard Foundation, among many others, have started developing their strategies and investing in microfinance. These high-profile organizations have raised the visibility of microfinance. For example, the Gates Foundation has announced its intention to provide several hundred millions of dollars for microfinance over the next few years and the \$100 million Omidyar Network grant to Tufts University for microfinance investment made big headlines in *The New York Times*.⁶

Philanthropic Funding—the Rise of Foundations⁷

Are private foundations the new rising stars among microfinance funders? In a world of increasing wealth among the few, philanthropy has been growing as well. More and more private foundations have turned naturally to microfinance with its promise of helping entrepreneurs help themselves.

Many of the newcomers have significant endowments, e.g., \$29.2 billion for the Bill and Melinda Gates Foundation (plus the \$37 billion just received from Warren Buffett). Foundations have the potential to be more flexible than many traditional development agencies. The decision-making process within most foundations is

⁶ The New York Times, November 4, 2005. "Tufts It Getting Gift of \$100 million, With Rare Strings."

⁷ Private Foundations involved in microfinance (illustrative list): Argidius Foundation, Bill and Melinda Gates Foundation, Charitable Gatsby Trust, Chevron Foundation, Citigroup Foundation, Deutsche Sparkassen Foundation, Ford Foundation, JP Morgan Foundation, Mastercard Foundation, Michael and Susan Dell Foundation, Omidyar Network, Open Society Institute, Rabobank Foundation, Rockdale Foundation, Shell Foundation, Skoll Foundation, Tinker Foundation

quicker, with fewer procedural steps than many public agencies where project approval cycles can easily run from 12-18 months. As a result, foundations can often be more flexible and responsive to market opportunities. Where many other agencies' programming must be linked to a specific country, private foundations can fund regional or global programs, enabling them to fill a wider range of gaps in the field. They are relatively independent of political pressures (but may face pressure from the founding family). Their approval, monitoring and evaluation requirements can be more rigorous than in public sector agencies.

Foundations' main instruments tend to be grants. Unlike loans, grants are well-suited to addressing the main bottlenecks in microfinance: building the capacity of a range of financial sector actors. Many foundations are also exploring program-related investments in the form of loans, guarantees and even equity.

The new private entrants are not limited to foundations. International banks such as Deutsche Bank, Commerzbank, Citigroup, HSBC, ING, and ABN Amro have begun financing microfinance through direct loans and other types of investment vehicles.⁸ Individual donors and investors have made sizeable gifts to and investments in microfinance institutions and networks, and can also directly channel money to microentrepreneurs, for example, through the online lending platform, kiva.org, that processed \$200,000 worth of loans to 450 entrepreneurs in its five first months of operation.⁹

Public flows continue from bi- and multi-lateral donors, who are spending more on market infrastructure and policy. Large public multilateral development agencies like the International Fund for Agricultural Development (IFAD) are major funders. IFAD committed approximately \$115 million for microfinance in 2004. An intriguing possibility is the entry of important emerging market countries as microfinance donors in their own right; the government of Venezuela, for example, provided \$100 million to the new Bolivian government to support microfinance.

However, both multilateral and bilateral donors are beginning to shift their funds for different activities and through different mechanisms. While direct funding to retail institutions is increasing, funds for strengthening market infrastructure and influencing government policy are increasing faster. Since

⁸ The Hidden Wealth of the Poor: a Survey of Microfinance". The Economist, November 2005 and Institute of Business Ethics. "A billion to Gain: A survey of global financial institutions and microfinance", 28.

⁹ For more information on Kiva, go to www.kiva.org.

2002, trends in overall development priorities began to emphasize systemic changes versus project-level work and this has affected microfinance as well. Development agencies increasingly fund through budget support, sector wide approaches (SWAs) and apex or second-tier institutions. Some agencies have adopted a “financial systems development” approach that involves activities beyond retail institution-building such as support services for microfinance (e.g., audit and MIS capacity). Bilateral agencies in particular are spending more money on financial market infrastructure. Some agencies like DFID, for example, have virtually stopped direct funding of individual institutions and direct management of projects, preferring to fund broad, multi-faceted projects like the Financial Deepening Challenge Funds that support a range of market players and are implemented by consulting firms and other third parties.

In spite of these recent trends, CGAP’s five country-level aid effectiveness reviews as well as observations from many more countries, show that funders still pay relatively little attention to market infrastructure.¹⁰ There is still much to learn about how to build sound market infrastructure that accommodates and accelerates the integration of microfinance into local financial markets.

