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Use of Donor Funds in the Financing of MFIs[1]

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Abstract: This paper focuses on the use of donor funds to finance MFIs. The role of donors in microfinance is rapidly evolving, particularly since the emergence of socially responsible and commercial investors. We argue that public policy should be designed to facilitate the entry of new private actors without abandoning the markets that could not work without some public support. Through a separation of socially-responsible investors from fully commercial ones, we come up to an original classification of the different funding sources and the actors and their potential market in the sector.

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1. Introduction

This paper addresses the changing role of donors in microfinance, particularly since the emergence of socially responsible and commercial investors. The entry of these new actors on the microfinance scene carries some significant challenges to the sector, especially building complementary policies rather than competition with public funds.

Donors' subsidies impact some core business decisions of MFIs, even if these are not related to better management performances. The microfinance sector has rapidly evolved during the last years and very large disbursement of investment funds or philanthropists such as Omidyar and the Gates Foundation are questioning previously established donor policies.

Donors have supported most microfinance programs since the emergence of the sector during the 70s[2]. Their common goal is to encourage the development of a more inclusive financial sector. Most MFIs have long only relied on donors' funds to finance their growth. Nevertheless, as a result of the prosperous financial results of some leading MFIs, donors are no longer the sole financiers of the sector. Interested by the promising returns and the positive image surrounding the sector, some socially-oriented or commercial investors are willing to develop their microfinance portfolios and endow major institutions.

The government-owned international financial institutions (IFIs) are however accused to crowd out the (most) profitable segments of the microfinance markets rather than letting the private lenders complement their activity (Abrams and von Stauffenberg, 2007). The current concentration of donors on the same institutions is clearly not optimal. For instance, regulated specialized institutions, often the largest ones, in the transition economies have benefited from a lion's share of the investments, securing nearly 90 per cent of the money. This leaves unregulated institutions largely without the benefit of this capital (UNCDF, 2005, p. 21).

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[2] For instance, BRAC in Bangladesh, one of the three biggest microfinance institutions (MFIs), has received funds from Department for International Development (U.K), DGIS (the Netherlands), CIDA (Canada), NOVIB (the Netherlands), NORAD (Norway) and World Food Programme (WFP) for its IVCVG program. In Latin America, Accion has received funds from USAID, CGAP, IADB, IFC or the World Bank. Data from BRAC and Accion's websites.

This paper will argue that, in many cases, donor support is focused on some of the already sustainable MFIs because of the failures of some of the previously sponsored, unstable MFIs and the lack of sustainability of the sector. When they select an institution to implement their strategy, donors actually face a trade-off between increasing competition in the sector and the sustainability ratios of their portfolio.

If part of their mission can be fulfilled by other actors, donors could however concentrate their action on segments of the market that are not likely to be naturally addressed without their support and select the best instrument for each segment. The microfinance sector must then accept not to judge donors' performance on the current sustainability ratios of the MFIs that receive subsidies. Assessment of donor's effectiveness must be done on the long term data when the institutions will ideally be less subsidized.

This paper is structured in the following manner; first, is addresses the question of how large of a consensus there is between different donors' public policy in microfinance. We particularly question donors' responsibility for the lack of sustainability of most MFIs. Second, we tackle the emergence of investment funds and socially-responsible investors in the sector. Third, we study the donors' role when interacting with these actors. We conclude with proposing a new organization of financial instruments and segments of the microfinance market.

2. How large is the area of consensus on donors' microfinance public policy?

Donors have been active in microfinance for a long time. Most of them have published a renewed version of their strategy in microfinance during the UN 2005 Year of Microcredit[3]. Many areas of consensus have emerged in the donors' community after almost 30 years of microfinance in developing countries. Good

[3] Some of these publications have been widely distributed such as the UN Blue Book on *Building Inclusive Financial Sectors for Development* and the CGAP Pink Book on *Donor Guidelines on Good Practice in Microfinance*.

or "best" practices have been drawn and are extensively shared in the sector. For instance, there is a clear consensus that the primary role of government in this field is to control or facilitate the macroeconomic framework and to correctly regulate microfinance in order to protect customers and enable microfinance activities. However, experience has taught us that it is very difficult to manage microfinance services in countries with high inflation[4] or during and after a macroeconomic crisis. Donors must therefore help government to achieve macroeconomic stability.

A second consensus arises on some specific subsidies. Many markets remain underserved by financial institution, certainly in rural areas. As very few MFIs have been created without subsidies, subsidizations will therefore remain inevitable in many cases. Consequently, the consensus remains that donors' subsidies are still needed to encourage products innovations (CGAP, 2004).

