

GOOD PRACTICE GUIDELINES FOR FUNDERS OF MICROFINANCE

MICROFINANCE CONSENSUS GUIDELINES

October 2006, 2nd edition

Thirty years of lessons learned, translated into operational advice for development agencies, foundations, social and commercial investors, international NGOs, and others that help build financial systems that work for poor people.





THE KEY PRINCIPLES OF MICROFINANCE

Commitment to applying good practice in microfinance comes from the highest levels of donor countries and agencies. In June 2004, the Group of Eight (G8) endorsed the “Key Principles of Microfinance” at a meeting of heads of state in Sea Island, Georgia, USA. Developed (and endorsed) by CGAP’s 28 public and private member donors, the Key Principles are translated into concrete operational guidance for staff of donors and investors in these *Good Practice Guidelines*.*

1. **Poor people need a variety of financial services, not just loans.** In addition to credit, they want savings, insurance, and money transfer services.
2. **Microfinance is a powerful tool to fight poverty.** Poor households use financial services to raise income, build their assets, and cushion themselves against external shocks.
3. **Microfinance means building financial systems that serve the poor.** Microfinance will reach its full potential only if it is integrated into a country’s mainstream financial system.
4. **Microfinance can pay for itself, and must do so if it is to reach very large numbers of poor people.** Unless microfinance providers charge enough to cover their costs, they will always be limited by the scarce and uncertain supply of subsidies from donors and governments.
5. **Microfinance is about building permanent local financial institutions** that can attract domestic deposits, recycle them into loans, and provide other financial services.
6. **Microcredit is not always the answer.** Other kinds of support may work better for people who are so destitute that they are without income or means of repayment.
7. **Interest rate ceilings hurt poor people by making it harder for them to get credit.** Making many small loans costs more than making a few large ones. Interest rate ceilings prevent microfinance institutions from covering their costs, and thereby choke off the supply of credit for poor people.
8. **The job of government is to enable financial services, not to provide them directly.** Governments can almost never do a good job of lending, but they can set a supporting policy environment.
9. **Donor funds should complement private capital, not compete with it.** Donors should use appropriate grant, loan, and equity instruments on a temporary basis to build the institutional capacity of financial providers, develop support infrastructure, and support experimental services and products.
10. **The key bottleneck is the shortage of strong institutions and managers.** Donors should focus their support on building capacity.
11. **Microfinance works best when it measures—and discloses—its performance.** Reporting not only helps stakeholders judge costs and benefits, but it also improves performance. MFIs need to produce accurate and comparable reporting on financial performance (e.g., loan repayment and cost recovery) as well as social performance (e.g., number and poverty level of clients being served).

* Since June 2004, five agencies joined CGAP. CGAP now has 33 members.

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HOW TO USE THE *GUIDELINES*

This edition of *Good Practice Guidelines* seeks to raise awareness of good practice and improve the effectiveness of donors' and investors' operations in supporting inclusive finance. Specifically, the *Guidelines* address the key question: What is the best use of subsidies? To answer this question, the *Guidelines* capitalize on lessons learned over the past 30 years about basic conditions for successful microfinance, and translate them into practical operational guidelines for staff of funding organizations. The intent is not to dictate one way to support microfinance, but rather to support diverse approaches and priorities within a framework of basic good practice principles.

Target Audience

Good Practice Guidelines for Funders of Microfinance provides operational guidance for staff of donors and investors in the field and at headquarters who conceptualize, design, implement, and monitor programs related to improving poor people's access to financial services. This includes bi- and multilateral development agencies, regional development banks, foundations, social and commercial investors, and other organizations that fund microfinance or manage microfinance programs on behalf of donors, such as international nongovernmental organizations (NGOs), project management units, and apex lending facilities. Though the *Guidelines* are relevant to the wide range of organizations that fund microfinance, the primary audience remains donors that manage public money.

Structure

Good Practice Guidelines has five sections:

- Part I introduces a new vision of inclusive financial systems that work for the poor majority and discusses the role of donors and investors (page 3).
- Part II addresses the financial service needs of poor clients (the demand side) and provides lessons learned and operational guidance (page 7).
- Part III looks at the financial system (supply side) and provides lessons learned and operational guidance on three levels (page 9): micro (retail financial institutions and other providers of financial services), meso (market infrastructure), and macro (enabling policy environment and the role of governments).

- Part IV explores basic principles for improving the effectiveness of donors' work in microfinance (page 21).
- Part V describes five “frontier issues” that require further experience before consensus on good practice can be reached (page 28).

For More Information and Support

Good Practice Guidelines for Funders of Microfinance is a rapid reference document and thus is intentionally concise. Many users of the *Guidelines* will require more information, operational tools, and perhaps training to successfully implement the guidance.

For a more in-depth explanation of the *Guidelines*, recommended background reading, case studies, operational tools, and training events, visit the CGAP Web site at www.cgap.org/Direct. The *Guidelines* include a glossary of terms, recommended readings, and minimum financial performance indicators at the end of the document.

FOREWORD

More than three decades ago, I decided to give up my life as a corporate executive to work in development. The decision was brought on by two traumatic events in Bangladesh's history: the devastating cyclone of 1970 followed by the war of liberation in 1971. From that time on, poverty reduction through the empowerment of the poor has been my sole preoccupation. I have learnt and understood many things in working with poor people, but nothing more clearly than that poor people, in Bangladesh or elsewhere, do not have to remain poor forever. The poor remain poor because they are powerless. Once empowered, the poor are able to change their lives and overcome seemingly impossible odds.

But people cannot transform their lives all on their own. One step is to change perceptions of poor people from needy beneficiaries into active architects of their own development. We need to work together within communities and across national boundaries, and international development agencies have a crucial role to play.

As a practitioner in both microfinance and development for more than 30 years, I have seen development projects and strategies succeed and fail. I have seen misguided project designs, poor implementation, and large sums of money wasted. But I have also witnessed incredible achievements. When development works, it transforms lives by providing the needed capital and knowledge to reduce poverty and open up opportunities.

So what is the link between these short guidelines and improving the effectiveness of development agencies? *Good Practice Guidelines for Funders of Microfinance* was written from a rich experience reflecting lessons learned in many countries. But this experience will be useful only if the guidelines are used—and put to the test—everyday by dedicated donor staff. Every person working for a funding agency is the repository of extraordinary power and can be a catalyst of change. From designing strategies to implementing programs, every small decision in the complex chain of delivering development assistance makes a difference.

I urge you to read the guidelines and to apply them in practice. As my work with the poor extends across Asia and Africa, I find that these guidelines have universal resonance.

Fazle Hasan Abed
Founder and Chairperson, BRAC

EXECUTIVE SUMMARY

Good Practice Guidelines for Funders of Microfinance seeks to raise awareness of good practice and improve the effectiveness of donors and investors' microfinance operations. The *Guidelines* draw on lessons learned during 30 years of support and translate them into practical operational guidance for staff. They are based on a vision for the future of microfinance that has been defined by CGAP's members.