The move upstream of so many donors to engage in policy work also has some cause for concern. Not every donor can or should engage at this level, which requires highly specialized expertise, experience rooted in the reality of the retail level, and influence with governments.

IFIs are an increasing and very important source of direct funding to microfinance providers. The investment arms of public development agencies like the International Finance Corporation have geared up their funding to microfinance by around 50 percent between 2003 and 2005, and

¹⁰ For more information on the country-level effectiveness and accountability reviews (CLEARs), visit cgap.org/clear.

provide more than two-thirds of it directly to microfinance institutions.¹¹ Though reliant on public funds, IFIs also raise money on international capital markets.

In contrast to most other funder categories, IFIs tend to provide sizeable financing directly to retail MFIs; retail providers receive more than two-thirds of microfinance funding from IFIs.¹² The IFC alone had an estimated outstanding portfolio \$1.7 billion directly to retail institutions as of 2005.¹³ The rapid growth of microfinance in these funders' portfolios suggests that microfinance institutions will continue to see large inflows.

Most funders fund intermediaries rather than supporting microfinance providers directly. Loans to governments are the main instrument for the big multilateral agencies (as we have seen, the largest public funders). Funds pass through a local government agency, and sometimes several more steps (e.g., Project Implementation Units, microfinance apexes), before reaching retail institutions. In 2004, only 2 percent of multilateral commitments went directly to the retail level. More funds eventually reach the retail level, but as noted above, the path can be long and winding, raising questions about value-for-money and efficiency (for both the funding source and recipient). In contrast, 20 percent of bilateral agency funding goes directly to the retail level; the balance flows largely through intermediaries such as international NGOs or investment funds.¹⁴ A look at investments by foundations also suggests a preference for funding through specialized NGOs, networks, and investment funds—probably to lower the originating funder's transaction costs and outsource due diligence.

Intermediaries that combine high-quality technical assistance with financing, such as the international microfinance networks or specialized consulting firms that manage broader financial sector deepening programs, generally

¹¹ CGAP research 2006

¹² CGAP research 2006

¹³ CGAP research on funding flows to microfinance, 2005/2006.

¹⁴ CGAP research on funding flows to microfinance, 2005/2006.

perform better than those that provide funding alone. Experience suggests that it is critical that intermediaries do not face undue disbursement pressure or politicization of decision-making about fund allocation.

The huge gap worldwide in microfinance retail capacity suggests the need to monitor carefully this trend by many funders away from direct funding for retail institutions. After all, retail institutions are the backbone of financial systems and many generally well-served countries are without any significant, solid retail capacity. Will microfinance providers—particularly those that are smaller, younger, or operating in different country contexts—be able to raise the resources they need to support their growth before quasi-commercial investment is feasible and available? Will local deposits, commercial bank loans, bonds, and equity investors step in to fill gaps met by international funders for the first tier of MFIs?

The International NGOs

Microfinance-specialized and multi-sector international NGOs are major intermediaries of both public and private funding for microfinance.

Microfinance-specialized NGOs are influential, both due to the funds they manage and their technical expertise.¹⁵ The combined annual operating budgets of the nine specialized NGOs studied amounts to \$150 million, with growth rates ranging from 10-30 percent per annum for six of them.¹⁶ Though originally funded primarily by public donors, specialized NGOs are increasingly diversifying their funding sources. ACCION and Freedom from Hunger, for example, are relying increasingly on private individual donations and institutional investors. In 2005, Opportunity International received \$34.1 million from private contributions, representing 80 percent of total revenues, ACCION received \$13.7 million from private contributions, representing 55 percent of total revenues; and Freedom from Hunger received \$2.7 million, representing 62 percent of total revenues.¹⁷

In the case of multi-sector institutional NGOs, such as CARE, Oxfam, World Vision, or Groupe de Recherche et d'Echanges technologiques (GRET), microfinance is just one small part of their annual operating budgets, anywhere from 2 to 20 percent, with the balance supporting health, education, humanitarian assistance, community development, etc.. This adds up to \$150 million per year combined for 10 of the larger ones.¹⁸ For these 10 NGOs, on average, 42 percent of their funds came from

¹⁵Microfinance Specialized NGOs included in study: ACCION, FINCA, Freedom from Hunger, Grameen, Mennonite Economic Development Agency (MEDA), Opportunity International, PlaNet Finance, ProMujer, World Council of Credit Unions (WOCCU).