Even if their practices differ, a core point of donors' vision is to build a large financial sector without creating aid dependence or weakening incentives to reach sustainability (Hardy et al., 2002, p. 13). Sustainability of microfinance operations, the ability to repeat performance through time (Schreiner, 2000), is a widely shared goal in the sector. Nevertheless, most analyses on the outcome of years of subsidisation in microfinance are mixed. On one hand, donors' role in the emergence of successful microfinance projects has often been highlighted (Imboden, 2005). After decades of subsidized credit programs or unsuccessful state-run credit schemes, many microfinance programs that have been subsidized in the past, exhibit impressive repayment rates, often above 90%.

On the other hand, even if microfinance has constantly argued to be a new sustainable development policy, one must recognize that very few MFIs have reached independence from donors' funds. Only around 100 MFIs out of the estimated 10,000 have achieved financial sustainability. If we analyze the *Mix Market* database, we find that less than 300 MFIs have been able to be operationally self-sufficient in 2004. Therefore, subsidies to microfinance NGOs can end up funding inefficient and lax management practices resulting in limited

[4] Vanroose (2006) however found out that MFIs reach more clients in high inflation countries.

outreach and high loan default (Bhutt and Tang, 2001). Excessive subsidization has in fact been problematic since the movement first gained steam in the 1980s (Morduch, 2005a). It is however unclear if donors are directly responsible for the low sustainability exhibited by the MFIs. The next section will tackle this issue.

2.1. Are donors responsible for the lack of sustainability?

Two main answers can be provided to explain the modest financial results achieved by the MFIs. The first one is that many donors were often too lax in the assessment of the MFIs and the management of their disbursement. The second one asserts that the microfinance activity will inherently require subsidies to fulfil its mission and therefore considers the modest financial results as inherent to the sector. Both sets of explanations will be addressed. One can directly notice that these two sets of explanations are however not fully mutually exclusive.

The first answer is given by some who argue that MFIs have not worked properly to achieve independence from donors' funds or were not sufficiently encouraged to target self-sufficiency. The argument is that MFIs have not had enough incentives to properly act towards becoming independent from donors' money. Over-reliance on subsidies and poorly designed subsidies limit scale and undermine incentives to build strong institutions (Morduch, 2005a).

Furthermore, exit strategies have not been properly considered or enforced. These must be directly designed by donor agencies in order to give appropriate incentives to local institutions. Exit strategies require the microfinance team to undertake both evaluation of what already exists and assessment of whether project involvement can be built upon an existing structure or process (Hendricks, 2003).

The push for self-sustainability has never been so high in the sector. While in the past, a few MFIs such as the Grameen Bank argued that they were only targeting operational sustainability rather than financial sustainability[5], very few are still openly considering subsidies in their long-term financial projections. This shift has

[5] The difference between the two entails the adjustments made on the price of cost of funds.

occurred partly due to the publication of the weak financial results, and partly because of the clear move towards financial sustainability. For instance, the Microcredit Summit (2005) clearly stipulates that MFI managers should try to build financially self-sufficient institutions[6]. Good financial performance is indeed caused primarily by low operating expenses and efficient management procedures (Hudon, 2006) that take time to be developed.

Some MFIs working in rural areas with very poor clients, such as ASA, have nevertheless been able to reach independence from donors. These MFIs have worked both on their costs and revenues. On the cost side, since transaction costs are very high, these MFIs are forced to improve their staff productivity but also to decrease staff salaries or hire less competent staff. Staff incentive schemes are one of the methods used by MFIs to improve their efficiency. Incentives should however be carefully managed. For instance, it is now well-known that incentives solely based on the number of clients served can put the quality of the portfolio at risk[7].

On the revenue side of the income statement, product diversification and a better analysis of the demand has been largely developed (Cohen, 2002). Very high interest rates have also been charged by some MFIs arguing that the access to credit is the most important issue, and that the high turnover of the activities of poor clients enables them to repay such high interest rates[8]. In short, this approach considers that donors should be more persistent in pushing the institutions to achieve sustainability, through incentives and clear strategies, among other approaches.

The **second** approach emphasizes that the overwhelming goal of independence from donors set by most MFIs is unreachable, except if the institutions charge very high rates that would put their social mission into question. Only MFIs working in specific environments, such as urban markets or area with high population density, or MFIs that offer very low staff salaries, can achieve

[6] Microcredit Summit Action Plan See www.microcreditsummit.org

[7] See, for instance, Bazoberry (2001)

[8] This pricing policy is however sometimes considered as unfair, by some actors or even more often by the local civil society.

independence from donors. Given this situation, since more than 90% of MFIs are not able to achieve independence, the current model of microfinance working with very poor clients entails recurrent subsidies.

