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MICROFINANCE  
EXPERTISE

# **Can “Bad” Microfinance Practices Be the Consequence of Too Much Funding Chasing Too Few Microfinance Institutions ?**

ADA, December 2010

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## THE ADA DISCUSSION PAPER SERIES

“Can ‘Bad’ Microfinance Practices Be the Consequence of Too Much Funding Chasing Too Few Microfinance Institutions ?” is the second issue of the ADA Discussion Paper series. Each ADA Discussion Paper raises a topic of interest, directly related to the microfinance sector. ADA distributes and presents the paper at different conferences, seminars and workshops and also organises a virtual debate (via an internet forum) in order to initiate discussions between microfinance professionals. In addition to the Discussion Paper, a Follow-Up Paper - which summarises participants' reactions and assesses their proposals for future action - is issued. We hope that the exchange of ideas with ADA, especially through these Discussion Papers, will continue to promote fruitful developments within the microfinance sector; and we look forward to your active participation in this exchange by sharing your experiences and opinions with us at: [discussion.ada@microfinance.lu](mailto:discussion.ada@microfinance.lu)



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## TABLE OF CONTENTS

<b>Foreword by Damian von Stauffenberg</b>	<b>7</b>
<b>Introduction</b>	<b>9</b>
<b>1. The Microfinance Funding Situation in Recent Years</b>	<b>10</b>
<b>2. Data Analysis: Is Too Much Funding Chasing Too Few MFIs</b>	<b>11</b>
2.1 The Funding by MIV Funders	11
2.2 The Funding of Group 1, Group 2 and Group 3 MFIs	13
<b>3. Argumentation: Can “Bad” Microfinance Practices Be the Result of Too Much Funding Chasing Too Few MFIs?</b>	<b>16</b>
3.1 The Perspective of MIV Funders	16
3.2 The Perspective of Group 1, Group 2 and Group 3 MFIs	17
<b>4. The Microfinance Sector Development in the Coming Years</b>	<b>18</b>
<b>Conclusion</b>	<b>19</b>
<b>Bibliography</b>	<b>20</b>



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## FOREWORD

by Damian von Stauffenberg, Director of MicroRate

Long the darling of development institutions, the media and, yes, even of private investors, microfinance suddenly finds itself on the defensive: are microfinance institutions (“MFIs” in the jargon) really helping the poor or are they exploiting them?

A rating agency provides a unique vantage point from which to search for answers. Since 1996, MicroRate has rated hundreds of MFIs. That experience leaves me convinced, that the hand-wringing we are seeing now and the uncritical enthusiasm for microfinance that preceded it, are both very much exaggerated. Microfinance never has had, and never will have the power to wipe poverty from the face of the earth; nor is commercial microfinance under a curse that compels it to exploit its clients. As all great untruths do, both claims contain enough truth to make them plausible. Microcredit really is effective in allowing poor people to improve their lives, but it cannot cure all the causes of poverty; and yes, credit is a two-edged sword: in the hands of unscrupulous or incompetent lenders it will make poor people even poorer. Microfinance therefore faces the double challenge of keeping expectations as well as abuses in check.

This paper explores problems with funding microfinance institutions. The words “funding problems” suggest scarcity. Surprisingly, the paper comes to the opposite conclusion. Often there is too much money. The reader should not imagine that all microfinance institutions are swimming in money. Most are not. But those that fund themselves internationally – a small minority, but a minority that includes practically all large institutions – find it difficult to absorb all the credit that is offered to them. Why? Over the last three years, MFIs have reduced their rate of growth. They still grow fast, but they no longer double in size every two years as many of them used to do. At the same time the financial sector in many developing countries has been surprisingly liquid. This has made it easy and cheap for most MFIs to borrow locally. Both of these trends have combined to reduce the demand for international funding. The supply of such funding, on the other hand, continues to expand. Microfinance investment vehicles (or “MIVs”) continue to grow, and official development finance institutions, far from stepping back to make room for private lenders, have aggressively expanded their lending to MFIs.

Isn't too much funding a good problem to have? For financial institutions, the answer is “decidedly not!”. An excess of funding leads to a host of problems. The institutions grow faster than is prudent; pressure to place their funds pushes them to lower their lending standards. Increasingly, we see MFIs competing for the same pool of clients, which in turn leads to multiple borrowing and over-indebtedness. Funders of MFIs, both public and private, are learning to cope with these problems, as are the MFIs themselves. Studies such as this one will accelerate the learning process, hopefully to the point where it leads to effective action.



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## INTRODUCTION

The microfinance sector has experienced years of consistent growth. After a moderate slow-down in the recent financial crisis, this trend is expected to continue in the future.

Funding, increasingly from microfinance investment vehicles (MIVs), has accompanied this growth and has reinforced some positive growth dynamics. Today, financially and socially well-performing MFIs can be found throughout all regions of the world, while still more innovative and healthy MFIs are being created. A significant number of individuals that were formerly excluded from the financial system are seen gaining access to sophisticated products and services and – with the help of microcredit, savings, insurance and other money management tools – progressing out of poverty.