Vision for Inclusive Financial Systems

A world in which poor people everywhere enjoy permanent access to a wide range of quality financial services, delivered by different types of institutions through a variety of convenient mechanisms.

To improve their lives, poor clients require responsive financial services beyond microenterprise credit—services that encompass deposit services, transfers, payments, and insurance. However, financial services may not be the best and only solution for all poor people. The destitute are often in need of other development interventions, such as social protection systems and safety net programs.

Large-scale, sustainable microfinance can be achieved only if financial services for the poor are integrated into overall financial systems. The key to the effectiveness of donors and socially oriented investors is to complement private capital and to accelerate innovative domestic market solutions. Concessional finance (grants and lending at below market rates) has a role in building the institutional capacity of financial service providers and underwriting the development of experimental services (micro level); supporting market infrastructure, such as rating agencies, credit bureaus, and audit capacity (meso level); and fostering an enabling policy environment (macro level).

All donors and investors cannot work well at all levels of the financial system. Rather, each donor or investor should act on its comparative advantage. Agencies can use the following five elements of donor effectiveness to define their specific strengths and identify partners that complement their capacities: (1) strategic clarity, (2) strong staff capacity, (3) accountability for results, (4) relevant knowledge management, and (5) appropriate instruments.

Financial System Levels and Role of Donors and Investors

Level of the financial system	Role of donors and investors
<p><i>Micro Level:</i> A wide range of financial and nonfinancial institutions, including NGOs; savings and credit cooperatives; private and state-owned banks; postal banks; member-owned community organizations; nonbank intermediaries, such as finance or insurance companies; and other suppliers (moneylenders, agricultural traders, etc.). The micro level is the backbone of the financial system.</p>	<p>Strengthen financial service providers to achieve financial sustainability, which is essential to reach significant numbers of poor people and to realize long-term social returns, support experimentation, and provide capital to expand the reach of retail financial institutions when the supply of commercial financing is limited.</p>
<p><i>Meso Level:</i> Locally available market infrastructure and services, including auditors, rating agencies, networks and associations, credit bureaus, transfer and payments systems, and information technology and technical service providers.</p>	<p>Strengthen the capacity of meso-level actors and extend their services to microfinance—include microfinance in the mainstream, rather than marginalize it.</p>
<p><i>Macro Level:</i> A conducive, stable macroeconomic and policy environment provided by the appropriate government entities.</p>	<p>Support interest rate liberalization, inflation control, and prudential regulation and supervision of deposit-taking institutions. Donors should not support the direct provision of credit by governments.</p>

Despite significant learning about how to be effective in microfinance, frontier issues, such as rural finance, the application of technology, social performance measurement, and others, require further experience to define good practice.

GENESIS AND DEVELOPMENT OF THE *GUIDELINES*

The public donor community spends an estimated US \$800 million–\$1 billion per year on microfinance. Donors value microfinance particularly because access to financial services by the poor can help reduce poverty and achieve the Millennium Development Goals (MDGs).¹ The MDGs prescribe concrete development outcomes related to multiple dimensions of poverty, including improving income, health, education, and the international development system.

Guidelines for donors were first published in “Micro and Small Enterprise Finance: Guiding Principles for Selecting and Supporting Intermediaries” (known as the “Pink Book”), jointly developed in 1995 by the Donors’ Working Group on Financial Sector Development and the Committee of Donor Agencies for Small Enterprise Development at the World Bank.

The Pink Book withstood the test of time with regard to funding retail microfinance institutions (MFIs). However, microfinance is a dynamic field that has evolved significantly since the Pink Book was published. Today, microfinance is increasingly seen as an integral—no longer marginal—part of the financial system. This realization not only offers the potential for a massive increase in outreach to the poor, it also implies a much broader, more diverse, and more complex set of operational issues and institutions.

There is increasing consensus about what is needed to ensure poor people’s permanent access to financial services through sustainable institutions. Some 30 years of experience and, more recently, active participation and exchange with CGAP and others have enabled donors and investors to learn a lot about what does and does not work in supporting pro-poor financial systems.

Yet, there is still a lot to learn and apply. With most poor people lacking access to basic financial services, microfinance and the funding it receives from donors and investors have still to reach their full potential. In fact, agreement among technical staff of donors and investors on basic good practice is still not consistently reflected in operations on the ground. Moreover, much of the funding is managed by staff without specific microfinance or finance expertise. These con-

¹ The MDGs are eight goals to be achieved by 2015 that respond to the world’s main development challenges. The MDGs are drawn from the actions and targets contained in the Millennium Declaration that was adopted by 189 nations and signed by 147 heads of state and governments during the United Nations Millennium Summit in September 2000.

ditions led CGAP to facilitate a process to draft updated good practice guidelines that would incorporate new learning.²

The Microfinance Donor Peer Reviews, launched by CGAP donor members in 2002, collectively addressed aid effectiveness from the perspective of internal systems, policies, processes, and incentives. In February 2004, the heads of the 17 participating agencies discussed the results of the peer reviews and underscored the importance of improved aid effectiveness in building inclusive financial systems. They agreed on a program of work to codify good practice and to take their joint aid effectiveness work to the field. *Good Practice Guidelines for Funders of Microfinance* builds on this high-level commitment to good practice and donor harmonization and incorporates lessons learned from a series of CGAP-led Country-level Effectiveness and Accountability Reviews (CLEARs) that analyze donor aid effectiveness in the field.

² A subcommittee of the CGAP Executive Committee led a highly consultative process, involving CGAP members and stakeholders, to draft the updated guidelines. The first edition of these guidelines was endorsed in November 2004 by CGAP members and was widely disseminated in several languages. The guidelines were then field tested over 18 months. This testing included interviews with donor staff to gather feedback on the guidelines' relevance and usefulness. This second edition of the guidelines integrates the suggestions received from over 80 different stakeholders. See www.cgap.org/donorguidelines for feedback received. Subcommittee members include Brian Branch, World Council of Credit Unions; Frank DeGiovanni, Ford Foundation; David Stanton, UK Department for International Development; and Gabriela Braun, Gesellschaft Für Technische Zusammenarbeit.

PART I

THE VISION OF INCLUSIVE FINANCIAL SYSTEMS

VISION

The stark reality is that most poor people in the world still lack access to sustainable financial services, whether it is savings, credit, or insurance. The great challenge before us is to address the constraints that exclude people from full participation in the financial sector.... Together, we can and must build inclusive financial sectors that help people improve their lives.

—Kofi Annan, *United Nations Secretary General, 2003*

Financial services play a critical role in reducing poverty. Permanent access to financial services can help poor people take control of their lives. When good practice is applied, financial services can put power into the hands of poor households, allowing them to progress from hand-to-mouth survival to planning for the future, acquiring physical and financial assets, and investing in better nutrition, improved living conditions, and children's health and education. Because financial services can be delivered sustainably, these benefits can be enjoyed well beyond the duration of donor or government programs.