This however does not mean that donors are always efficient when granting and allocating subsidies, but these subsidies will still be needed for a long time nonetheless. In cases where transaction costs are intrinsically too high because of the environment, market rates may be too expensive for poor clients to get a surplus margin; alternatively, clients will need to take other loans to repay their initial debt. Moreover, when working with very poor clients, institutions may be reluctant about increasing their interest rates to get higher margins because that would mean putting at risk their repayment rates. Thus, micro-lenders can keep interest rates lower with more subsidies. As a result, removing subsidies will not only put upward pressure on fees charged to clients but will also, for instance, influence how staff are hired and treated[9].

In some of these difficult cases, state-owned institutions may be efficient providers of financial services or innovators. For instance, Caixa Economica Federal in Brazil has been successful in implementing card based accounts for their microfinance programs. The chance of success is likely to be related to the application of goof management and professional standards rather than ownership composition per se (Helms, 2007). In brief, it is not consensual that all MFIs must become fully financially sustainable and independent from public funds, regardless of the impact on their clientele.

If all agree that subsidies are needed to foster innovations or expand the outreach of MFIs in underserved areas, the choice of the MFI in charge of the implementation of the strategy is contentious. Even if the donors' responsibility for the lack of sustainability is not clearly determined, the goal of achieving self-sufficiency as well as their own perception of their responsibility may well affect donors' choice of their partners. Funding a sustainable and well-managed institution is clearly less risky than supporting smaller, more risky operations. The next section describes this trade-off faced by donors.

[9] Armendariz de Aghion and Morduch (2005)

2.2. Should donors support new or well-established institutions?

Recent investment decisions from donors suggest that many of them desire to operate with well-established institutions. These MFIs offer long track record with international agencies and are likely to be easier to monitor. For instance, Agence Française de Développement (AFD) has signed in 2006 an agreement with the major and most sustainable MFI in Morroco, Al Amana, to develop housing lending and expand their presence in some rural areas[10]. The rationale is that subsidies should be awarded to MFIs benefiting from the required capacity of absorption, and preferably with existing good governance and management mechanisms.

Data on donors' investments confirm this trend. International financial institutions, bilateral or multilateral agencies with more than 50% government-owned equities, nearly doubled their direct funding to top-rated MFIs in 2005[11]. Since subsidies do not guarantee sustainability for many of the microfinance institutions, some donors are thus tempted to keep supporting the expansion of already sustainable institutions instead of investing in more risky ones.

It is therefore no surprise that donors investing consistently in the same institutions are blamed of not taking sufficient risks in their investment, such as, for instance, in the Belgian resolution on microfinance[12]. Choosing experienced and already sustainable institutions creates two problems, namely the lack of competition in the market and the ousting of the private sector.

There is a trade-off between working with the more experienced and often the most sustainable institutions and fostering competition in the sector. Competition could be instrumental in driving down interest rates. Competition in the sector should also force the institution to improve their working process and the transparency of their activities. As is the case with AFD's recent involvement with

[10] See AFD website consulted in April, 2007.

[11] See Abrams and von Stauffenberg (2007) for an analysis of these data.

[12] In the resolution adopted on February, 16, 2007, the Belgian Senate (p. 6) considers that Belgian Investment Company (BIO), a semi- public entreprise financing MFIs and SMEs, too narrowly focuses on fairly unrisky institutions.

Al Amana in Morocco, such agreements are likely to accentuate the leadership of the well established institutions instead of developing the competition. At the end of 2005, Al Amana[13] had 52% of the amount of loans disbursed in Morocco and the best rating evaluation in the country[14]. The choice to be made is thus between selecting a smaller institution already active in rural areas or a major one, like Al Amana, that is likely to benefit from a better management and reporting capacity.
Second to the competition argument, private investors accuse donors of spoiling the market by funding major institutions at concessionary rates while these institutions may be able to pay market prices. Private lenders are forced thus to compete with public institutions that charge concessionary rates for credit lines to MFIs. To some extent, socially-responsible investors that do not charge market rates should also be condemned if one is to follow this rationale. The critics on the lack of risk are therefore primarily addressed at the financing institutions, IFC, KfW or BIO rather than the projects of the development agencies. When a donor finances a project that could not be achieved through self-financing of the institution or private financing, donors' grants are however vital.