However, funding, especially from MIVs, did not accompany the growth of the microfinance sector equally and might therefore also have contributed to some negative growth dynamics. It is often suggested that most MIVs focus almost exclusively on larger, older and more mature MFIs, and that only some of them also fund smaller, younger and less mature MFIs. This somewhat “careless” selection of institutions on the part of MIVs might, however, translate into a somewhat “careless” selection of clients and projects on the part of MFIs. The larger, older and more mature MFIs might grow even faster and become more competitive, but they might also become less strict in their analysis and follow-up of clients and projects, offering riskier loans, consumer loans and loans for other non-productive purposes, thereby contributing to repayment problems and to over-indebtedness. The smaller, younger and less mature MFIs, on the other hand, might have fewer opportunities to grow and to become more competitive, and they might see no chance to survive in the environment in which they operate, but to go very much “down-market”, also entering riskier areas, accepting riskier clients and offering riskier products and services, thereby contributing once again to repayment problems and to over-indebtedness.

This second issue of the ADA Discussion Paper series focuses on these very aspects. The first part of the paper describes the overall microfinance funding situation in the last few years. The second part of the paper analyses some data on the direction of MIV funds and discusses the issue of whether too much funding is indeed chasing too few MFIs. The third part of the paper formulates arguments from the perspective of MIVs and from the perspective of MFIs in order to approach the question whether “bad” microfinance practices can indeed be the result of a trend towards too much funding chasing too few MFIs. Finally, the fourth part of the paper offers suggestions for the development of the microfinance sector in the coming years.

The purpose of this paper is to initiate and to stimulate a discussion between microfinance professionals from around the world, and all readers are thus warmly invited to contact ADA with their ideas, comments or questions, by sending an email to: [discussion.ada@microfinance.lu](mailto:discussion.ada@microfinance.lu).

## 1. The Microfinance Funding Situation in Recent Years

The first part of the Discussion Paper presents the overall microfinance funding situation in the last few years.

As the data from 2008, 2009 and 2010 shows, the microfinance funding situation has improved consistently over the last few years: Both the funding from donors, foundations and investors (i.e. from the primary sources of funding, intermediaries not included), as well as the funding from MIVs (i.e. from the secondary sources of funding) has increased.

With regards to the **primary sources of funding**, the 2008 CGAP Microfinance Funder Survey<sup>1</sup>, which counted 54 respondents (among them bilateral and multilateral donors, foundations, development financial institutions, individual investors and institutional investors), found that 11.7 billion USD were committed to microfinance in 2007. The six largest funders thereby accounted for more than 50% of the overall funding, and an analysis by regions showed furthermore that Eastern Europe and Central Asia, as well as South Asia received close to 50% of the overall funding. The main funding instruments were debt, equity, loan guarantees and grants, with debt, comprising 63% of total funding, as the most widely used instrument.

The financial crisis does not seem to have affected the support of microfinance from primary sources of funding to a very large extent. The 2009 CGAP Microfinance Funder Survey<sup>2</sup> counted 61 respondents and the commitments of funds to microfinance increased by 24%, amounting to 14.8 USD billion in 2008. Commitments were roughly equal for donors and for investors, which reflects the growing importance of funding from investors. The five largest funders still accounted for about 50% of total funding, and an analysis by regions showed that South Asia, as well as Eastern Europe and Central Asia were still the main receivers of funds. Again, about two-thirds of total funding commitments were in the form of debt instruments, with grants comprising 17% of total funding, equity 11% and guarantees 5%.

On the **secondary sources of funding**, equally solid figures are observed<sup>3</sup>. As the annual MicroRate MIV Survey shows, total MIV assets grew by an impressive 97% in 2007 to reach 3.9 billion USD. In 2008, they still increased by 28% to reach 4.9 billion USD, and in 2009, they increased by another 22% to reach over 6 billion USD. There is, of course, a slow-down in the growth figures from 2007 to 2008 and again from 2008 to 2009. Nevertheless, the figures are still very remarkable, considering that, even in times of financial crisis, 11 new MIVs were created and were able to attract over 1 billion USD in additional funding.

Furthermore, as the 2009 CGAP MIV Survey finds, from 2007 to 2009, the Top 5 MIVs always accounted for about 50% of assets under management. Their investments were mainly concentrated on Eastern Europe, as well as on Latin America, and fixed income investments dominated, with equity investments growing fast.

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<sup>1</sup> See CGAP (2008).

<sup>2</sup> See CGAP (2009a).

<sup>3</sup> See MicroRate (2010), CGAP (2009b).

## 2. Data Analysis:

### Is Too Much Funding Chasing Too Few MFIs?

Having described the positive aspects of the microfinance funding situation in recent years, we now also need to consider the negative aspects of this development.