¹⁶ The study included ACCION, FINCA, Freedom from Hunger, Grameen Foundation, MEDA, Opportunity International, PlaNet Finance, ProMujer, and WOCCU.

¹⁷ www.opportunity.org, www.accion.org, and www.freedomfromhunger.org.

¹⁸ Multi-sector NGOs included in study: World Vision, World Relief, American Refugee Committee (ARC), CARE, Concern Worldwide, Catholic Relief Services, Save the Children, Groupe de Recherche et d'Echanges technologiques (GRET), Mercy Corps, PLAN International.

public sources, although these NGOs are also diversifying by tapping more private individual and foundation funding.

Multi-sector NGOs can play an important role in laying the foundations for sound microfinance. They are often first to arrive after conflicts or natural disasters. They often focus on very poor or remote clients, and have piloted alternative models such as community-managed loan funds that are innovative and have performed well under conditions that are more challenging for traditional MFI models.¹⁹

Both multi-sector and specialized international NGOs tend to focus their work on creating and strengthening a range of retail financial service providers. Some are also venturing into policy work and market infrastructure development -- such as ACCION with its work on technology-- to strengthen national microfinance sectors rather than individual institutions.

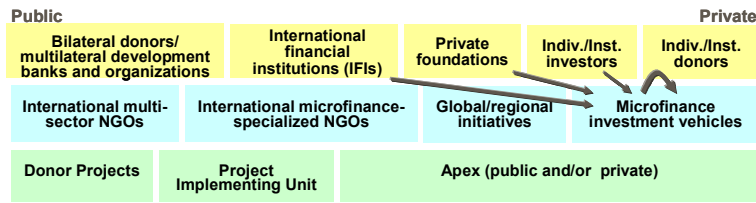
Investment vehicles for microfinance have proliferated in the past five years. These new players represent another type of intermediary, one that collects money from investors and provides primarily debt or equity financing to MFIs. Profund, created in 1995, was the first microfinance investment fund, with only a handful of others joining in the next few years, such as Dexia, Oikocredit, Unitus, and Deutsche Bank's Global Microfinance Consortium. The number of funds soared to 44 in 2004, and climbed up to 60 in 2006.²⁰ IFIs, microfinance networks, and individuals have started most of these funds, boosted in some cases by significant public funding. Recently, the U.S. Pension Fund TIAA-CREF announced a \$ 100 million fund.²¹ Figure 1 depicts the scenario of a MIV that receives money from an IFI, a foundation, and an institutional investor and invests in an MFI. The MIV also invests in another MIV.

¹⁹ Murray, Jessica and Richard Rosenberg. Community-Managed Loan Funds: Which Ones Work? CGAP Focus Note No. 36. Washington D.C. CGAP: May 2006.

²⁰ CGAP Capital Markets Update: www.cgap.org/mcm

²¹ Press Release from TIAFF-CREF. New York, September 19, 2006. "TIAFF-CREF creates \$100 million Global Microfinance Investment Program, first investment \$45 million private equity stake in ProCredit Holding AG.

Figure 1:



In 2004, 21 percent (\$216 million) of MIV flows went into other funds, and from there to yet another fund or retail institution.²² Blue Orchard Loans for Development, for example, received a \$2 million loan in 2006 from the responsAbility Global Microfinance Fund.²³

Many new apexes are springing up—often with significant donor

funding.²⁴ Apexes are second-tier or wholesale organizations that channel funding (grants, loans, guarantees) to multiple MFIs in a single country, with or without supporting technical

services. Examples include FONDESIF in Bolivia and the Pakistan Poverty Alleviation Fund (PPAF). Table 2 shows the regional distribution of 132 apexes identified. At least 25 of these apexes were started since 2000.

Apexes receive funds from multiple donors. For example, the World Bank, USAID, CIDA, DFID, Sida and CGAP all fund the Microfinance Investment and Support Facility, Afghanistan

(MISFA), a public-private apex established in 2003. For donors, channeling funds through apexes is an easy way to move large amounts of money quickly, and to outsource the identification,

Region	#	%
Africa	24	18
E. Asia and Pacific	14	11
Europe and Central Asia	18	14
Latin America and Caribbean	49	37
Middle East and N. Africa	6	5
South Asia	21	16
Total	132	100

²² Ivatury, G. and Julie Abrams The Market For Foreign Investment in Microfinance, 3

²³ CGAP Capital Markets Newsletter, June 2006, www.cgap.org/mcm.