Donors clearly fear some major collapses, such as Finansol in Latin America or Projet de Promotion du Petit Crédit Rural (PPPCR) in Africa, even more when they are part of public-private consortium such as in the Belgian BIO. The performance indicators of the donors' policy are at stake in this debate. If donors have to take more risk, their success should not be measured by the current or direct sustainability ratios of their partner MFIs but at the light of the outreach and viability of the institutions after a few years of partnership.
Despite the fact that many public entities still support some sustainable institutions that could be financed by the market, private actors are entering the microfinance markets. Contrary to what the choice of their partner MFIs could suggest, (public) donors have not opposed this entry. They have even been

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[13] Al Amana was launched with the support of USAID through US $10.5 million of subsidies while almost simultaneously, the United Nations Development Programme (UNDP) offered support services to six microfinance institutions through a US $1.7 million technical assistance program (Cohen and Goodwin-Groen, 2003).

[14] See Al Amana's 2005 annual report for data on the Moroccan.

influential to start-up the first investment funds in microfinance. The next section gives some evidences on this entry of new players and the role that donors have played in this process

3. Financial sector deepening and investment funds in microfinance

Many investment funds have been launched during the last five years. They gather socially responsible investors such as Triodos, donors such as the IFC, or in a few cases more traditional ivestors such as pension funds[15]. The flow of investments has boomed during the last years and the trend is still increasing. Microfinance investment vehicles portfolios grew of 113 % up to € 828m between 2004 and 2005[16]. Few of these investments are however 100% commercial. Out of the 57 investment vehicles identified at the end of 2005, only 16 were solely commercial funds. Nevertheless, most growth of microfinance vehicles comes from quasi-commercial and commercial vehicles rather than the traditional "development" vehicles.

Donors can favour equity investments since buying shares for cash gives them some control over the MFI through seats on its board (Schreiner, 2000, p. 16). Other forms of subsidized resources do not provide a real control on the MFI's evolution, except if the donors put some conditionality on future disbursement[17].

Since many donors believe that microfinance can access the international financial markets and make it one of their priorities, interactions between donors - or NGOs sponsored by donor agencies - and private investors is likely to increase progressively. The creation of the first fully for-profit funds has shown that this situation could become classic in the future. The interactions can be complex.

A good example of interaction between private investors and a NGO is AMRET, formerly EMT, in Cambodia. EMT was created in 1991 by GRET, a French

[15] For instance, Conger (2003) reports that pension funds in Peru invested in Mibanco's bonds. They bought 82% of a $6 million issue6.

[16] Data provided on investment funds come from Goodman (2006)

[17] For instance, a donor can condition an additional disbursement on the financial results or the social impact.

NGO after two experimental phases of a project to deliver microcredit to the rural population of Cambodia. It is now a non-bank financial institution with private investors such as La Fayette Participations or I&P that aim to achieve adequate returns on its investments. GRET is still holding 47.45% of the shares[18], providing technical assistance to the institution. The technical assistance is done by I&P technical assistance's branch, Horus.

An example of an investment fund turning profitable is ProFund. ProFund is a fund that has invested in 13 MFIs in Latin America and the Caribbean[19]. By investing in major MFIs, ProFund played a crucial role in integrating microfinance into the financial sector. The fund estimates that its investments indirectly benefit over 500,000 micro and small entrepreneurs. Most of its equity is held by bilateral or international donors (76%), while private shareholders have 8% of the shares[20]. The strategy is to liquidate the fund within ten to twelve years. At first sight, returns were not enormous since ProFund achieved an average 6.65% internal rate of return with difficult years in the beginning. These moderate returns are partially due to the socio-economical or political environment. Nevertheless, after nine years of operations, six of the eight reported annualized ROE of these MFIs were above the 15% level as of June, 30, 2004. Three of them were above the 45% level. ProFund was set up to foster the trend of commercial interests entering this market and was then terminated in 2005.
Almost all investment funds loose money during their first years. While the market is progressively maturing, the returns become increasingly more significant in some MFIs and thus benefit some of the funds holding these MFIs' equities. When donors invest in a fund that aims at booking high profits, the main question for them is then when to withdraw.
The justification of constant very high level of profitability for private investors could be particularly harsh for a donor or a subsidised NGO, certainly when they are obtained with high operating costs or inefficiency. In these cases, one could

[18] Information on AMRET come from its website consulted on May 2006.
[19] Information on Profund come from its website consulted on May 2006. See also diLeo and Cuadra (2002) or the Economist (2005)
[20] The remaining shares are held by NGOs.

easily argue that private investors could take their place and that donor money should be put in other activities or in more risky institutions.
Donors can protect weak microfinance organizations from being ousted by market forces at initial stages, but protecting them too long can also damage the success and impact of the institution[21]. Most investment funds invest in the same MFIs. Ivatury and Abrams (2005, p. 5) found that just 10 of the 505 MFIs that have received investment captured 25 percent of all the direct investment, and the 148 MFIs that each received at least US $1 million in foreign debt, equity, or guarantees accounted for 89 percent of all foreign investment.