The MicroRate MIV Survey, mentioned above<sup>4</sup>, considers it a reason for concern that MIVs are finding it difficult to place their funds. According to the authors, the part of MIV assets that ends up in microfinance is on the decrease, while MIV liquidity is increasing, and this trend does not appear to be changing.

What is more, a study by the Microfinance Information Exchange (MIX)<sup>5</sup> suggests that there is not only too much funding by MIVs and also by investors, foundations and donors, but that there is also a concentration of this funding in only a few MFIs. And this trend too does not appear to be changing.

In the second part of this paper, we will now analyse some data on the direction of microfinance funds. We will try to find out whether the largest part of the funding does indeed flow to only a small number of MFIs, namely to the older and more mature MFIs, with a much smaller part flowing to the mass of the MFIs, namely to the younger and less mature MFIs. And we will discuss this issue by first looking at 7 top MIV funders and then looking at the so-called “group 1”, “group 2” and “group 3” MFIs.

#### 2.1 The Funding by MIV Funders

Using the data available on the MIX, we listed all the funders by their total allocated microfinance funds and identified the first 10 funders on this list. Among these Top 10 funders, we found 7 MIVs and focused on analysing their outstanding amounts to microfinance institutions in the years 2007, 2008 and 2009.<sup>6</sup>

In 2007, as shown on Table 1, the 7 top MIVs funded 405 MFIs and had outstanding amounts of 1.07 billion USD. In 2008, they funded 508 MFIs and had outstanding amounts of 1.57 billion USD, and in 2009, they funded 574 MFIs and had outstanding amounts of 1.60 billion USD.

**NUMBER OF MFIs FUNDED, TOTAL OUTSTANDING AMOUNTS AND AVERAGE OUTSTANDING AMOUNTS OF THE 7 TOP MIVs FROM 2007 TO 2009**

**TABLE 1**

	2007	Growth in percentage 2007-2008	2008	Growth in percentage 2008-2009	2009
Number of MFIs funded	405	25.43%	508	12.99%	574
Total outstanding amounts (in thousand USD)	1 066 296	47.54%	1 573 240	1.53%	1 597 321
Average outstanding amounts (in thousand USD)	2 633	17.62%	3 097	-10.14%	2 783

The total number of MFIs funded by the 7 top MIVs thus grew by 25% from 2007 to 2008, and by 13% from 2008 to 2009. The total outstanding amounts of the 7 top MIVs, however, grew by 48% from 2007 to 2008, and by only 2% from 2008 to 2009, i.e. in times of financial crisis. These developments are illustrated in Chart 1.1 and Chart 1.2.

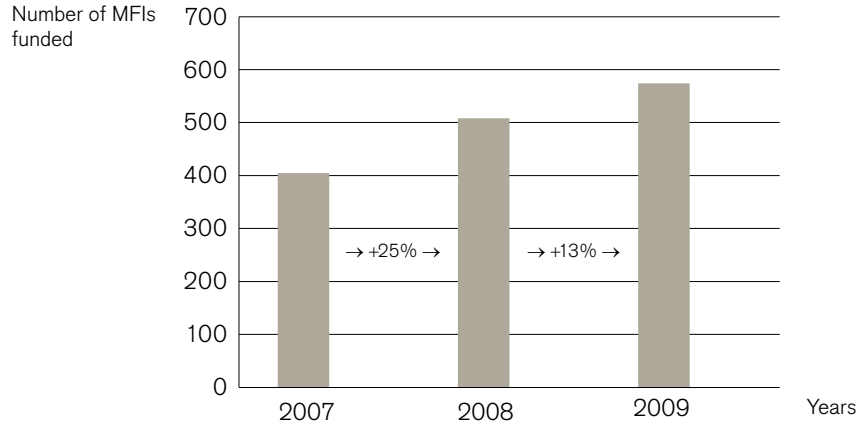
<sup>4</sup> See MicroRate (2010).

<sup>5</sup> See MIX (2010 a).

<sup>6</sup> Unfortunately, we were unable to conduct an analysis of the entire group of Top 10 funders, as only 8 of these funders provided us with their complete data.

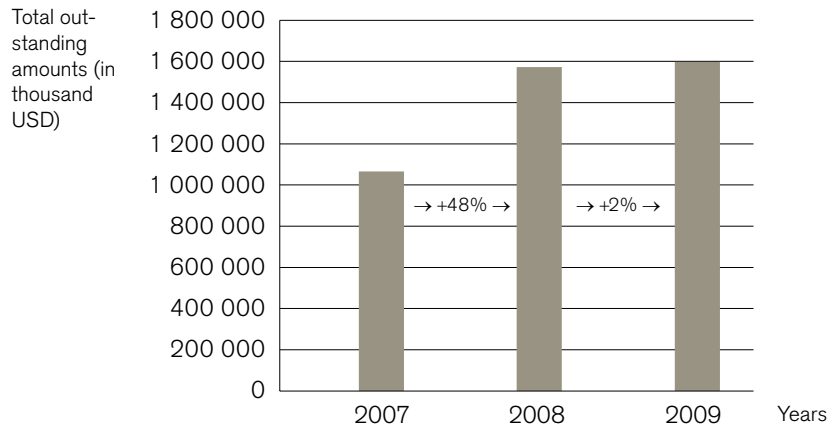
**CHART 1.1 NUMBER OF MFIs FUNDED BY THE 7 TOP MIVs FROM 2007 TO 2009**

The 7 top MIVs funded 405 MFIs in 2007, 508 MFIs in 2008 and 574 MFIs in 2009. The total number of MFIs funded thus grew by 25% from 2007 to 2008, and by 13% from 2008 to 2009.