²⁴ For the purpose of CGAP's 2006 desk research on apexes, an apex institution is defined as a second-tier or wholesale organization that channels funding (grants, loans, and guarantees) to multiple microfinance institutions in a single country or region. Funding may be provided with or without supporting technical services. Here are a few different types of "Apexes": 1) Public – housed in a local government agency; 2) Public – housed in a donor agency/project; 3) Private – Non-profit (founded by NGOs and/or donors); and 4) Bank – Commercial/quasi-commercial (Finance Company, banks on-lending donor or government funds). For this research, federations of cooperatives, Self-Help Groups, Financial Service Associations etc. were not included.

screening, funding, and monitoring of MFIs. These goals make sense, though in practice many apexes may lack the preconditions for good performance—sufficient technical expertise, political independence (many apexes are partly funded by national governments, for example, which can compromise their independence) and market knowledge to manage large funding flows effectively.

Debt is the main instrument of IFIs and investment vehicles. Debt comprises 74 percent of funds deployed by IFIs and 74 percent of funds deployed by microfinance vehicles. Many regulated microfinance institutions are still underleveraged and have a preference for debt. A study by the Council of Microfinance Equity Funds revealed that “of the thousands of the MFIs in operation,” only 115 are legally structured to take equity investments. The rest are, for example, NGOs and cooperatives.²⁵

The use of guarantees is on the rise. Estimated at only 8 percent of total foreign investment in 2004, several IFIs and development agencies are showing increasing interest in guarantees to connect MFIs to domestic funding sources.²⁶ For example, the USAID Development Credit Authority provides \$78 million in guarantees to microfinance.²⁷ Investors and donors believe that guarantees facilitate MFIs’ access to local lenders, leverage scarce socially-motivated financing, and protect MFIs from currency risk. A recent CGAP study on guarantees confirms that these benefits indeed often materialize. Yet, the study also revealed that the all-in cost of a guarantee-backed retail bank loan can be more expensive for MFIs than other funding sources: MFIs pay annual fees ranging from 0 to 4.5 percent of the guarantee amount on top of the bank interest rate. And despite these guarantee fees paid by MFIs, the study suggests that most guarantor institutions are not covering their costs in providing guarantees. Perhaps most significant of all, the study showed that guarantees do not, in fact, consistently lead to subsequent direct lending by domestic banks without

²⁵ Kaddaras and Rhyne, *Characteristics of Equity Investment in Microfinance*, 2004.

²⁶ Ivatury, G. and Julie Abrams. *The Market for Foreign Investment in Microfinance: Opportunities and Challenges*, 5

²⁷ CGAP Research on funding flows to microfinance, 2005/2006 and CGAP foreign investment research in 2004.

additional collateral. Overall, the study offers a sobering reminder that guarantees must be well-designed to achieve their purpose of leveraging local capital to support MFI growth and funding diversification.

The number of stand-alone microfinance programs, relative to credit components, is increasing. Currently, a large proportion of microfinance funding is in the form of credit line components of large multi-faceted development projects. These “components” tend to perform poorly as they often lack financial sector expertise in both design and implementation. These “add-on” components have been declining in use (see table below). IFAD, for example, reports an increasing trend toward stand-alone rural finance programs in almost all regions, especially in Africa. Since 2002, the number of multi-sector projects at the African Development Bank with microfinance inserted as a component has declined in favor of stand-alone projects. At the European Commission, there are still more multi-sector projects with credit components than stand-alone projects but recent trends suggest this is changing.

Table 3: Evolution of the European Commission’s Microfinance Portfolio		
	before 2004	after 2004
Stand-alone microfinance projects (in % of total number)	12.1%	58.3%
Projects with microfinance components (in % of total number)	87.9%	41.7%

Investments remain highly concentrated. CGAP research on microfinance investment vehicles and IFIs shows that funding is heavily concentrated in certain regions, types of institutions and individual MFIs. Seventy-three percent of investment vehicles’ funding goes to institutions in Eastern Europe/Central Asia and Latin America.²⁸ IFIs’ direct exposure is particularly concentrated in the same two regions (70 percent). There is a similar concentration by institutional type: 82 percent of funding by IFIs and

²⁸ MicroRate Survey 2006.

microfinance investment vehicles has gone to MFIs that are licensed and regulated by banking authorities.

