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DONOR BRIEF
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*Helping to Improve Donor Effectiveness in Microfinance*

# WATER, WATER EVERYWHERE, BUT NOT A DROP TO DRINK

*In January 2002, CGAP published a "Viewpoint" on the Microfinance Gateway entitled "Water, Water Everywhere, but not a Drop to Drink." The Viewpoint sparked a frank discussion among 78 donor, investor and MFI representatives. This Donor Brief highlights the key lessons relevant to donor staff that emerged from the original Viewpoint and subsequent discussion.*

The overall supply of funds chasing strong microfinance institutions (MFIs) exceeds demand. In Africa alone, CGAP estimates that the available supply over the next three years will exceed absorption capacity by a factor of three to one. But a shortage of available funds is the reality for many promising microfinance institutions. This apparent anomaly can largely be explained by the ineffectiveness of much of the supply of funds to MFIs, which is often narrowly targeted and poorly structured.

Donors can change this situation by focusing on their comparative advantage: take more risk and allow the best MFIs to graduate to more sustainable and commercial funding; invest resources in the more time-consuming business of building institutional capacity; improve the legal and policy environment; and raise reporting, performance and transparency standards for the burgeoning industry.

***Why is donor funding often ineffective?***

- Significant sums of money languish unspent in single- or multi-country apex facilities whose design was driven by donor or government priorities, rather than by the needs of the MFIs themselves. Many of these facilities, which provide or guarantee loans for on-lending to clients, remain untapped due to the conditionality, application and reporting requirements attached to them.
- Many smaller MFIs require institution-strengthening grants and technical assistance before they can efficiently utilize apex or guarantee facilities. On the other end of the spectrum, stronger MFIs no longer need donor funds for on-lending at all. They can increasingly access commercial and quasi-commercial banks and socially responsible investors (SRIs), yet donor mechanisms can 'crowd out' this private sector and SRI funding.

> ***Two's a crowd***: *One SRI lamented the loss of a high-potential client capable of affording a commercial product: "we were offering them a loan at 24-months maturity for a rate of Libor + 4.5%... We were driven out by an international donor which was offering the same amount, at 15 years horizon, 5 years grace period, a nominal interest of 5%, and an additional 100,000 USD gift for technical assistance."*

- Most donor funds are concentrated in a few countries and on a few strong and/or nearly sustainable MFIs with a track record. Other donors fund MFIs or projects with very limited potential for sustainability, while more promising candidates face funding shortages. This concentration of funding leaves many MFIs off the donor radar screen.

> ***Culture clash:*** *While more risk capital for lesser-known MFIs may be needed, donor agencies face challenges in playing the role of the venture capitalist. As one donor official remarked, "it is perhaps scarcely surprising that they [donors] encounter difficulties in relating effectively to small-scale, foreign (to the HQ of the donor), private sector, market-based, entrepreneurially managed MFIs for whom risk and uncertainty is an unavoidable feature of day-to-day business life."*

- In some countries, successful MFIs may not access commercial funds, even with donor guarantees, because cheap donor funds skew incentives. Single and multi-donor guarantee facilities in Latin America and Africa, for example, remain under-utilized due to lack of demand.
- Donor staff face limitations of time, skills, and available information to identify less visible but promising MFIs and design appropriate technical assistance packages.

***How can donor funding become more effective?***

- The principal task of donors should be to identify and bet on promising but riskier MFIs, leaving the known winners to commercial investors.
- In addition to investing in less proven MFIs, donors need to devote more resources to technical assistance, including the time-intensive task of building institutional capacity.
- Donors should adjust their country-level programming approach to facilitate funding of global or multi-country MFI networks, which provide much-needed technical assistance to network members while supporting industry-wide measures such as performance standards.
- Increasing donor staff competence in microfinance, as well as the flow of quality information on MFIs on a country-by-country basis, would allow donors to more easily identify and effectively support less prominent MFIs.

***What should be the role of donors relative to commercial investors?***

- Donors and investors have important and complementary roles, which vary depending on the development stage and institutional type of MFI.

> ***A match made in heaven:*** *One SRI has had a great experience working in harmony with an international donor agency: "There are two institutions [in East Africa] in which we participate as shareholders and where [Donor X] finances part of the TA that is still needed. Here a good understanding of each other's roles and coordination of different actions work very effectively..."*

- Funding should be sequenced, with different instruments matched to different cycles in the life of an MFI. Such an approach would involve donor funding in the seed and capital growth stages of an MFI, with private social equity stepping in as an MFI approaches the break-even point.

> ***Right place, right time:*** *An MFI network emphasizes that "it's critical that institutions receive sufficient grant financing in their early years – otherwise they'll never reach the point where they can realistically absorb commercial financing."*

- Donors can help prepare MFIs for commercial financing by insisting that they prepare internationally audited financial statements and provide cashflow reports and projections. Donors should also ask for commercially understandable, standard financial ratios as part of MFI reporting requirements.

> ***A frustrated investor's tale:*** *An investment banker expressed exasperation at the response of NGO MFIs to requests for basic financial reports and information. She was often told either that such reports were unavailable, or was provided with incomplete or unreliable data. She had gone out on a limb to broaden her bank's options to include NGO MFIs, but they had been unable to respond appropriately. "This is precisely the type of behavior that helps contribute to a perception among investors that NGOs are not serious players in microfinance," she concluded.*

Both capital and capacity building are needed for the expansion of microfinance services to the poor. The challenges for donors include taking more risks, sequencing funding instruments to match the development stage of MFI partners, and clarifying their roles *vis-à-vis* private investors.

**Authors:** Brigit Helms and Peggy McInerny. **Source:** The original CGAP "Water, Water" Viewpoint by Doug Pearce, the subsequent discussion, and related documents can be found on the Microfinance Gateway at http://www.ids.ac.uk/cgap/water.

**Where to go for more information. Articles/Books: Websites:**

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