**CHART 1.2 TOTAL OUTSTANDING AMOUNTS OF THE 7 TOP MIVs FROM 2007 TO 2009**

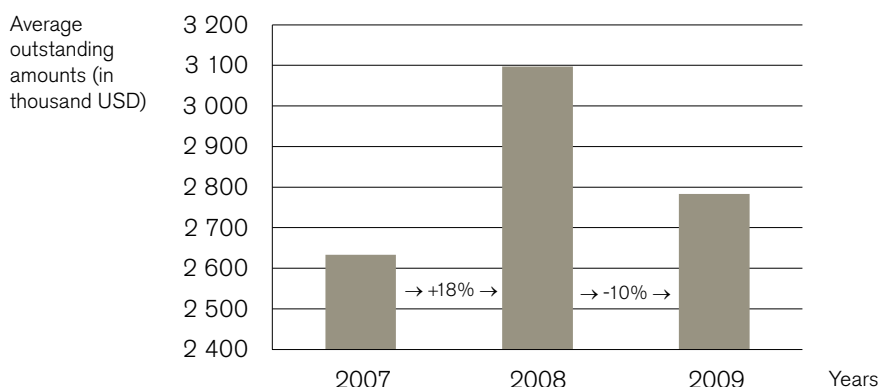
The 7 top MIVs had total outstanding amounts of 1.07 billion USD in 2007, 1.57 billion USD in 2008 and 1.60 billion USD in 2009. The total outstanding amounts thus grew by 48% from 2007 to 2008, but by only 2% from 2008 to 2009, i.e. in times of financial crisis.



The average outstanding amounts of the 7 top MIVs lay at 2.63 million USD in 2007, at 3.10 million USD in 2008 and at 2.78 million USD in 2009. The average outstanding amounts of the 7 top MIVs thus increased by about 500 thousand USD or 18% from 2007 to 2008, but decreased by about 300 thousand USD or 10% from 2008 to 2009, i.e. in times of financial crisis. These developments are illustrated in Chart 2.

## AVERAGE OUTSTANDING AMOUNTS OF THE 7 TOP MIVs FROM 2007 TO 2009

CHART 2



The average outstanding amounts of the 7 top MIVs lay at 2.63 million USD in 2007, at 3.10 million USD in 2008 and at 2.78 million USD in 2009. The average outstanding amounts thus increased by 18% from 2007 to 2008, but decreased by 10% from 2008 to 2009, i.e. in times of financial crisis.

The development in the number of funded MFIs and in the total outstanding amounts to microfinance institutions from 2007 to 2009 shows that the 7 top MIVs continued to support the growth of the microfinance sector even during and after the financial crisis.

The relatively high average outstanding amounts to microfinance institutions over the same period, however, show that this support focused mainly on larger, older and more mature institutions and not on smaller, younger and less mature institutions – a fact that stands out even further when considering the following data.

### 2.2 The Funding of Group 1, Group 2 and Group 3 MFIs

Using the data available on the MIX, we listed all MFIs by their total assets and then examined them more closely: MFIs in the first 250 places held total assets of over 30 million USD, and all MFIs in this range formed our so-called “group 1 MFIs”, MFIs in places 251 to 400 held assets totalling between 30 million USD and 10 million USD and made up our “group 2 MFIs”, and the remaining MFIs in places 401 onwards held total assets below 10 million USD and made up our “group 3 MFIs”.

In 2007, as can be seen in Table 2, the outstanding amounts of the 7 top MIVs to group 1 MFIs lay at about 918 million USD, while the outstanding amounts to group 2 and group 3 MFIs lay at about 102 million USD and 46 million USD, respectively. Similarly, in 2008, outstanding amounts to group 1 MFIs reached 1.37 billion USD, outstanding amounts to group 2 MFIs reached 151 million USD, and outstanding amounts to group 3 MFIs reached 56 million USD. And again, in 2009, group 1 MFIs were granted outstanding amounts of 1.36 billion USD, group 2 MFIs outstanding amounts of 156 million USD and group 3 MFIs outstanding amounts of 78 million USD.

<sup>7</sup> We used this classification of MFIs because, so far, the sector has not yet agreed on one single and clear definition of “Tier 1”, “Tier 2” and “Tier 3” organisations.