Even more telling is the high concentration in a few MFIs and networks. Just ten of the 505 MFIs participating in a CGAP survey captured 25 percent of all IFIs' and microfinance vehicles' funding. ProCredit Holding and its affiliates captured 17 percent of investments, including nearly 37 percent of all equity. Concentration is also present on the supply side: just three IFIs (AECI/ICO, KfW, and the IFC) provided more than 60 percent of all investments. It should be acknowledged, however, that these development investors moved into these markets and institutions at a time when true private investors were not on the scene.²⁹

The largest and poorest microfinance markets—sub-Saharan Africa and Asia—have attracted relatively little foreign investment from the IFIs and investment vehicles. The predominance of NGOs in Asia and credit unions in Africa means fewer opportunities for equity investors as well. The announcement of a new initiative for Africa by KfW and IFC (Greenfield Microfinance Initiative, MIFSSA) of \$103 million may, however, signal a change. CGAP research shows that IFIs increased their funding to Africa from 1.3 percent to 6.4 percent between 2003 and 2005.

Return expectations from microfinance investments may be unrealistic. With over 60 microfinance investment vehicles and more than 17 IFIs seeking to invest in a relatively concentrated market and a small pool of institutions, one might anticipate market consolidation and lower investment returns. While some equity investors seek real returns as high as 25 percent, there is no evidence of a fund having achieved, much less sustained, such a return. The lack of exit opportunities for investors can also create pressure and lead to other forms of concentration; most exits have occurred as other funds or co-investors buy up shares.

²⁹ Ivatury, Gautam and Julie Abrams. The Market for Microfinance Foreign Investment: Opportunities and Challenges, 6-7

Careful sequencing, coordination among funders, and rationalization of national funding markets can yield big benefits. In some countries, funders have succeeded in overcoming barriers of multiple missions, instruments, and political pressures, contributing to rapid development of a diverse microfinance sector that is increasingly integrated into financial markets. In others, the funding market remains fragmented, with funding roles characterized more by competition than cooperation and complementarity.

A Tale of Contrasts: Funding Microfinance in Cambodia and Nicaragua

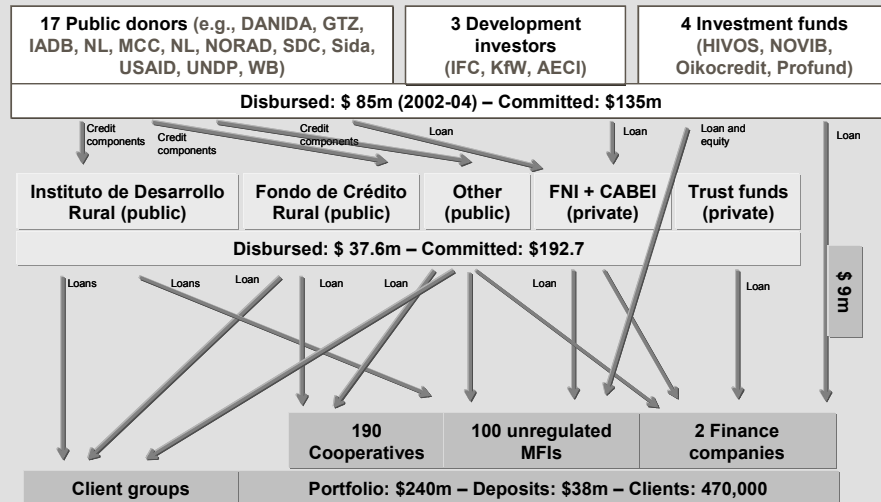
These countries are strikingly similar: both are small, poor countries that went through extreme crisis. Nicaragua is the poorest, most heavily indebted country in Central America, with 45 percent of the 5.5 million residents living below the poverty line. One of the poorest countries in East Asia, 36 percent of Cambodia's 13.4 million citizens live below the national poverty line.