From an institution's perspective, equity from international donors has obvious benefits but also associated risks. The **first advantage** is the relative low cost of funding. Equity is intrinsically cheap, certainly with the low level of dividend in microfinance distributed until now. Nonetheless, this assumption can be challenged since new investment funds often target very high return on equity (ROE), sometimes as high as 15%. This ROE target facilitates the complete 'privatization' or transfer to profit-oriented investors after a few years of operations. It also aims at serving as an example to show that microfinance can be a very profitable investment.
The **second advantage** is that donors' equity investment ratio can be related to discount credit lines, frequently granted with free technical assistance to start the activities. International credit lines are also a relatively cheap source of funds. Even when they are corrected for inflation, international interest rates are often lower than comparable domestic interest rates[22] (Brugger and Duggal, 2004). Nevertheless, there is an important caveat. Most of them carry a foreign exchange risk that is serious for institutions that hold all assets in local currency (UNCDF, 2005, p. 13).
The **third advantage** of the international donor's presence is that it reassures local regulators but also other investors. As for any formal owners, it helps to qualify for prudential regulation and supervision (Shreiner, 2000, p. 16). The

[21] Brugger and Duggal (2004), p. 19
[22] Funding from domestic sources is also more likely to be truly commercial than most foreign investment that MFIs receive (Ivatury and Adams, 2005, p. 4)

institution must however be cautious, because in case of a donor withdrawal, the regulator can remove the institution's license or banking status. This is very crucial since in many countries, the licence or banking status allows the MFI to operate and take deposits.

International donors' presence can also enable MFIs to attract commercial investors and leverages additional funds. Investors can value the expertise of the donor and can also assume, correctly or not, that donors will add funds in case unforeseen problems arise. Since involving the private sector is a main priority for many donors, their interactions with these new players in microfinance should be carefully managed.

Next to these three advantages, the presence of a donor or an NGO can also represent a danger or **risk** of conflict. If the donor is noticeably socially-oriented, conflicts with the NGO may arise on the level of profitability and clientele targeted by the institutions. If the institution is not yet sustainable, the time to reach sustainability may also be a conflicting issue. Donors' investment horizon is certainly different than from that of commercial actors. In contrast to private owners, donors often do not seek dividends, nor do they plan to sell their shares for a gain (Schreiner, 2000). Some donors, such as the European Commission, are even not allowed to lend some money back or get some return from an investment in a MFI.

The risk is however not always justified. Some donors try to mimic international markets' rationale in order to attract additional funds or promote microfinance in international markets, for instance through rapid and high profitability targets. In this case, fewer conflicts with commercial actors may appear. Furthermore, the donor or the NGO provides cheap (if not free) technical assistance and training to the MFI. This allows saving costs for the institution. NGOs also facilitate the granting of subsidised credit lines or subsidies from donors. This can of course be very profitable for investment funds.

So far, a review of the activities of investment funds in microfinance has shown that donors are involved at different phases of development of these funds. The next section will try to determine what should be the main focus points for donors when interacting with these commercial actors.

4. What role for donors when interacting with private actors?

One may question what the donors could do when they interact with private investors. Two main roles will be presented. The first and the most obvious one, is to try to attract new players in microfinance. The second one is to track the social mission of the MFI, and to prevent any drift. While some donors try to play both roles, others only focus on either one or the other.

Many donors advocate that their involvement in investment funds should be seen as a catalyser of for-profit investors. This is therefore a **first** potential **role**. They can act as catalysts by helping an institution become profitable and finally withdraw for market investors or by using their investments as examples in order to determine commercial banks to downscale their activities.

While the entry of new players offering financial services to the underserved poor is certainly welcome, the donor must always do a cost-benefit analysis of their investment and assess alternative investments. In some cases, a grant for capacity building may well be more appropriate. For instance in areas where commercial players are not likely to entry soon, the reinforcement of a group of cooperatives may well be a better alternative. Furthermore, opportunity costs of the investment should be constantly reviewed since many remote areas still need foreign aid to get out of their poverty trap. A cost-benefit analysis on the opportunity to use microfinance rather than another development policy is instrumental to this end[23].

Any additional equity investment from public donors is certainly welcome by most of the microfinance community if it doesn't imply donors' withdrawal from the most difficult areas.

A major threat is also that most grants and technical assistance are provided to MFIs funded by microfinance investment funds that avoid risky and very remote areas. In this case, one may clearly fear a slow shift from clientele in the sector. Namely, MFIs will probably target less risky clientele active in areas with low-cost service delivery and closer to economically active commercial centers and

[23] See Morduch (1999) or Sachs (2005) for a global picture

industrial clusters (Chao-Beroff, 1997), in order to reach a higher ROE. Concretely, this would lead to the financial exclusion of the poorest customers with low turnover, even if these clients develop a productive activity and are potentially reliable clients for the MFI.