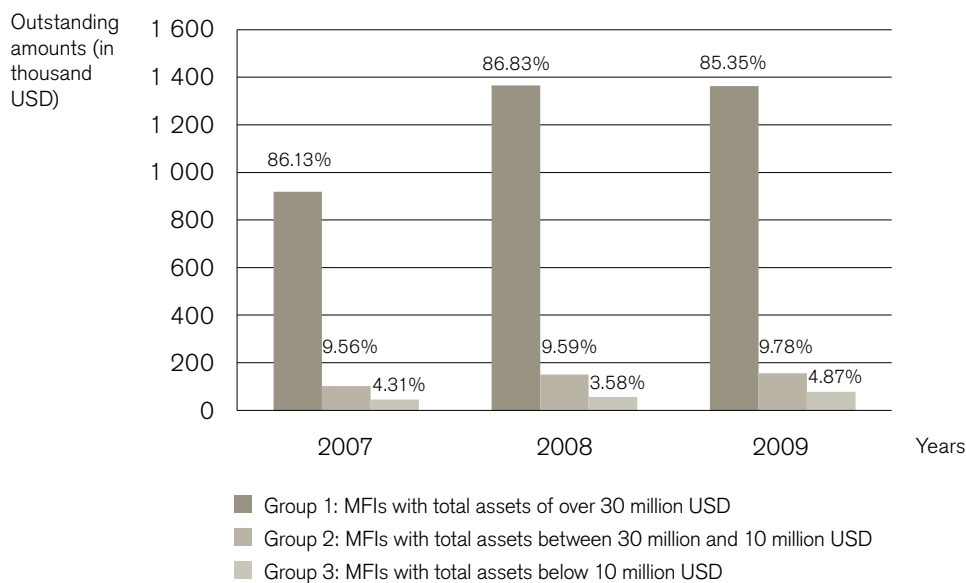
**TABLE 2** OUTSTANDING AMOUNTS OF THE 7 TOP MIVs FROM 2007 TO 2009 BY GROUPS OF MFIs

	2007		2008		2009	
	Outstanding amounts (in thousand USD)	Percentage of total	Outstanding amounts (in thousand USD)	Percentage of total	Outstanding amounts (in thousand USD)	Percentage of total
<b>Group 1 MFIs</b>	918 343	86.13%	1 366 088	86.83%	1 363 365	85.35%
<b>Group 2 MFIs</b>	101 902	9.56%	150 817	9.59%	156 196	9.78%
<b>Group 3 MFIs</b>	46 052	4.31%	56 335	3.58%	77 760	4.87%
<b>Total</b>	1 066 296	100%	1 573 240	100%	1 597 321	100%

Thus, every year from 2007 to 2009, group 1 MFIs' outstanding amounts reached about 86% of total outstanding amounts, group 2 MFIs' outstanding amounts reached about 10%, while group 3 MFIs' outstanding amounts only reached about 4%. This distribution is illustrated in Chart 3.

**CHART 3** OUTSTANDING AMOUNTS OF THE 7 TOP MIVs FROM 2007 TO 2009 BY GROUPS OF MFIs

Every year from 2007 to 2009, group 1 MFIs' outstanding amounts reached about 86% of total outstanding amounts, group 2 MFIs' outstanding amounts reached about 10%, while group 3 MFIs' outstanding amounts only reached about 4%.



MIV funding in 2007, 2008 and 2009 did not only focus on particular MFI groups, but also on particular regions of the world.

More specifically, we find that Eastern Europe and Central Asia (EECA), as well as Latin America and The Caribbean (LAC) were the two primary regions in terms of total outstanding amounts, with East Asia and The Pacific (EAP) following at a certain distance.

Table 3 shows the outstanding amounts of the 7 top MIVs by world regions between 2007 and 2009. As can be seen, the outstanding amounts to MFIs in Eastern Europe and Central Asia (EECA) reached 49% of the total outstanding amounts in 2007, 48% in 2008 and 45% in 2009. Furthermore, the outstanding amounts to MFIs in Latin America and the Caribbean (LAC) reached 22% of the total outstanding amounts in 2007, 24% in 2008 and 23% in 2009. And finally, the outstanding amounts to MFIs in East Asia and The Pacific (EAP) reached 7% of the total outstanding amounts in 2007, 10% in 2008 and 8% in 2009.