Through a participatory process involving multiple stakeholders, CGAP's members have defined a vision for the future of microfinance: A world in which poor people everywhere enjoy permanent access to a wide range of quality financial services, delivered by different types of institutions through a variety of convenient mechanisms.

Financial services for the poor encompass savings, credit, payment and transfer services, and insurance. Providers include NGOs; savings and credit cooperatives; private- and state-owned banks; postal banks; member-owned community organizations; nonbank intermediaries, such as finance or insurance companies; and other suppliers, such as agricultural traders. *Good Practice Guidelines* codifies what is already known about basic principles of good practice, thus consolidating a body of operational knowledge that can lead to the realization of this vision.

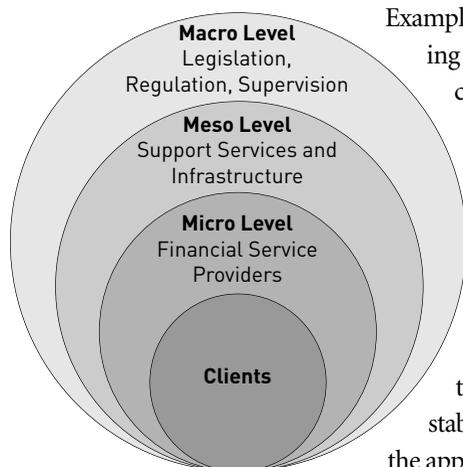
Financial services play a critical role in reducing poverty.

WHAT ARE INCLUSIVE FINANCIAL SYSTEMS?

Inclusive financial systems are accessible to the majority of citizens living in a country. The new vision for microfinance recognizes that “access for all” can be

achieved only if financial services for the poor are integrated into all three levels of a financial system: micro, meso, and macro.

Retail financial institutions and other suppliers that provide services directly to clients are the backbone of inclusive financial systems (micro level).



Examples include financial and nonfinancial institutions, including NGOs, finance companies, banks, savings and credit cooperatives, and others. In addition, a supporting, locally available market infrastructure is required to reduce transactions costs, increase outreach, build capacity, and foster transparency among retail institutions (meso level). Meso-level service providers comprise auditors, rating agencies, professional associations or networks of retail financial service providers, credit bureaus, transfer and payments systems, information technology, technical service providers, and trainers. Finally, conducive, stable macroeconomic and policy environments provided by the appropriate government entities are necessary to underpin a

pro-poor financial system. Central banks, ministries of finance, and other national government entities are the primary macro-level players. At all levels, but especially at the market infrastructure or meso level, relevant stakeholders can transcend national boundaries and include regional or global actors.

Integration into the financial system could open financial markets to the majority of people living in developing countries.

In general, integrating microfinance into financial systems allows for greater access to capital on the part of institutions serving the poor, better protection of poor people's savings, and increased legitimacy and professionalization of the sector. As a result, a far greater number of people living in developing countries, including poorer and more remote clients, will have access to financial services than are currently being reached.

Success in building inclusive financial systems hinges on the ability of a wide range of actors to work together to improve existing conditions, such as infrastructure, access to markets, production technology, and availability of information to mitigate risk. Before designing a new program or investing in a new market, donors and investors should assess the existing financial system (e.g., demand and supply of financial services; stakeholders and donors and investors working on each level of the financial system; constraints and opportunities of the policy environment, etc.). Any new intervention should complement actions already under way and should take into account the country's historic and cultural background to best adapt the project to local demand.

It may be difficult to develop all aspects of an inclusive financial system in all countries. As in every other area of development, an important starting point is the country context. For instance, in countries with dysfunctional or nonexistent financial systems, the entry point for building permanent access to financial services for poor people will differ from that of countries with flourishing finan-

cial systems. A functioning financial system should be seen as a necessary, but certainly not sufficient, condition to ensure permanent access to financial services for poor people. Even in some countries with the best financial systems, unequal access to financial services is present, and interventions may be required to remedy market failures and expand access.

WHAT IS THE ROLE OF DONORS AND INVESTORS AND THEIR SUBSIDIES?

Donors and investors play an important role in supporting the emergence and evolution of microfinance. However, because development programs on the ground do not consistently reflect donors' commitment to good practice, these programs do not always achieve the desired impacts. In some cases, these programs actually harm the development of inclusive financial systems by distorting markets and displacing local commercial initiative with cheap or free money. Donors and investors need to recognize that their role is limited to support and that it is their partners on the ground who actually deliver financial services. At the very least, *Good Practice Guidelines* seeks to enforce a sort of Hippocratic oath for donors and investors to "do no harm."

As microfinance evolves and becomes more complex, so does its funding sources. Today, there are numerous microfinance funders, ranging from public development agencies to private or semi-private investors. In contrast to the past, today's donors and investors play different roles both vis-à-vis each other and with regard to the local private sector in countries where they work. Their individual added value depends on their instruments, institutional cultures and missions, risk profiles, and staffing.

As new entrants (private foundations, investment funds, commercial banks, etc.) offer their support, donors need to continually reassess their position and be ready to fill the gaps—such as expanding and deepening access—that the private financial system may not automatically address.

Public donors and private foundations with grant funding have the unique ability to promote innovation in products and delivery mechanisms through research and development, forge linkages with a variety of actors in the financial system, promote increased transparency and competition among retail providers of financial services, and build capacity at all levels, especially for emerging retail financial service providers. International financial institutions and social investors that provide disciplined funding (including loans and equity), often coupled with technical assistance, are particularly strong at building solid retail providers. Regional development banks with good contacts with governments often can be effective at the policy level. Private foundations with flexible funding can work on high-risk, innovative projects, including exploring national or regional solutions to market infrastructure weaknesses (e.g., multicountry action research programs, training institutes, etc.).

At the very least, the Guidelines seek to enforce a sort of Hippocratic oath to "do no harm."

In many countries, dependence on subsidies from public donors and governments—including government-financed development banks—should diminish in relative terms as local financial institutions that serve poor clients mature. However, concessional finance is still needed at all levels of the financial system. At the same time, more is not necessarily better when it comes to subsidies: the most effective interventions generally do not require large amounts of funding, but do require intensive technical and human resource inputs. In all cases, the purpose of subsidized funding should be to support experimentation; fill gaps that are not addressed by mainstream local capital markets; reduce real or perceived risks and transaction costs of local, mostly private-sector, actors; and engage these actors more fully in serving the poor.

Concessional finance is still needed at all levels of the financial system.

A donor cannot necessarily work well on all three levels of a financial system, but each intervention—whatever the level—should promote the growth of the sector as a whole. Additionally, the role of donors at different levels depends on the stage of development of the larger financial system. A fundamental challenge faced by donors and investors is how to deploy the range of instruments at their disposal to best support the emergence of inclusive financial systems.

A donor cannot necessarily work on all three levels of a financial system.

Inclusive Financial Systems and Country-Level Mechanisms

Public donors increasingly engage with national governments to integrate financial-sector reforms, including financial deepening, within country-level mechanisms such as Financial Sector Assessment Programs (FSAPs), Poverty Reduction Strategy Papers (PRSPs), sector-wide approaches (SWAPs), and budget support.