Yet despite these similar challenges, patterns of microfinance funder behavior and funding flows have been radically different. In both countries, modern microfinance emerged in the 1990s, aided by the arrival of significant international funds, with bilateral and multilateral donors and international NGOs supporting projects to deliver credit to the poor. A CGAP country-level effectiveness review (CLEAR) estimated donor funding of about \$85 million in Nicaragua from 2002–2004, microfinance borrowers totaled 470,000 in 2004. Over a similar period in Cambodia, 2001–2003, donors and investors disbursed just under \$20 million; the number of borrowers in 2004 stood at 400,000. While many factors affect this variance, and the link between donor funds and outreach is not linear, the different amounts of money spent over a roughly similar period to reach very similar numbers of clients is striking.

The two countries highlight dramatic contrasts in donor and investor operations. In Cambodia, by the mid-1990s donors began separating credit components from integrated multi-sector projects and moving from microfinance projects to MFI institution-building. New Central Bank regulations in 2000 and 2002 opened the door to commercialization. Building on the foundation laid by public development agencies (including the AsDB, UNDP, USAID and AFD), the IFIs (e.g., IFC, KfW) and then social investors (e.g., Shorecap, Triodos, and SIDI) supported the market leaders, bringing much needed equity and governance experience. The early donors helped broker MFI-investor relationships, and with private capital entering the market, they stopped lending to strong MFIs. Microfinance today is arguably the most sophisticated part of the financial system, and extends services in virtually every province; the main suppliers of financial services to the poor are ACLEDA Bank, 9 licensed MFIs, and 20 registered non-government organizations.

In contrast, in Nicaragua the proliferation of and competition among donor initiatives (about 23 bilateral and multilateral donor agencies and 5 social investors) has produced structural fragmentation at all levels of the financial system. For example,

12 different donors use grants for technical assistance in Nicaragua. The funding flows map is complex indeed.



Coordination among different types of funders and rational sequencing of their investments is much less in evidence than in Cambodia. In short, many observers agree that too many donor agencies continue to channel too much money through too many channels. The sector—consisting of roughly 300 microfinance providers at the retail level and 55 second-tier funding vehicles—also suffers from politicization. This fragmentation is undermining the efficiency and overall viability of the financial system. In addition, the volume of subsidy and grant funds in the system likely acts as a barrier to private investment.

While many factors doubtless contribute to the contrasts between these two microfinance sectors, the behavior of funders played an important role. The funder community in Cambodia appeared more able to forge a common vision of commercial finance, fully integrated into the financial system, and to coordinate with one another and other key stakeholders to achieve that vision. As a group, they sequenced their interventions and adapted their roles based on the maturity of individual institutions and the overall market. This behavior, in turn, appears to have contributed to the rapid move from unsustainable, donor-financed credit projects in the 1990s to a sector led by profitable, regulated financial institutions a mere decade later. The sector in Nicaragua has not benefited from the same degree of strategic coherence and coordination among donors and investors. The fragmentation evident in Nicaragua raises questions about the transactions costs involved in funding flows, and about what percentage of development funds ultimately reaches the intended recipients.

The Future: Channeling the Flows Effectively

With the changes in the overall amount and composition of funding flows to microfinance come both opportunities and threats. Clearly, additional financial resources are required to achieve the vision of extending appropriate and comprehensive financial services to the hundreds of millions of poor families around the world currently excluded from effective access. The funding market is seeing some very positive developments – the entry of new players with the ability to fill in gaps in the current funding picture, the nascent interest of commercial funders to dramatically scale up investment in market-ready providers, innovative partnerships that lever in new capital and expertise, and increased investment in the necessary infrastructure and policy frameworks for inclusive financial sectors, to name a few encouraging signs.

However, the problems of international funding to microfinance have been well-documented as well. The lack of capacity remains a major constraint, but long-term, patient money to fund it is all too scarce. Yet the flood of cheap money in some markets risks hampering deposit mobilization, perpetuating operational inefficiencies, and in some cases, even politicizing microfinance. Approval and disbursement pressure within funding agencies can lead to insufficient attention to absorptive capacity of institutions and markets and an overemphasis on credit—rather than savings, insurance and transfers. Hard currency loans can place MFIs at risk—risks they rarely hedge or fully understand. Erratic disbursement schedules from funders can make it difficult for MFIs to manage obligations to clients. The lack of meaningful performance monitoring and reporting can result in bad projects that continue and are even sometimes renewed, thereby missing opportunities to learn from failures and successes.