## OUTSTANDING AMOUNTS OF THE 7 TOP MIVs FROM 2007 TO 2009 BY WORLD REGIONS

TABLE 3

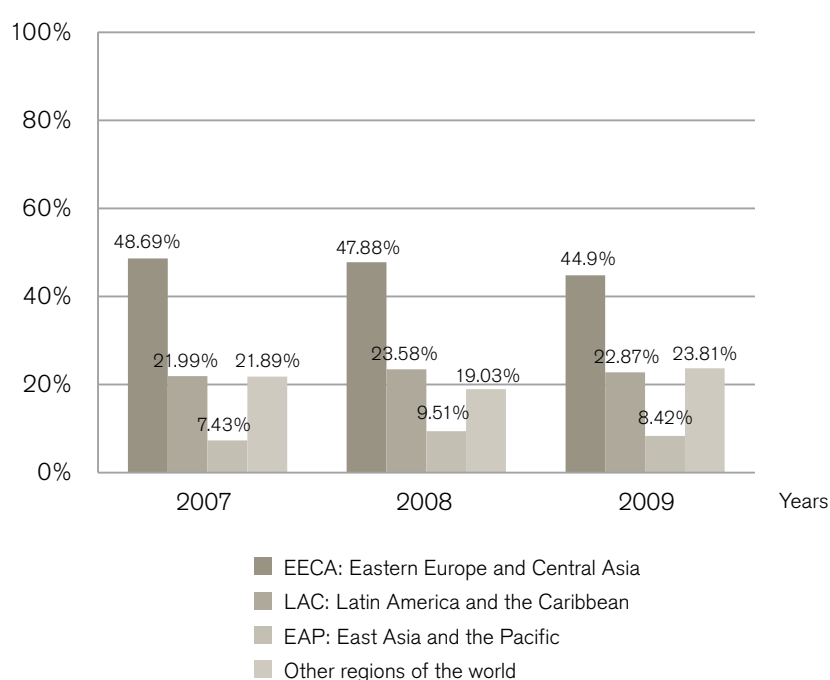
	2007		2008		2009	
	Outstanding amounts (in thousand USD)	Percentage of total	Outstanding amounts (in thousand USD)	Percentage of total	Outstanding amounts (in thousand USD)	Percentage of total
<b>EECA</b>	519 166	48.69%	753 222	47.88%	717 193	44.90%
<b>LAC</b>	234 451	21.99%	370 978	23.58%	365 258	22.87%
<b>EAP</b>	79 278	7.43%	149 663	9.51%	134 497	8.42%
<b>Other</b>	233 401	21.89%	299 377	19.03%	380 373	23.81%
<b>Total</b>	1 066 296	100%	1 573 240	100%	1 597 321	100%

Thus, every year from 2007 to 2009, the part of the outstanding amounts to MFIs in Eastern Europe and Central Asia (EECA), Latin America and The Caribbean (LAC), as well as East Asia and The Pacific (EAP), taken together, amounted to about 78%, while the part of the total outstanding amounts to MFIs in the rest of the world only amounted to about 22%. This distribution is illustrated in Chart 4.

## OUTSTANDING AMOUNTS OF THE 7 TOP MIVs FROM 2007 TO 2009 BY WORLD REGIONS

CHART 4

Parts of the outstanding amounts (in percentage)



Every year from 2007 to 2009, the part of the outstanding amounts to MFIs in Eastern Europe and Central Asia (EECA), Latin America and The Caribbean (LAC), as well as East Asia and The Pacific (EAP), taken together, amounted to about 78%, while the part of the total outstanding amounts to MFIs in the rest of the world only amounted to about 22%.

The distribution of MIV funds shows that the largest part of this microfinance funding does indeed flow to only a few MFIs, namely to the most mature MFIs in the most mature microfinance regions, with a much smaller part flowing to the mass of MFIs, namely to the younger and less mature MFIs in the less mature microfinance regions. In other words: there seem to exist valid reasons to conclude that too much funding is chasing too few MFIs.

### 3. Argumentation: Can “Bad” Microfinance Practices Be the Result of Too Much Funding Chasing Too Few MFIs?

Having demonstrated that the largest part of the funding of the 7 top MIV funders is indeed flowing to the older and more mature group 1 MFIs, with only a much smaller part going to the younger and less mature group 2 and group 3 MFIs, we now also need to consider the possible consequences of such a trend.

According to a recent contribution to the Microfinance Open Book Blog<sup>8</sup>, the microcredit crises in Nicaragua, Morocco, Bosnia Herzegovina, Pakistan and very recently also in India constitute the bursting of a microfinance “bubble”, a “bubble” inflated by MFIs who granted ever increasing loans to their clients without even asking whether they could “handle” them. However, as microfinance professionals admit in interviews, presentations, and informal conversations<sup>9</sup>, this “bubble” is linked to yet another “bubble”, one inflated by funders who granted ever increasing loans to MFIs, once again without even asking whether they can “handle” them.

In the third part of the paper, we will present some arguments to discuss the issue of whether “bad” microfinance practices can indeed be the consequence of a trend towards too much funding chasing too few MFIs. We will do this by assessing the situation first from the perspective of MIV funders and then from the perspective of group 1, group 2 and group 3 MFIs.

#### 3.1 The Perspective of MIV Funders

Today **MIV funders** face the following reality<sup>10</sup>:

MIVs receive more and more funds from various types of investors, with various types of investment goals. In order to live up to institutional as well as individual expectations, each MIV is forced to develop a detailed strategy. MIVs are thus in a situation of abundant funds, but also in a situation of pressing placement objectives, and this situation might lead MIV funders to fail to perform a “consistently careful” selection of MFIs.