The donors most involved in these reforms, such as the International Monetary Fund (IMF), the World Bank, and other multilateral development banks, should highlight access to financial services within these broader frameworks. It is up to these and other donors, working through national stakeholders, such as governments, civil society, and the private sector, to maximize the coherence of microfinance-related activities within this larger picture, using the good practice guidelines in this document.

CGAP's CLEARs is one mechanism that could help donors design interventions that build on their respective comparative advantage so that they can work more effectively in the field. One outcome of this country-level process could be a code of conduct among international donors and investors for specific countries.

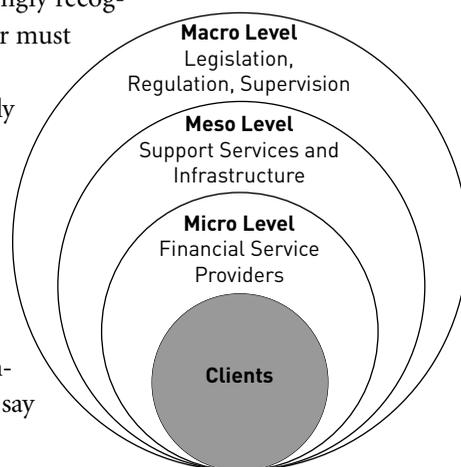
PART II

UNDERSTANDING THE NEEDS OF POOR CLIENTS

The microfinance community has made great strides in learning how poor people use financial services and the impact these services have on their lives.³ Earlier models of microfinance delivery were mostly supply driven, with an emphasis on replicating specific credit methodologies. It is increasingly recognized that, to be effective, financial services for the poor must be market driven and thus respond to client needs.

Donors and investors generally do not engage directly with the clients of microfinance services (although some international and local NGOs may do so). Nevertheless, it is important that staff of donors and investors understand the financial reality of the poor to ensure that projects consistently meet client demand.

This section outlines some of the key lessons learned about microfinance clients. Many of these lessons are counterintuitive and discredit firmly held beliefs (some would say myths) about the poor.



- Understand the financial reality of the poor
- Enable partners to respond to market demand
- Promote other financial services besides credit

LESSONS LEARNED

- Poor clients need and are willing to pay for a variety of financial services (e.g., credit, savings, money transfers, payments, insurance), not only microenterprise loans.
- Poor people, even very poor people, save. Often savings are made informally, in kind, or in other relatively insecure ways (e.g., animals, jewelry, cash under the mattress).
- Financial services for the poor should be client responsive, not supply driven. Attempts to import credit methodologies from other contexts have had mixed results.

To be effective, financial services for the poor must be market driven and thus respond to client needs.

³ *Good Practice Guidelines* does not attempt to define the poor. Rather, it tries to capture the whole range of people currently excluded from access to financial services. Each development partner should define its own group of potential or existing microfinance clients.

- Financial institutions and other financial service providers, not their donors and investors, are best placed to understand client needs and design appropriate services because they have direct contact with poor clients on a daily basis.
- The destitute have very limited absorptive capacity for debt and often no income to repay loans. Microcredit thus may not be the most appropriate solution for them. Similarly, microcredit may not be appropriate for every situation (e.g., refugee resettlement).
- Targeted social safety net programs and investments in infrastructure and production technology offer destitute and extremely vulnerable people better alternatives than microcredit (e.g., food security programs, wage employment in small and medium enterprises).
- Consumer protection initiatives (e.g., ensuring the transparency of financial disclosure, financial education) can protect microfinance clients from predatory lenders.

OPERATIONAL GUIDELINES

- **Verify that credit is truly needed** to achieve donor goals, especially in projects where microfinance is not the main component. Public donor-funded projects often assume credit is needed when the main constraints lie elsewhere (e.g., weak infrastructure, poor production technology, limited market access) and other financial or nonfinancial services would be more appropriate. They also often neglect to consider informal financial arrangements when designing a project. In some cases, the support of savings or insurance services might be more relevant than credit.
- **Do not use microcredit merely as a resource transfer mechanism** for high-risk groups. Other methods may be more efficient for the purpose of resource transfer (e.g., safety net programs for extremely vulnerable groups). Programs that channel credit to specific groups without applying good practices may dilute financial discipline, resulting in poor repayment, harm to clients' motivation and confidence, and institutional collapse.
- **Conduct due diligence to ensure financial service providers have sufficient institutional capacity and commitment** before engaging in product development; do not push financial institutions to develop services that overload their capacity.
- **Provide flexible funding** to cover research, product refinement and development, and technical assistance for capacity building, enabling partners to **introduce innovative financial services and delivery mechanisms**. This work, which should be funded with grants, includes **market research** by financial institutions or other appropriate market players that help better understand the behavior and preferences of the poor with respect to financial services.
- Support **consumer protection** measures aimed at safeguarding poor clients from predatory lenders. The range of measures includes clear disclosure of the true costs of lending, guidance on lender practices, mechanisms for handling complaints and disputes, and consumer education/financial literacy.

PART III

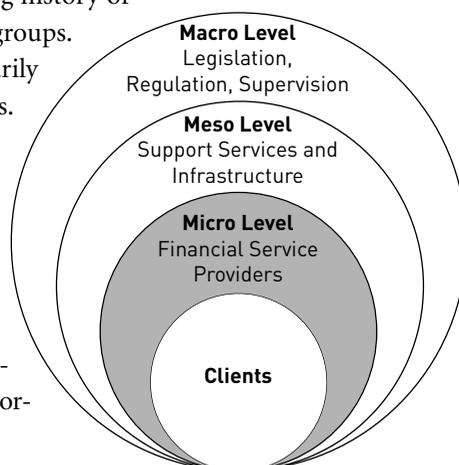
BUILDING INCLUSIVE FINANCIAL SYSTEMS

This section describes lessons learned and offers operational guidelines to support microfinance at the micro level (retail financial institutions), the meso level (financial market infrastructure), and the macro level (policy environment) of the financial system. Work at all three levels is needed to meet the demand for diverse financial services among the large numbers of poor people who remain excluded from the financial system today.

MICRO LEVEL: PROMOTING STRONG RETAIL INSTITUTIONS⁴

Public donors and international NGOs have a long history of supporting the delivery of credit to specific target groups. They also have helped build individual MFIs, primarily (but not exclusively) NGO microcredit organizations.

The range of retail financial institutions with potential to serve poor people is much broader than NGOs and includes private and state-owned banks, postal and savings banks, savings and credit cooperatives, member-owned community organizations, and other nonbank intermediaries, such as finance or insurance companies. Furthermore, nonfinancial institutions, such as agricultural traders, are sometimes important providers of financial services.



- Do not crowd out local funding sources
- Promote collaboration among institutions
- Support specialization

The lack of strong, competent retail capacity remains the main bottleneck to extending financial services to large numbers of poor people, especially in rural areas.