These core challenges should preoccupy international funders. The recent public discussion has been distracted by the debate on the roles of public

versus private investors (e.g., whether the IFIs are crowding out the private social investors and unfairly competing with them). It is true that understanding the origin of money—public or private—is important to understand funding sources’ incentives that either align or run counter to good practice. But, the public/private distinction does not line up in all cases with the developmental/commercial distinction. Private sources are not necessarily less developmental or less interested in achieving a social return than public ones. Indeed, some of the leading advocates of social performance tracking are private foundations and investors.

The role of socially-oriented money is to help strengthen and prepare institutions and fill their funding gap, until they can access truly private local capital deposits, loans, and bonds on their own.

Drawing on the experience of the Microfinance Donor Peer Reviews and subsequent country level effectiveness reviews, and the recent quantitative analyses of the international funding market, it is possible to offer broad suggestions on how to increase the effectiveness of funding market for microfinance and optimize the contributions of each category of donor and investor.

Suggestions for all funding sources

- Prioritize transparency – better data on funding flows and portfolio performance from all types of sources are needed.
- Invest more in performance measurement, including for work at the meso and macro level – this will require collaborative efforts to ensure consistent approaches
- Analyze the performance of different types of intermediaries, and shift funding toward the best performing ones and out of weaker mechanisms such as PIUs. Select intermediaries carefully for technical expertise and independence, and match disbursement expectations to absorptive capacity of the microfinance sector.
- Forge partnerships – various funding sources offer different instruments, staffing, structures, risk appetites, etc. Linkages among different types of funders can achieve greater impact and leverage, especially in difficult environments.

Grant funders—whether public development agencies or foundations—need to be ready to fill the gaps that investors and commercial players in the private financial system may not automatically address. They are in a position to take more risk than many investors and work on high-risk, innovative projects.

Donors can apply grants for research and development to promote innovation in products and delivery mechanisms, work in unstable regions, reach out to harder-to-reach populations, or experiment with new technologies. They can and should forge linkages with a variety of financial sector actors, to leverage investment in the sector; grants can fund the high-risk slice of large investment vehicles (such as the recent private placements implemented by Blue Orchard) that enables large sums of more truly commercial financing to come into microfinance. With more flexibility and facing less pressure than public donors to fund country-level activities and governments, private foundations can also help fund global public goods and explore regional solutions to market infrastructure weaknesses (e.g., multi-country action research programs, training institutes, etc.).

Grant funders can build capacity at all levels, especially for emerging retail financial service providers by supporting younger and less proven MFIs. Donors can play a proactive role in promoting increased transparency on MFI financial and social performance, as well as spurring competition among retail providers of financial services. (In supporting retail MFIs, however, grant donors need to guard against displacing public and private investors, by being slow to transition out of MFIs that have developed the capacity to use investment financing and no longer need grants. Large credit lines can also delay deposit mobilization.)

These activities require a complex set of skills, especially since microfinance is evolving so quickly. Yet, staff capacity is quite limited in many bilateral and

multilateral development agencies and foundations.³⁰ For example, in 2004 the European Commission had about \$209 million allocated to microfinance (outstanding and committed) and yet had no assigned staff member dedicated to microfinance. Funding agencies and their stakeholders need to augment staff skills to take smarter risks competently.

IFIs that provide disciplined funding (including loans and equity) often coupled with technical assistance, have helped build many solid retail institutions. However, they have been criticized for concentrating excessively on the most mature institutions and markets. As matters stand, they could be accused of using scarce socially-motivated resources to compete with private investment, rather than catalyze it. For example, private investors argue that they are regularly undercut by the cheap rates offered by public donors and IFIs. But, IFIs have been instrumental in building some of the most solid greenfield banks that experienced fast outreach, often both on the loan and savings mobilization fronts.

Commercial and quasi-commercial investors tend to fund relatively advanced institutions or start-ups promoted by management (like ProCredit) that have a track record of success. There is a body of analytical techniques and sound practice developed for commercial investment (in microfinance and other sectors) with which the new private investors are likely to be familiar. Being on guard not to displace commercial capital – by being open to financing less well-known MFIs, for example, or exiting from more mature markets—is equally important for the private social investors as the IFIs. And those public and private investors that are in a position to take on greater risk due to their funding sources, shareholder expectations, etc., will be in a better position to finance activities that are truly additional.