When MIV funders are looking for fundable MFIs, they find that most (even if not all) of group 1 MFIs are regulated and regularly monitored by the supervision authority according to certain pre-defined criteria. They have already performed financial and social ratings, and so there is enough information and data available on their past performance. On this basis, an assessment of their future potential is relatively quick and easy, and their funding seems to carry low risks. Furthermore, the relationship with group 1 MFIs appears to be professional. By contrast, funders find that many (even if not all) of group 2 and group 3 MFIs are not regulated and regularly monitored by the supervision authority. They have not yet performed financial or social ratings, and so there is not enough information and data available on their past performance. On this basis, an assessment of their future potential is relatively slow and difficult, and their funding sometimes seems to carry higher risks. Furthermore, the relationship with group 2 and group 3 MFIs appears to be characterized by a lot of assistance (also in domains such as management, information systems etc.).

**MIV funders who are in a situation of abundant funds and pressing placement objectives might fail to perform a “consistently careful” selection of MFIs.**

<sup>8</sup> See Microfinance Open Book Blog (2010).

<sup>9</sup> See SOS Faim (2010), Microfinance Focus (2010) .

<sup>10</sup> See Microfinance Focus (2010).

### 3.2 The Perspective of Group 1, Group 2 and Group 3 MFIs

MFIs face the following reality<sup>11</sup>:

**Group 1 MFIs** know the funders and are known by the funders, they are able to produce and to diffuse data and information on their institution, and they can thus set up the right funding relationships at the right time. They are in a situation where they have abundant funds at their disposal and easy access to new funds. This helps them to grow even faster, to become even more profitable and to offer even more competitive conditions. However – similarly to MIVs – group 1 MFIs are also in a situation in which they feel pressure to place their funds, and this situation might mean that group 1 MFIs may fail to be “sufficiently selective”.

As we suppose, group 1 MFIs might thus continue engaging in overlapping activities, i.e. they might pursue their focus on the same areas, approaching the same clients and proposing the same products and services, and this might make it much easier for clients to engage in multiple borrowing. Furthermore, group 1 MFIs might offer consumer loans and loans for other non-productive purposes, and they might engage in a less careful analysis and follow-up of clients and projects, which again might make it much easier for clients to engage in borrowing beyond their means. So, group 1 MFIs, with their abundant funds, might contribute to the over-indebtedness of clients and to failures of MFIs<sup>12</sup>.

**Group 2 and group 3 MFIs** face a different situation. For them finding funding alternatives is a challenge. Funders define minimum requirements relating to age, size and performance of institutions and often apply them to group 2 and group 3 MFIs just as they apply them to group 1 MFIs. However, group 2 and group 3 MFIs do not yet meet these requirements or they are unable to provide the respective data and information on their institution. Establishing a productive funding relationship at the right time is therefore difficult and costly. They are in a situation in which they have only modest funds at their disposal and difficult access to new funds. This does not allow them to grow any faster, to become any more profitable and to offer any more competitive conditions, and so this situation might also mean that group 2 and group 3 MFIs may fail to be “sufficiently selective”.

As we suppose, group 2 and 3 MFIs may see no other chance of survival in the competitive environment they operate in, but to go considerably “down-market”, thereby also entering riskier areas, accepting riskier clients and offering riskier products and services. This may occasionally be a deliberate move, but is very often due to a lack of resources and tools, required to carry out a careful analysis of these very risks. As a result, group 2 and group 3 MFIs, with their limited funds, may also contribute to the over-indebtedness of clients and to failures of MFIs.

When considered under this angle, there does indeed appear to be a parallel between the funders’ somewhat “careless” selection of institutions and the MFIs’ somewhat “careless” selection of clients and projects. Or in other words: there seem to exist valid reasons to conclude that “bad” microfinance practices may be the consequence of too much funding chasing too few MFIs.

**Many group 1 MFIs have abundant funds at their disposal and easy access to new funds. This helps them to grow faster, but it might also mean that group 1 MFIs fail to be “sufficiently selective”.**

**Most group 2 and group 3 MFIs have only modest funds at their disposal and difficult access to new funds. This does not allow them to grow very fast, and it might also mean that group 2 and group 3 MFIs fail to be “sufficiently selective”.**

<sup>11</sup> See CGAP (2010), MIX (2010 a, 2010 b).

<sup>12</sup> See CGAP (2010), Le Monde (2010). As mentioned in the article in Le Monde, a recent study undertaken by an IRD-CIRAD team (Institut de Recherche pour le Développement and Centre de coopération Internationale en Recherche Agronomique pour le Développement) found that, in general, 8 out of 10 loans are used for non-productive purposes.