Although there is general agreement among donors and investors that a wide range of institutions should be supported, there is some debate about whether donors and investors should pick “winners” and support promising institutions on an individual basis, or whether they should fund broader capacity building and other serv-

⁴ At the micro level, *Good Practice Guidelines* draws heavily from the 1995 Pink Book. In fact, much of the specific Pink Book guidance remains valid for the micro level, particularly for traditional MFIs, such as NGOs, including those that have transformed into licensed financial intermediaries.

ices to a range of institutions. Some donors pursue both strategies. In either case, donors and investors should not crowd out the market. Care should be taken to encourage specialization among financial institutions and to support collaboration, while promoting competition (or at least avoiding anti-competitive behavior). The lessons and guidance in this section refer mainly to support for individual financial service providers, while the section on the meso level provides guidance on interventions that support multiple institutions simultaneously.

LESSONS LEARNED

No matter what strategy, donors and investors should complement and not crowd out the market.

- The lack of strong, competent retail capacity remains the main bottleneck to extending financial services to large numbers of poor people, especially those in rural areas.
- Designed as inputs to larger multisector donor projects, credit components often perform poorly. They rarely continue beyond the project and thus do not provide permanent access to financial services.
- A wide range of national financial and nonbank financial service providers is required to serve the needs of poor people, including institutions with existing capacity for widespread outreach, such as commercial banks and postal outlets. Specialization allows different institutions to serve distinct market needs.
- Ownership and governance (management oversight) are critical determinants of successful financial service providers.
- Public donors generally are not good owners of financial institutions, and they rarely have the appropriate expertise and capacity to provide adequate board oversight. However, some international financial institutions and investors that invest equity in financial institutions have staff with the sufficient expertise to take on useful ownership and governance roles.
- Financial sustainability is essential to reach significant numbers of poor people and to realize long-term social returns. This means, among other things, charging interest rates consistent with full cost recovery to ensure profitability and growth. Over time, competition, improved efficiency, and increased accountability for results should drive costs (and thus interest rates) down.
- The time required to achieve financial sustainability depends on country context, local market conditions, the capital structure of the retail financial service provider, and the market segment served. Evidence suggests that more recently established institutions achieve financial sustainability much faster than the earlier generation of financial institutions, though some institutions still take up to 5 to 10 years to become sustainable. It is important for donors to specify a time horizon for each institution to encourage the most effective use of donor subsidies.
- Savings-based community-managed loan funds have shown promise, but those that are externally funded with a capital infusion from a donor almost always fail, usually because of poor repayment.

- Improving the efficiency of microfinance operations translates into higher quality, lower cost services for poor people. Institutions can achieve greater efficiencies, and thus reduce costs, by investing in quality management information systems, technological improvements, and well-trained staff.
- Institution building requires a long-term commitment by donors and investors. This commitment should be balanced by a defined time limit for funding support. Ad-hoc technical assistance and abrupt withdrawal, as opposed to long-term strategic commitment, may fail to build domestic capacity. However, long-term dependence on foreign technical service providers rarely builds, and might even replace, domestic capacity.
- If not applied properly, grants, subsidized loans, and excessive guarantees to financial service providers can undermine or crowd out national or international commercial capital markets and/or domestic savers.

OPERATIONAL GUIDELINES

- **Find institutions that share the vision of the donor or investor** with regard to reducing poverty and building sustainability, rather than imposing an external vision or targeting a specific social group.
- **Adapt funding to the institutional stage of development of a financial service provider.** Support needs to be structured according to the specific needs of different developmental stages (e.g., start-up, growth, etc.). Do not support institutions that require instruments and capacity the donor or investor cannot effectively provide or hire.
- **Retail financial service providers, not donors and investors, should drive key strategic and operational decisions** about the business of providing financial services. Support to financial institutions should be demand driven, and managers of the specific institutions, not the donor or investor, should take the lead.
- **Support financial service providers progressively to intermediate commercial funds and/or deposits** (when permitted by law) without supplanting local equity or debt markets. However, avoid encouraging NGOs to transform into formal financial institutions unless they have sufficient potential to do so. Donors and investors need to analyze the costs and benefits of transformation to determine the appropriateness of supporting this long and arduous process.
- **Support informal and member-based organizations** (e.g., savings and credit cooperatives, etc.) with a track record of sustainably providing quality financial services to their clients. Avoid credit lines to these organizations that might undermine the balance between savers and borrowers.
- **Let financial service providers set their own pricing policies and encourage them to be transparent about their pricing.** Avoid, for instance, compelling financial service providers to charge below-market interest rates on loans to clients (or rates lower than those necessary to cover costs in the medium term).

- **Assess financial service providers properly**, looking at factors such as vision, mission, strategy, ownership structure, governance, human resource capacity, quality and mix of services, outreach, efficiency, financial performance, and portfolio health.
- **Pay specific attention to governance issues**, such as board composition, risk management, fiduciary responsibility, transparency, and potential conflicts of interest. Ensure appropriate checks and balances between management and the board, and confirm the existence of key board committees (e.g., audit, compensation, investment). Ownership and governance are especially important for member-owned institutions, such as savings and credit cooperatives.
- **Use performance-based funding:**⁵
 - Use **performance-based contracts** with agreed performance targets (including exit strategies).
 - Include a **few core indicators** to track performance (e.g., general outreach, outreach to the poor, portfolio quality, profitability/sustainability, efficiency). Avoid burdening financial institutions with too many indicators.
 - Tie renewal or continuing support to achievement of meaningful and **clear performance targets**.
 - **Be prepared to exit** from institutions that do not perform as agreed, either by discontinuing subsequent tranches of support or requiring reimbursement (where feasible).
 - Live up to the **donors' and investors' responsibilities** under the contract (e.g., predictable funding patterns, timely disbursement, prompt responses to reports).
- **Promote transparency and accountability**
 - Require **regular financial reporting** that complies with international financial reporting standards (IFRS), national regulations, and *CGAP Microfinance Consensus Guidelines, Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance*.
 - Ensure that reporting requirements **harmonize** with those needed by management and governing bodies, other donors and investors, and supervisors.
 - Encourage third-party **performance assessments and ratings** of MFIs to enable sound funding decisions and to help MFIs analyze and improve their operations.
 - When cost-effective methods to measure social performance are established, and when social performance is a key goal of the donor or investor and the MFI in question, **include regular social performance monitoring** in the performance measurement system.⁶
- **Build exit strategies** that define the life of the relationship into contracts and grants from the beginning of a project, including a timeframe to achieve

⁵ See Annex 2 for sample indicators that donors can use to track performance and CGAP, *Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance*, Microfinance Consensus Guidelines (Washington, D.C.: CGAP, 2003).

⁶ As of mid-2006, there were several efforts under way to define appropriate social performance and impact indicators for microfinance (see Annex 1 for more information).

financial sustainability. For donors and investors using instruments such as equity, the question of exit is not posed in the same manner. Equity investors do not need to define an exit at the early stage.