Finally, when donors withdraw in order to let the new private actors come into the institution, the transfer price is certainly crucial. When the MFI acts as a cooperative or an NGO (if customers own or partly own the institution such as the Grameen Bank), the funds invested in the institution automatically benefit to its clients since it is also the shareholder. For a microfinance bank or a NGO becoming a bank, in most cases, the customers will not receive anything from the transfer of shares between the donor and the private investor.

The **second role** of donors is to continuously determine and supervise that the targeted clientele and practices of the MFI are compatible with its social mission. Funds with a majority of for-profit investors are often willing to act as socially-responsible investors, achieving a double bottom line of financial and social performances. As socially-responsible investors, it is also the donor responsibility to check if borrowers receive a fair share of the benefits of the transaction and are truly better-off after the transaction.

There is thus a constant trade-off in the management of these MFIs, which could seem very problematic if the private investor really seeks consequent returns. From this, we infer that the donor does not only defend his taxpayers' (social) interests but also the customers' interests in the field. While the social objective and mission are primary related to the existing clients, a sustainable institution is more likely to serve the potential clients. The donor objective function is in this case particularly cumbersome.

Nevertheless, while the financial objectives are well assessed today by the rating agencies or some international platforms, such as the Mix Market, social indicators are still lagging behind in donors' evaluations. Hence, one of the main challenges for donors is to develop indicators to involve social elements in the investment decisions but also to monitor the fulfilment of the MFI's social mission. The rating grade issued by microfinance rating agencies is not sufficient to assess the MFIs performances. Rating agencies often provide very useful information on the

environment and on the clientele, but these are often not taken into account in the rating attributed nor have a low impact on the final rating. Social indicators use and their enforcement are consequently much needed for socially-responsible donors.

With sustainability a priority, MFIs may be tempted to simply increase their interest rate before improving their working process and management, letting their customers pay for internal inefficiencies. It was, for instance, long thought that clients are not sensitive to interest rates. Two recent surveys have found that demand for micro loans is not inelastic (Karlan and Zimmer, 2004; Dehejia et al., 2005). Other donors and practitioners think that there is increasing price sensitivity in the borrowers' attitudes (UNCDF, p.7). Clientele targeted and environmental factors should consequently be taken into account for grant disbursement but also in the social impact analysis. The impressive repayment rates achieved show that high interest rates are certainly affordable for many clients, but MFIs funded by socially-responsible investors and working with very poor clients, should first study the demand and try to improve the efficiency of their working process before increasing the interest rates.

Similarly, some socially-minded practitioners question the strategy of targeting very high ROEs. While this strategy may be a good one if the goal is to attract banks in the market, some emphasize that all additional profits booked by the MFI always represent a smaller surplus for the customer. Even if the profits are fully reinvested, this highlights an intrinsic trade-off between the institution (and its future potential clients) and the current borrower. From a socially-responsible perspective, the MFI interest rate should not only be assessed in comparison with the moneylender's rates but also with the local commercial banks' rates.

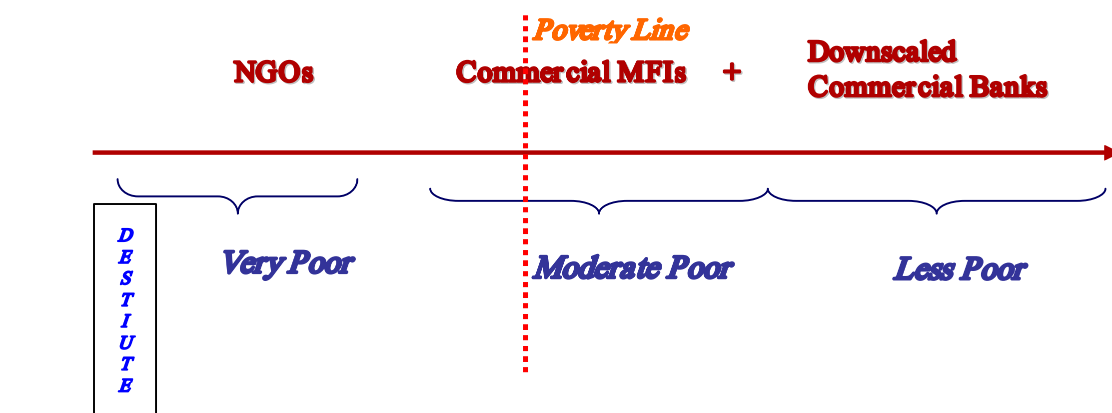
5. The distribution of the market and the funding sources

The variety of investors and shareholders leads to a variety of microfinance institutions that have different social missions and objectives. The range has broadened in the last few years, by including for-profit investors, but also

institutions targeting the 'missing gap' between micro enterprises and small and medium enterprises (SMEs). Therefore, interest rates charged vary among institutions, according to their social mission and enforcement. There are some institutions which, under the umbrella of microfinance, act as purely profit-oriented institutions, while others target very poor people. While the first ones can show notable profits, the second ones sometimes do not require full repayment of the loan or do not charge an interest rate.