## 4. The Microfinance Sector Development in the Coming Years

What must be stressed here is that it would not be a problem if there was fair competition between MFIs in terms of funding, i.e. if the “better” MFIs received the larger amounts of funds and the “worse” MFIs the smaller amounts. Fair competition, leading to a consolidation of the microfinance sector and to an elimination of those institutions with a lower performance and with less potential, would – to a certain extent – be rather welcome. The problem lies in the fact that there is no fair competition between MFIs in terms of funding. Group 1 MFIs have better access to funding not on account of always achieving the highest performance and of presenting the most potential; and group 2 MFIs have limited access to funding not on account of always achieving lower performance and of presenting the least potential. In some cases, the performance and potential of group 2 MFIs are even higher than those of group 1 MFIs. The issue is that funders with their abundant funds and pressing placement objectives do not always carry out a very “careful” selection of institutions. Furthermore, the problem would not be the cause of such concern if group 1 MFIs with their large amounts of funds only engaged in “good” practices and brought the whole microfinance sector forward. The problem lies in the fact that this unequal funding situation might in turn lead both group 1 MFIs as well as group 2 and group 3 MFIs to make a less “careful” selection of clients and projects and to engage in various “bad” microfinance practices.

The dynamics described, are challenges that are to be tackled with the greatest eagerness, out of concern for the development of the microfinance sector in the coming years. But, how can the matching of funders and MFIs be improved, and what can be done to create further opportunities, particularly for high potential newcomers?

Ratings of MFIs, just as labels for MIVs might play a crucial role in this context. Ratings allow MFIs to communicate about their strengths and weaknesses and help MIVs in making decisions on the placement of their funds. Similarly, labels allow MIVs to communicate about their strengths and weaknesses and help investors in making decisions on the placement of their funds. Ratings and labels contribute to the overall transparency within the sector, but in order for them to be effective in playing their selection and disciplining function, the issue of what information and data the ratings and labels should contain, how much they should cost and who should pay for them, must be answered in further detail.

**The creation of more MIVs with a structure that allows for a better risk management might be one important contribution to the microfinance sector development in the coming years.**

Another important contribution to the development of the microfinance sector could be the establishment of a greater number of MIVs with a structure that allows them to be more effective in managing their risks, resulting in an ability to take more risks in the first place (for example by making shares of one class guarantee for shares of another class). Such MIVs might be more attracted to investing into smaller, younger and less mature MFIs and could help these high potential newcomers to grow, to become more profitable and to be able to offer more competitive conditions.

Furthermore, besides commercial funds, the sector also needs subsidy funds, paying for technical assistance, independent of, but in addition to funding. For this purpose, a greater number of organisations offering technical assistance (such as capacity building measures, management support, the development of indicators and tools etc.), especially for smaller, younger and less mature MFIs, should be created, and existing ones should be given better promotion.

Achieving these goals, requires joint efforts from all directions.

Let us discuss how we can best deal with this challenge.

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## CONCLUSION

This second ADA Discussion Paper analysed some data on the direction of microfinance funds and found that too much funding is chasing too few MFIs. The average outstanding amounts of the 7 top MIVs lay at 2.63 million USD in 2007, 3.10 million USD in 2008 and 2.78 million USD in 2009. Furthermore, every year around 86% of the total outstanding amounts of the 7 top MIVs went to the first 250 MFIs, some 10% went to the next 150 MFIs, and only about 4% went to the remaining MFIs. Finally, every year from 2007 to 2009, the part of the outstanding amounts to MFIs in Eastern Europe and Central Asia (EECA), Latin America and The Caribbean (LAC), as well as East Asia and The Pacific (EAP), taken together, amounted to about 78%, while the part of the total outstanding amounts to MFIs in the rest of the world only amounted to about 22%.

The paper formulated some arguments from the perspective of MIVs and from the perspective of MFIs and suggested that there appear to exist valid reasons to conclude that “bad” microfinance practices can be the consequence of too much funding chasing too few MFIs. For MIVs with abundant funds at their disposal and pressing placement objectives, the past performance and the future potential of large and more mature MFIs are naturally easier and less costly to evaluate; at the same time, funding smaller and less mature MFIs seems to involve more risks. However, MIVs concentrating their funding on the older and more mature MFIs may lead to the following: older, more mature MFIs might grow even faster, but might also become less strict in their analysis and follow-up of projects, offering riskier loans, consumer loans and loans for other non-productive purposes, thereby contributing to the over-indebtedness of clients. Meanwhile, there might be fewer opportunities for the younger, less mature MFIs to grow, and so they might see no other chance of survival in the environment they operate in, but to go considerably “down-market”, also entering riskier areas, accepting riskier clients and offering riskier products and services. And all of this, once again, might contribute to the over-indebtedness of clients.

The paper finally makes some suggestions on how to improve the matching of MIVs and MFIs and how to create further opportunities, especially for high potential newcomers. It states that ratings of MFIs and labels for MIVs, the creation of more MIVs with a structure that allows for a more efficient risk management, as well as the support of more organisations that offer technical assistance might be important contributions in this context, but that joint efforts will be required to achieve all of this.

As mentioned at the beginning, the purpose of this paper is to initiate and to stimulate a discussion between microfinance professionals from around the world, and all readers are thus warmly invited to contact ADA with their ideas, comments or questions, by sending an email to: [discussion.ada@microfinance.lu](mailto:discussion.ada@microfinance.lu).

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