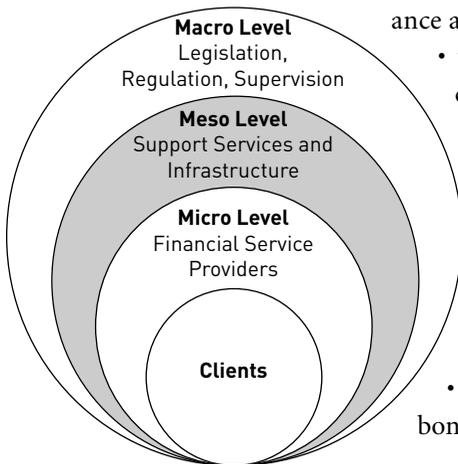
- **Support improvements in efficiency** (streamline procedures, introduce new technologies, etc.), **governance structures, and learning** to reduce costs for poor clients. Donors should support the development of standardized tools and instruments for financial projections and product development.
- **Take informed risks on promising, but unproven, institutions** that have the potential to reach large numbers of unserved clients or offer less available services (e.g., savings, insurance). Commercial, private-sector funders should support the strongest institutions with the capacity to absorb market-rate investments. Funding organizations with large amounts of public subsidy or grant funds should take more risk to build the next generation of strong institutions, support product development and experimentation, and expand outreach to underserved populations.
- **Price loans to financial institutions at commercial or near-commercial rates** to avoid undermining incentives to mobilize deposits or tap other local sources of capital. Donors and investors may price loans at lower rates to help financial institutions serve sparsely populated regions or otherwise difficult-to-reach populations, as long as these institutions charge their clients a rate that allows them to cover all their costs.
- **Provide loans and guarantees only when financial institutions are unable to attract adequate and appropriate capital** from local or international capital markets, or to fill gaps in medium- and long-term funding (i.e., when medium- to long-term funds are not available on the domestic market).
- **Structure guarantee instruments** (i.e., guarantees to local banks that on-lend to MFIs) with incentives to **forge permanent linkages** between the two parties, so as to increase local banks' appetite for future unguaranteed lending. Sharing risk with the bank in question is the key to ensuring the amount of resources devoted to microfinance over the medium term exceeds the amount that would be available without a guarantee.
- **Gradually phase out grants and subsidized loans** as local and/or international commercial capital markets and domestic savers become viable sources of capital for the financial institution.
- **Promote potential linkages among different types of financial service providers** to increase outreach and offer a broad product mix to clients. Examples include collaboration between formal financial institutions and various types of smaller and informal financial institutions and linkages between financial institutions and nonfinancial providers, such as retailers and agricultural input suppliers. Promote mergers and consolidation in countries where too many financial institutions exist relative to market demand.

Lack of appropriate market infrastructure constrains the ability of retail institutions to expand their services to poor clients.

MESO LEVEL: SUPPORTING MARKET INFRASTRUCTURE

The meso level refers to the overall infrastructure of the financial system and the support services micro-level providers need. Limited availability or lack of appropriate market infrastructure can seriously constrain the ability of retail institutions to expand their services to poor clients. Actors involved at the meso level work nationally, regionally, or even on an international basis. Specifically, the market infrastructure includes the following:

- payments and clearing systems
- information infrastructure, including rating agencies, auditors, and credit bureaus that promote transparency on institutional performance and transactions
- technical support and education services (research companies, universities, training and technical assistance providers, consultants)
 - associations and networks of retail financial service providers and other institutions engaged in advocacy and information dissemination
 - financing infrastructure (wholesale or second-tier mechanisms, such as apex lending facilities, commercial banks, etc.)
- financial and capital markets (investment funds, bond issues, securitization)



- Ensure local ownership
- Extend market infrastructure to microfinance
- Concentrate on market building rather than individual projects

Whatever the intervention, support from donors and investors should emphasize local ownership to guarantee the service will still exist after their support phases out.

Support at the meso level should aim to extend established services to the microfinance sector, to include microfinance in the mainstream rather than to marginalize it. Creating separate market infrastructure just for microfinance is generally too costly, unnecessary, and unsustainable. Because the meso level is a relatively new area for donor funding, this section offers fewer concrete lessons and guidelines.

LESSONS LEARNED

- Building markets for support services, and sharing the risk of creating such markets, is vital for the long-term viability of retail financial institutions.
- A majority of apex lending institutions (sometimes referred to as second-tier or wholesale institutions) have disappointing results. They typically are set up in countries that do not have a critical mass of good financial institutions that

have the capacity to absorb apex funding, and they often lack independent and competent leadership.

- Investments in industry infrastructure benefit most financial service providers.
- Weak institutional and human capacity are among the key constraints at all levels (micro, meso, and macro).
- Strong national microfinance associations can potentially support capacity building of retail institutions, promote transparency, and advocate for policy changes in a specific country. However, other nonmember-based, private service providers also can play many of these same roles.
- Accurate, standardized, and comparable information on the financial performance of retail institutions is imperative for bank supervisors, regulators, donors, investors, and clients to adequately assess risk and returns.⁷
- Advances in information systems and delivery technologies (e.g., automatic teller machines [ATMs], point-of-sale devices, cell phone banking) are crucial to increase market knowledge and spur investments that reduce transaction costs.
- Some ongoing subsidies may be required to develop and support financial infrastructure, especially those that clearly accelerate the development of support services or markets or are considered public goods (e.g., establishment of national and regional networks or action research programs).
- Information disclosure, contract enforcement, and security of transactions are necessary to instill confidence and will increase the breadth and depth of financial transactions.

Support should emphasize local ownership to guarantee the continued existence of the service after donor support phases out.

OPERATIONAL GUIDELINES

- **Comply with established good practices** as defined by *Business Development Services for Small Enterprises: Guiding Principles for Donor Intervention* when supporting private service providers to stimulate market development.⁸
- **Work with existing service providers**, including mainstream organizations, at the national, regional, and international levels to build their capacity to offer market-based, demand-driven services. Avoid creating separate support structures that do not match the level of retail activity.
- **Funding or creating apex lending institutions** requires rigorous financial and operational analysis of the apex and potential recipients of funds, a

⁷ The definition of relevant financial performance indicators can be found in *Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance*, Microfinance Consensus Guidelines (Washington, D.C.: CGAP, August 2003).

⁸ *Business Development Services for Small Enterprises: Guiding Principles for Donor Intervention* was written in 2001 by the Committee of Donor Agencies for Small Enterprise Development at the World Bank for donors to use when supporting private service providers to stimulate market development.

strong strategic focus, minimized disbursement pressure, political independence, sound governance structure, performance-based disbursement, and management with financial management skills. Donors should ensure that sufficient retail capacity exists to absorb funds before supporting an apex lending institution.