This diversification of practices under the same name leads to a constant broadening of the definition of microfinance. For instance, microfinance is no longer defined as primarily group lending, or an activity targeting very poor clients[24]. We thus arrive at a definition of microfinance that is no longer described in term of practices, but of a segment: that serves a large variety of citizens[25]. If commercial players enter the market, many analysts foresee that the primary role of NGOs will be to innovate. NGOs can create new products or new methodologies to serve difficult clients. The outcome would then look like Graph 1[26].

Graph 1: Distribution of the market among MFIs



[24] With the change in language, from microcredit to microfinance, came a change in orientation, toward "less poor" households and toward the establishment of commercially-oriented, fully-regulated financial entities (Armendariz de Aghion and Morduch, 2005).

[25] See, for instance, a quotation from Michael Chu, President of Accion in Elisabeth Rhyne's *How lending to the poor began, grew, and came of age in Bolivia* (2001): "BancoSol is not mission-driven it is segment-driven. Just as McDonalds is not likely to start serving haute cuisine, BancoSol is not likely to move away from the segment of market it serves best" (p. 162).

[26] This graph partly draws on CGAP (2005), The Impact of Microfinance, Donor CGAP Direct. Cooperatives have not been explicitly referenced but one can estimate that they can serve any segment of the market.

The question then becomes who will fund which segment and which tools will be used for each of them[27]? MFIs working in areas of high density and with clients with high turn-over often require limited subsidies except start-up funding. If no new clients or products are involved, recurrent subsidies either for subsidized, quasi-commercial loans or capacity building represent a market distortion. At the other end of the spectrum, most practitioners agree that sparsely populated and otherwise difficult-to-reach populations may require long-term subsidies (CGAP, 2004).

Similarly, through subsidies, the IVCVG program in Bangladesh has shown that the poorest of the poor or destitute can be linked to safety net programs to finally graduate to MFIs as clients (Hashemi and Rosenberg, 2006). A clarification is therefore needed for the in-between cases, where MFIs serve population with lower turn-over and productive activities (and often below the poverty line).

A study on BRI's clients and potential clients in Indonesia found that there appeared to be a large group among the very poor who were under-served by micro banks but who were nevertheless potentially reliable customers. The challenge is to understand the need and constraints of this majority[28] (BRI and Center for Business and Government, 2001, p. 53). In BRI's case, in addition, to reaching the "feasible" half of the poor population, BRI staff would have to find inexpensive ways to determine who was in the half that was deemed a good prospect for repaying loans, and who was not. BRI is experimenting with ways to achieve these goals cost-effectively (Morduch, 2005b, p .4).

Preliminary experiences in some North-African countries also suggest that, even though they partly self-finance their enterprises, many major MFIs fear launching new activities in rural areas if they do not receive extra subsidies. Moreover, MFIs struggling to reach independence are likely to broaden their clientele, adding richer

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[27] Of course, all funding decisions should be based on the local environment, the existence of competitors and the population. Therefore, this should be taken as a rough attempt to characterize the microfinance market.

[28] The study found out that many among these potential viable clients are more concentrated in agriculture.

clients, or simply shifting from clientele. Though the broadening of clientele may enable cross-subsidies, for instance reaching more of the rural population, a simple shift allowing the poorer to be ignored is often related to the so-called 'mission drift' of MFIs. For all these reasons, donors' intervention, incentives or exit strategies should not neglect the clientele basis in their appraisal of the MFIs.

In this context, the issue becomes what one can expect from investment funds in microfinance. Other sources of funds are certainly not fully tapped. Many MFIs can attract more savings. New products can also provide additional financial resources to sustain their portfolio growth. Investment funds can be very useful, for instance to fund Greenfield MFIs. Investment funds targeting very high ROEs will however have serious difficulties in reaching very poor clients.