³⁰ CGAP's Microfinance Donor Peer Reviews with 17 development agencies showed that staff capacity is a vital ingredient for quality projects. To learn more about the reviews, see www.cgap.org/portal/site/CGAP/menuitem.2319fcd20442bc5167808010591010a0/

Suggestions for bi-and multi-lateral public agencies

- Invest in staffing and build quality management systems by achieving a minimum level of performance in the five core elements of aid effectiveness, often depicted as the Aid Effectiveness Star, agreed-upon by CGAP member donors³¹
- Introduce core performance indicators (focused on repayment and efficiency performance, for example) in all contracts with retail level institutions for more transparency
- Capitalize on ability to take more risk by funding promising institutions or new delivery mechanisms to improve retail service delivery in underserved areas
- Proactively assess comparative advantage and redefine roles and partnership opportunities, when appropriate, given newer funding sources in the market

Suggestions for IFIs

- Develop innovative risk sharing mechanisms and other new creative instruments to better leverage local capital markets and commercial investors
- Link with grant funders to leverage technical assistance funds into investees
- Ensure additionality by taking as much risk as possible, and limiting investment in or exiting from institutions (e.g., the most advanced, lowest-risk MFIs) and activities that are now in a position to handle commercial financing

A FEW CONCLUDING THOUGHTS

It is too soon to tell what the impact of the changes in funding flows to microfinance will be. Will new actors with a private sector ethos become steady suppliers of smart and patient capital to microfinance institutions and financial market infrastructure or will they quickly tire of microfinance's challenges and move on to other investments? Private players such as foundations have the potential to fill important gaps that are difficult for the traditional public funders to address. New private sector investors, even more than their public forebears will need to resist the pressure to commit large funds, the temptation of quick fixes and the notion that money can alone solve problems. They need to learn about the core challenges of achieving a breakthrough in reaching scale and focus on important remaining investment gaps.

³¹ CGAP Donor Brief 22, Maximizing Aid Effectiveness in Microfinance

If they can learn from the failures and successes of the early funders, the new private players could be a real boost for financial access—raising the bar on financial rigor while taking smart risks and introducing the innovations that will be necessary for massive scale. And the more traditional development agencies also need to re-think their role and positioning to concentrate on areas where private funders will not be attracted. And exploration of the potential for *combined* public-private initiatives in the microfinance arena has only just begun. When all funding sources develop a keen understanding not only of their comparative strengths but also of how they can fit in within the broader funding landscape, we will see more rational and effective funding decisions and more robust development of financial services for the poor.

List of Acronyms

AECI/ICO	Spanish Agency of International Cooperation/Instituto de Crédito Oficial
AFD	French Development Agency
AfDB	African Development Bank
ARC	American Refugee Committee
AsDB	Asian Development Bank
AusAid	Australian Agency for International Development
BIO	Belgian Investment Company for Developing Countries
CAF	Andean Development Corporation
CGAP	The Consultative Group to Assist the Poor
CIDA	Canadian International Development Agency
DANIDA	Danish International Development Agency
DFID	Department for International Development
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EIB	European Investment Bank
FMO	Netherlands Development Finance Company
GRET	Groupe de Recherche et d'Echanges technologiques
GTZ	Gesellschaft für Technische Zusammenarbeit
IADB	Inter-American Development Bank
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IFI	international financial institution
JBIC	Japan Bank for International Cooperation
KfW	KfW Development Bank
MEDA	Mennonite Economic Development Agency
MFI	microfinance institution
MIF	Multilateral Investment Fund
MIFSSA	Microfinance Initiative for Sub-Saharan Africa
MIS	management information system
MISFA	Microfinance Investment Support Facility for Afghanistan
MIV	microfinance investment vehicle
NGO	nongovernmental organization
PAF	Pakistan Poverty Alleviation Fund
PIU	project implementing unit
SDC	Swiss Agency for Development and Cooperation
Sida	Swedish International Development Cooperation Agency
SIFEM	Swiss Investment Fund for Emerging Markets
SWAps	Sector-wide approaches
TIAA-CREF	Teachers Insurance and Annuity Association - College Retirement Equities Fund
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Program
USAID	United States Agency for International Development
WOCCU	World Council of Credit Unions

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FIRST Initiative, Development Gateway

ADA European Microfinance Actors Inventory

Council of Microfinance Equity Funds

Gautam Ivatury, CGAP, for raw material of Investment fund study

Websites:

www.accion.org

www.freedomfromhunger.org

www.foundationcenter.org

www.kiva.org

www.oecd.org