- **Consider technical assistance for organizational and institutional development**, as well as for product development among service providers at the meso level.
- **Support research and development** on the use of technology for points of service, transfer and payments mechanisms, credit bureaus, etc. Avoid duplicating efforts and rather collaborate to create standards for sharing technology platforms and managing information.
- **Fill human resource gaps** through training programs, technical assistance, mentoring, dissemination of standards, and technology sharing. To ensure long-term capacity, public donors and private foundations also should promote integrating a microfinance curriculum into formal education.
- **Support country-level associations** as a means to build the capacity and voice of multiple financial service providers and to disseminate microfinance knowledge. Apply the same rigorous appraisal and performance-based funding that are applied to retail financial institutions. Proof that members value network services (e.g., cost sharing and other means of supporting network services) should be built into all support.⁹ Long-term, performance-based subsidies may be appropriate for associations that provide services qualified as “public goods,” e.g., research, standards, etc.
- **Facilitate funding of global or multicountry networks, programs, or innovation/technical assistance funds** that span the different levels of the financial system. Seek linkages between these networks and other national associations.
- **Develop performance indicators** for meso-level service providers to measure success and impact at the meso level.
- Encourage financial standards by **developing standardized reports and audits**.
- **Promote transparency of funding for microfinance and microfinance providers’** financial statements, performance, and outreach on an industry platform, such as the Microfinance Information eXchange.¹⁰

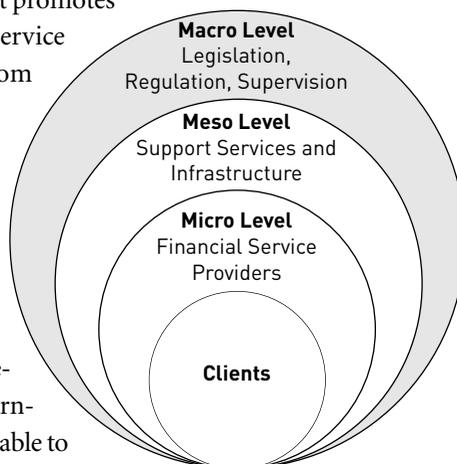
⁹ For more guidance on how donors and investors can support microfinance associations, see SEEP, “Recommendations on Donor Guidelines to Support Microfinance Associations.” Report prepared for the GTZ, Washington, D.C., 2004.

¹⁰ The Microfinance Information eXchange MIX, (www.themix.org) is a nonprofit organization whose mission is to help build the microfinance market infrastructure by offering data sourcing, benchmarking, and monitoring tools, as well as specialized information services. *The MicroBanking Bulletin* (MBB) is available at its Web site.

MACRO LEVEL: FOSTERING A CONDUCTIVE POLICY ENVIRONMENT AND ENSURING THE APPROPRIATE ROLE OF GOVERNMENT

There is an emerging consensus that governments do have a constructive role in helping build financial systems that work for the poor. Governments are the only actors that can ensure a policy environment that promotes competition among a wide range of financial service providers, while also protecting consumers from predatory or fraudulent practices.

In addition, governments should themselves embrace and apply good practice in microfinance. Governments are the main partners of many public (especially multilateral) donor agencies and often play a similar role in financial systems development. Therefore, especially for the micro and meso levels, these guidelines also apply to governments. Finally, governments should hold donors and investors accountable to comply with the guidelines.



- Promote the appropriate role of the government
- Sustain long-term dialogue with appropriate government entities

A key to effective donor support at the macro level is ensuring that appropriate government entities, such as the Central Bank and the Ministry of Finance, are not by-passed when supporting financial systems development. These entities have the key mandate on all issues pertaining to financial system development, though in many countries other ministries are also involved in microfinance. Local governments and parliamentarians need to be familiar with good practice financial systems development.

Hot debate: What is the appropriate role of the government?

Should governments be involved in microfinance? Should governments themselves direct credit to those in need? Or should governments stay as far away as possible from the delivery of microfinance, leaving the private sector to do the job?

Historically, governments in developing countries have used credit schemes as a way to transfer resources to specific target populations. Such programs continue to exist today, often with public donor support. The negative impact of most of these schemes (low repayment rates and creation of a poor credit culture, decapitalization of funds, diversion of subsidized loans to wealthier citizens, etc.) has led many donors and experts to advocate that national governments disengage from

microfinance. This hard line against government's direct involvement has not always worked. Moreover, it may be too restrictive: some governments believe they can and should have a more active role.

Governments' heightened interest in microfinance brings opportunities and risks.

On the one hand, well-informed governments understand and comply with the principles in the *Guidelines*. They can implement policies that encourage the emergence of permanent, sustainable financial institutions that serve the poor and provide effective prudential regulation and supervision. At the very least, they can eliminate policies that block microfinance.

On the other hand, some governments still undermine microfinance markets, and increased attention risks politicization, especially regarding microcredit. Many governments equate microcredit with handing out money to poor people. A danger of too much government involvement in microcredit is that political criteria, rather than sound credit administration, could drive decision making on topics such as who gets credit and where branch operations are located. The focus of political attention remains largely on loans, instead of the gamut of financial services required by poor people. The track record of government-owned banks is better with small balance savings, however.

LESSONS LEARNED

- A government's primary role is as an enabler, not a direct provider, of financial services, especially credit.
- A government's most critical contribution is to maintain macroeconomic stability.
- Governments are responsible for ensuring that legal and supervisory systems support and ensure the soundness of a range of financial organizations, including prudential regulation for financial institutions that collect savings from the public.
- Low interest rate ceilings restrict poor people's access to financial services by inhibiting the financial sustainability of service providers, thus choking off the supply of credit and possibly eliminating attractive savings/investment opportunities for clients.
- Government-run credit programs generally distort markets, because they are subject to political rather than commercial imperatives. These political imperatives impair the sustainability of institutions that provide financial services to the poor. Government-controlled apex-lending organizations rarely perform well. However, some government-owned financial institutions (e.g., postal banks) offer important deposit services.
- In special situations, such as market failures that the financial system cannot overcome by itself, government funding for sound and independent MFIs may be warranted, if other funds are lacking. In such cases, clear barriers must

be put in place to separate political considerations from the provision of financial services.

- Work at the policy level requires public donor staff who have specialized technical capacity and operational experience. Policy changes, especially legal reform, are more permanent than other types of donor projects. They are often irreversible and affect the sector as a whole (for better or for worse). Donors have, in some cases, successfully supported strong, representative national microfinance associations to advocate for policy changes.
- Project implementing units (PIUs)—generally set up by donors and staffed with personnel from a government ministry—usually do not successfully deliver permanent access to financial services for poor people.