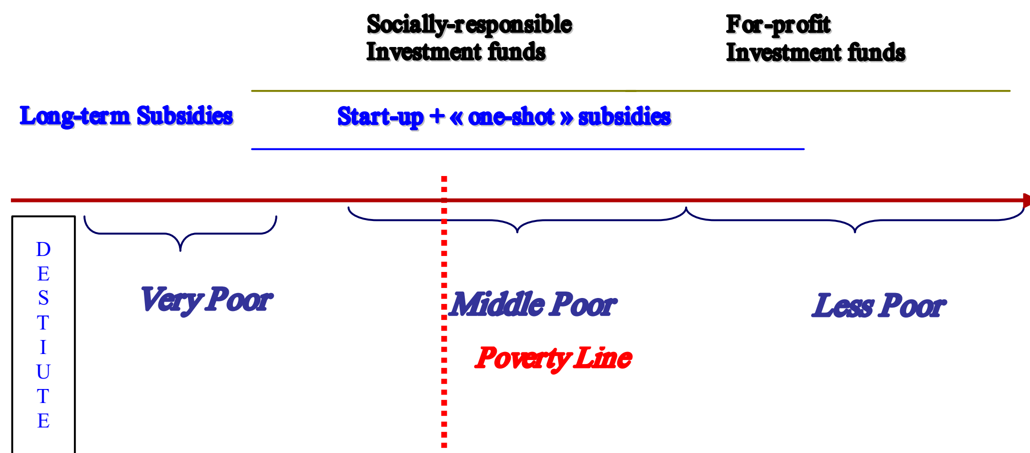
There is thus a rationale to separate international funds in two components: the socially-responsible funds and the fully commercial one. If donors want to see more commercial actors in the future, many analysts agree that they should now target more risky MFIs (Ivatury and Abrams, 2005). While the fully commercial funds will target safer clients or moderate poor in some cases, the socially responsible one and the donors should target riskier populations. As argued by Morduch (2005a): "subsidized credit does not equal "cheap credit" (i.e. credit at interest rates well below rates available elsewhere in the local credit market) and the poor incentives that ensue".

For very poor but potentially reliable clients, as described in the BRI case study, a two-step system can be developed. MFIs, for instance in collaboration with specialised NGOs, would first receive some subsidies or grants from private foundations to develop specific products. While the safe clients can be funded by the for-profit investment funds, the poorer but sill reliable population could be funded by socially responsible investors (Cfr Graph 2).

Abrams and von Stauffenberg (2007) report the case of a (government-owned) international institution offering an interest of 6% on a 4-year loan while private investors typically charge 8%-9% in the same market.. If the clientele is similar to the very poor but potentially reliable clients, one can consider that these sorts of financing could be done through socially-responsible funds rather than the public

ones. This assumption also relies on the fact that with the development of recognized social indicators, microfinance could well attract more socially-responsible funds.

Graph 2: The Microfinance Market and its funding source



Hence, rather than focusing strictly on the price that the institution is able to pay, donors should also take the relative poverty of the clientele into account in their funding decision. An inclusive approach to public policy would also be based on the client and not only the institution. Better poverty measurements or assessments of the clientele are therefore crucial for the institution to know what its clientele is but also for donors to help them to take the right decisions[29].

This graph is a broad picture of what is likely to emerge. Once again, the ownership composition is not per se the major success factor. This holds for each segment of the market. One can easily imagine some NGOs successfully serving wealthier clients. Similarly, under some conditions that reduce transaction costs such as the density or the personal costs, commercial actors could be interested in very poor clients.

[29] See, for instance, van Batselaer and Zeller (2006) on poverty assessments.

6. Conclusion

The last few decades have seen a dramatic development of MFIs, partly due to the international donors' support. These institutions serve populations that were until now thought to be too risky for sustainable banking. Nevertheless, few of them are sustainable and most actors agree that additional funds will be needed to serve the vast majority of excluded poor. In this paper, we have described the emergence of investment funds, the potential role of donors in these funds but also the challenge that they pose in the public policy debate in microfinance.

Despite these practices and approaches in microfinance, all actors agree that too many poor are still excluded from the financial sector. The demand for financial services is estimated, at minimum, at 500 million households (UNCDF). Donor's money is currently insufficient to reach all these potential borrowers. Some proponents of microfinance have stated that donors' microfinance budget should dramatically increase.

Many others consider that there is already too much money in microfinance and that we should first try to apply good practices to these investments and use any additional funds for other purposes. To find some additional funds public policy should be designed to facilitate the entry of new private actors without abandoning the markets that could not work without some public support.

After having separated socially-responsible investors from fully commercial ones, we have come up to an original classification of the different funding sources in the sector. The classification also provides examples of potential markets for long-term, start-up and "one-shot" subsidies. For very poor clients, a two-step system of grants and then socially-responsible funding is advocated.

Further research is needed to design more precise policies to implement these strategies. Furthermore, the various institutions' objectives in terms of sustainability or outreach could be added to this approach.

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