

*This is the third of three MBP Technical Briefs focused on natural disaster preparedness. This brief discusses donor actions to prepare microfinance institutions (MFIs) for unexpected natural disaster; Brief No. 6 discusses MFI techniques to protect their institutions and staff from disasters; and Brief No. 7 discusses MFI techniques to prepare clients for disasters.*

# Microfinance Donors: Preparing For Natural Disaster<sup>1</sup>

Donors hold substantial resources to respond to rapid-onset natural disasters. But to respond effectively requires information and thoughtful policies. Therefore, the first task of donors is to understand the risks posed by rapid-onset natural disasters or other crises to the microfinance industry. As microfinance programs penetrate ever more difficult environments, often at donor urging, risk levels facing the industry have increased while risk management skills have remained rudimentary. Secondly, donors need to understand the challenges facing microfinance institutions (MFIs) when crises strike. These challenges have been increasingly documented but are not yet common knowledge across the industry.

Finally, donors need to examine their own roles in risk-proofing the microfinance industry against unexpected large-scale disasters. These roles and responsibilities are the topic of this technical brief.

## FOUR AREAS FOR DONOR ACTION

### 1. Even in the Face of Disaster, Promote Microfinance Sound Practices

Most importantly, donors should encourage disaster-struck MFIs to remain faithful to long-term objectives of providing sustainable financial services at the best cost to poor clients. There are three specific areas where donors can be particularly supportive:

- ❑ **Donors should never set up new MFIs as a response to natural disasters.** MFIs born in disaster times do not have the necessary experience, systems, or knowledge about clients to make smart long-term decisions about post-disaster lending, and the vast majority do not mature into well-functioning MFIs. Moreover, newly established MFIs that are not well versed in the principles of microfinance can threaten the integrity and success of existing MFIs. Instead, donors should support established MFIs that are better equipped to deal with the early stages of disaster, particularly if they have an extensive branch network.



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**MICROENTERPRISE BEST PRACTICES**

Development Alternatives, Inc., 7250 Woodmont Avenue, Suite 200, Bethesda, MD 20814 USA

- ❑ **Donors should not encourage MFIs to forgive client debts or make financial grants to clients after a disaster.** Donors can help educate other donors and government counterparts that debt forgiveness, while well meaning, undermines the long-term goals of the institution. Likewise, distribution of grant monies can undermine clients' long-term credit discipline. Debt rescheduling or emergency low-interest loans may be called for in MFI branches heavily affected by disaster, but these policies should be determined within the MFI.<sup>2</sup>
- ❑ **Donors should not expect MFIs to serve as social safety nets for communities or even all clients.** Donors should avoid burdening long-term MFI operations with the cost of relief operations. If MFIs do distribute relief supplies in the immediate period after a disaster strikes, then it is appropriate for donors to use grant funds to compensate MFIs for these activities. This helps MFIs return to full capitalization after a disaster, while still allowing them to participate in immediate relief efforts. Moreover, donors can guide relief and government institutions to quickly step into the breach after disaster strikes, relieving MFIs of ongoing relief activities that would undermine the MFI's recovery process (see Brief No. 4: "Non-Financial Emergency Services to MFI Clients").

Following these principles preserves the strength and integrity of the overall microfinance industry. It requires that donors follow a long-term development vision in the face of enormous pressure to respond to a disaster "at all costs."

## 2. Prepare a Natural Disaster Response Policy for MFIs

Efficient donor support to disaster-struck MFIs depends on the existence of clear policies within the donor institution that are communicated to the MFI community *before* disasters strike. Such a policy should include the following elements:

- ❑ Identify which MFIs have shown stability and financial responsibility—and be prepared to provide financial resources to help these MFIs recover from disaster.<sup>3</sup>
- ❑ Decide on the terms and conditions under which disaster funds will be made available to qualifying MFIs. For what purposes will *grant* funds be available? For what purposes will *loan* funds be available? What rate should be charged on loan funds?<sup>4</sup> What institutional structure is most appropriate for managing and distributing funds?
- ❑ Design a standard format for MFI post-disaster resource requests. What sort of pre- and post-disaster information will the MFI have to provide to prove the actual level of damages sustained by the institution and its clients? What post-disaster reporting will be required to account for disaster-relief monies?
- ❑ Have a plan to move emergency funds quickly to qualifying MFIs.<sup>5</sup> If emergency monies cannot be accessed quickly within donor institutions, where else can donors obtain funds to deal with immediate requirements (within a few weeks of the disaster)? Are the conditions in place to pursue the establishment of a long-term disaster loan fund to provide emergency liquidity to MFIs when disasters strike?<sup>6</sup> Finally, the microfinance unit within the donor agency should identify which department within its agency is most likely to provide disaster response funding and ensure that this department understands microfinance at a basic level.

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- ❑ Set up a mechanism for post-disaster inter-donor coordination. In post-disaster situations, donors may mobilize large amounts of money for specific regions or institutions without being aware of what other donors are doing. Donor coordination avoids duplication of efforts, improves outreach to clients in more remote locations, and may reduce information collection costs to individual donors.

If a donor has a concrete disaster policy, including an emergency financing strategy and knowledge of MFI capabilities, financial support can be moved quickly to MFIs that can manage it properly and reach disaster victims when help is most needed.

### **3. Provide Disaster Preparation Support to the MFI Industry**

Preparing for disasters that may or may not strike costs money, which is a scarce commodity in an industry still striving to reach full financial cost recovery. Obviously, many MFIs may resist investing in the unknown. Donors have an important role to play in providing financial incentives for MFIs to plan wisely. This may be done by investing directly in public goods or by supporting targeted investments in risk-reduction strategies or development of new products.

Donors may choose to channel industry-wide resources into a nationwide network of MFIs or a national apex organization that can serve as a public clearinghouse of information and support to individual MFIs. This strategy not only reduces the donors' costs of dealing with individual MFIs, but it also provides the donors an institutional setting to discuss technical issues with MFIs outside of the donor-MFI relationship.

Donors may want to encourage or invest in the following preparedness activities:

- ❑ Liaison with early warning systems and disseminate this information regularly to MFIs;<sup>7</sup>
- ❑ Develop safekeeping systems for duplicate MFI records;
- ❑ Give support to MFIs so that they can purchase disaster-resistant communication systems, such as cell phones;
- ❑ Train MFI leadership and staff in disaster preparedness;
- ❑ Collect information from a range of commercial banks, donors, and other institutions to identify policies and requirements for large-scale emergency loans;
- ❑ Support alliances between qualifying MFIs and emergency funders;
- ❑ Develop industry-wide techniques for assessing damage from natural disasters;
- ❑ Serve as a conduit for international research on disaster-proofing products and techniques for MFIs and their clients (such as housing loans to improve quality of construction in floodprone areas);

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- ❑ Document and disseminate high-quality risk-proofing efforts within the industry to encourage local adoption; and
  - ❑ After disasters, support the dissemination of information from relief and government organizations to MFIs.

#### **4. Develop a Consensus on Disaster Response in the Microfinance Industry**

Even in the best of times, MFIs struggle with countless technical issues that emerge continually, leaving little time to plan for unexpected events. But sudden natural disasters can undermine even the most stable and well-managed MFIs. In fact, some of the most successful MFIs—those that rely on client savings to fund all or part of their loan portfolio—are the most vulnerable to natural disasters, when vast numbers of clients may require access to savings at the same time that loan repayments slow to zero. The resulting liquidity crisis can drain the reserves of even the largest and most stable MFIs. The result is that MFIs turn to donors for emergency support to weather the crisis.

Donors have a voice in encouraging, or even insisting, that MFIs undertake proper disaster-preparedness planning to minimize the impact of disasters on the industry and their clients. In particular, donors and MFIs should discuss the following:

- ❑ Although donors may agree to serve as the “lender of last resort” in the case of colossal disasters (such as 1998’s floods in Bangladesh and Hurricane Mitch in Central America), should well-managed MFIs be prepared to cope with disasters of smaller proportions? Should the industry develop and incorporate disaster funds or insurance products that can protect clients and MFI portfolios in the case of disaster? If so, donors may agree to fund development and pilot testing of these products and may also provide capital to seed specific MFI disaster funds.
- ❑ What are appropriate reserve requirements, given the magnitude and expected frequency of natural disasters in a given geographic area? Are current MFI reserve requirements adequate to deal with moderate-sized disasters? If not, what would be the effects on MFI capitalization and client interest rates if reserve requirements were raised? Are donors willing to step in with emergency capital if MFIs have not incorporated risk into their reserve planning?
- ❑ If MFIs are willing to shoulder some of the financial risks of disaster, are donors also prepared to support, fund, or manage a national or international disaster reserve fund such as a DLF? What liabilities might this fund protect against, and what standards of preparedness, general operations, and reporting would be required for MFIs to access such a fund?

These discussions cannot take place in an environment still recovering from a disaster. But they should take place while memory of large disasters is still fresh in everyone’s mind and before another disaster strikes. Once a dialogue is under way, it is reasonable for donors to provide post-disaster support only to those institutions that are willing to work as partners in risk management. Donor support of irresponsible MFIs will only undermine efforts to direct the

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microfinance industry to address the questions of adequate risk management for their own portfolios and their clients.

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## ENDNOTES

- <sup>1</sup> This document draws on information presented in MBP papers, "Microfinance in the Wake of Natural Disasters: Challenges and Opportunities," by Geetha Nagarajan, 1998; "Bangladeshi Experience in Adapting Financial Services to Cope with Floods: Implications for the Microfinance Industry," by Warren Brown and Geetha Nagarajan, 2000; and "Disaster Loan Funds for Microfinance Institutions: A Look at Emerging Experience," by Warren Brown and Geetha Nagarajan, 2000 (all available at [www.mip.org/pubs/mbp-def.htm](http://www.mip.org/pubs/mbp-def.htm) under "Managing Risk").
- <sup>2</sup> In Bangladesh, MFIs tried debt forgiveness, which reduced long-term credit discipline of clients and created significant financial damage to the MFI's loan portfolio. Moreover, MFIs found that clients were able and willing to repay loans after disasters, but typically with a revised payment schedule. As of 1998, Bangladeshi MFIs uniformly do not forgive debts, despite requests from donors and the government to do so.
- <sup>3</sup> Disasters may serve as an industry-cleansing period. "Turn disaster into opportunity by consolidating the industry focusing on minimum standards of accepted best practice," writes M. Emrul Hasan ("Effects and Implications of High Impact Emergencies on Microfinance: Experience from the 1998 Floods in Bangladesh," Dhaka: SANMFI, 1998). Following this advice, donors should not provide emergency financial and operational support to poorly functioning MFIs.
- <sup>4</sup> Grant funds may be appropriate for rebuilding damaged MFI infrastructure, such as buildings or management information systems. Loan funds are more appropriate for emergency liquidity infusions, although the interest rate may not reflect the full cost of capital.
- <sup>5</sup> Liquidity is a major issue if MFIs are to allow clients immediate access to savings or to reschedule debts for the short term. These needs emerge within days of disaster and are more easily met if institutional agreements are in place before disaster strikes.
- <sup>6</sup> Disaster loan funds (DLFs) are a new mechanism funded by donors to provide MFIs with immediate access to liquidity for emergency loans to clients affected by disasters. DLFs are described in detail in the MBP Publication, "Disaster Loan Funds for Microfinance Institutions: A Look at Emerging Experience," by Warren Brown and Geetha Nagarajan, 2000, available at [www.mip.org/pubs/mbp-def.htm](http://www.mip.org/pubs/mbp-def.htm) under "Managing Risk."
- <sup>7</sup> The importance of linking MFIs to early warning systems cannot be overstated. For example in 1999—one year after Hurricane Mitch devastated Central America—major MFIs in Latin America are not taking note of International Red Cross hurricane alerts or Inter-American Development Bank warnings of expected repeat flooding.