OPERATIONAL GUIDELINES

- **Support interest rate liberalization** through education and advocacy, both directly and by working with stakeholder networks.
- **Support alternative methods for protecting consumers**, such as measures to promote transparency on loan costs to clients, consumer education, and consumer complaint mechanisms.
- **Build on existing policy frameworks and dialogue** (e.g., PRSPs, FSAPs, financial-sector reforms) to promote the legitimacy of inclusive financial systems.
- **Do not support direct provision of credit services by a government**, government-mandated portfolio quotas, directed credit, borrower loan guarantees, or operational subsidies. In some cases, an exception can be made for governments to provide financing, subsidies, or guarantees to well-run financial institutions that are unable to obtain sufficient financing from local capital markets, especially those that serve hard-to-reach populations.
- **Support financial institutions directly rather than through government entities.** When this is not possible, as often is the case of multilateral development banks, ensure proper procedures, controls, and training are in place to minimize political interference and ensure adherence to good practice principles contained in these guidelines.
- Encourage adaptation of policy and legal frameworks that **reduce barriers to market entry of financial institutions** to increase competition and, ultimately, improve the quality of services available to poor clients. Regulation should not prohibit market entry and development by, for instance, requiring a single legal structure for all licensed microfinance providers.
- **Help governments adjust the regulatory and supervisory framework for deposit-taking institutions** (cooperatives, postal banks, etc.), without pushing for premature or restrictive legislation. (Do not “rush to regulate.”) Before recommending prudential regulation, make sure it is truly necessary to protect the safety of savings, that there is a critical mass of retail institutions qual-

ified for such regulation, and that supervisory capacity exists to handle these institutions.

- In cases where nonbank institutions, such as NGOs, need explicit legal authorization to lend, **encourage regulatory changes that allow credit-only institutions to lend without prudential licenses** or supervision.
- **Build the capacity of key government staff** in ministries of finance and central banks (including supervisory capacity). Also, **engage members of parliament** on important issues (e.g., cost recovery pricing) to influence political decision making.
- **Support improvements in the legal framework for collateral, taxation, and registration** in a transparent and enforceable manner.
- **Promote the development of socioeconomic statistics** by government or other relevant bodies to facilitate market research by financial institutions.
- In cases where donor agencies must fund through budget support, **ensure a quality design of the project**, avoid setting up or funding through a public apex lending facility, and define a clear exit strategy that ensures the private ownership of the funds after the lifetime of the project.

PART IV

ENSURING EFFECTIVENESS OF DONORS

Effectiveness ultimately depends on the ability of donors and investors to respond to the needs of various actors within the financial system on a demand-driven basis and in a collaborative way, while avoiding over-funding private-sector initiatives or distorting markets. In any given country, this means obtaining a clear picture of existing initiatives before moving forward to avoid duplicating efforts and working at cross-purposes with others. It also means identifying and building on each agency's comparative advantage and collaborating with those that have complementary strengths.

Paris Declaration on Aid Effectiveness

In March 2005, the Organization for Economic Co-operation and Development/Development Assistance Committee (OECD-DAC) countries issued the “Paris Declaration on Aid Effectiveness” (available at www.aidharmonization.org). In this document, 90 countries and 27 development institutions committed to continuing and increasing efforts in five key principles known as the aid effectiveness pyramid.

Several important donors of microfinance are signatories to the Paris Declaration. *Good Practice Guidelines* paves the way for development agencies to put the Declaration into practice, especially on three of the principles—harmonization, managing for results, and mutual accountability.

This section echoes many of the tenets of the Paris Declaration and provides concrete guidance for how donors can progress toward key principles. For example, these guidelines suggest practical scenarios for a more effective division of labor of donors supporting microfinance. It also stresses the importance of developing transparency and establishing key performance indicators, and offers specific core performance indicators for microfinance. Finally, *Good Practice Guidelines* is about accountability. By adopting and following the guidelines in this document, donors can take an important step toward becoming more accountable for results and promoting transparency in at least one development area.

LESSON LEARNED—WHAT DOES IT TAKE FOR DONORS TO BE EFFECTIVE?

The Microfinance Donor Peer Reviews, facilitated by CGAP on behalf of development leaders and conducted from May 2002 to November 2003, examined the *modus operandi* of 17 bilateral and multilateral agencies, yielding five core elements of donor effectiveness:¹¹



These elements help shape an agency's ability to apply good practice to its microfinance operations, thus helping the organization make a greater impact on the lives of poor people. The peer reviews revealed that a minimum level of performance in each of the five elements of effectiveness is critical for the effectiveness of donors in microfinance. The following lessons learned emerged from intensive work with donors; some may be applicable to other types of microfinance funders as well.

1. Strategic clarity and coherence. An agency's vision of microfinance needs to be coherent, and the relationship between this vision and

¹¹ The following agencies participated in the peer reviews: Agence Française de Développement, African Development Bank, Asian Development Bank, Canadian International Development Agency, DANIDA, Department for International Development, European Commission, Gesellschaft für Technische Zusammenarbeit, International Fund for Agricultural Development, International Labour Organisation, KfW Entwicklungsbank, The Netherlands, Norwegian Agency for Development Cooperation, Swedish International Development Cooperation, Swiss Agency for Development and Cooperation, United Nations Development Programme/United Nations Capital Development Fund, and the US Agency for International Development.

accepted standards of good practice affects the quality of implementation and results.

2. **Staff technical capacity.** There is a direct link between an agency that has staff with solid microfinance technical expertise and the quality of that agency's microfinance operations. Within donor agencies, most microfinance programs are managed by staff who do not have microfinance experience, functionally putting those with technical expertise on the one hand, and those with control over money on the other.
3. **Accountability for results.** Transparency about the performance of microfinance programs is critical to aid effectiveness. Many donor agencies do not know how much money they have invested in microfinance, nor do they have sufficient knowledge of the performance of their microfinance operations. Agencies need accurate information to make sound decisions on whether to continue, extend, terminate, or replicate programs. In many donor agencies, especially multilateral organizations, pressure to approve and disburse projects exacerbates the problem.
4. **Knowledge management.** When knowledge management enables agencies to learn from their own and others' experiences, it greatly contributes to effectiveness. However, knowledge management can present a real challenge, especially in decentralized agencies.
5. **Appropriate instruments.** Microfinance is a private-sector activity, and projects show best results if the funding agency is able to work directly with the private sector through a range of different instruments. Trends toward new aid modalities (e.g., government budget support and SWAs linked to PRSPs) pose certain trade-offs for expanding financial services for the poor. Good microfinance operations are usually incompatible with large budgets and direct government intervention. Many agencies recognize that credit components (also known as credit lines, revolving funds, and community development funds) within larger multisector programs do not produce intended results and should be avoided.

A minimum level of performance in each of the five elements of effectiveness is critical.

In addition to the findings related to the five elements of effectiveness, the peer reviews and subsequent CLEARs revealed the following lessons:

- Few donors think strategically about their comparative advantage. Many agencies support microfinance in too many different ways, thus “spreading themselves too thin” to have significant impact. Many donors want to do a little of everything, rather than specialize on where they have the most to contribute.
- Incentives in many development agencies result in pressure to approve or disburse funds, giving staff little incentive to pay attention to implementing and monitoring programs.

- Donor collaboration and harmonization remains weak, causing confusion and inefficiencies for partners receiving donor support.

OPERATIONAL GUIDELINES

- **Use the elements of effectiveness as an input to define comparative advantage** and to determine the optimal level of involvement in microfinance. Beyond the elements of effectiveness, donors should also consider other factors. For example, decentralized decision making and technical expertise is important for microfinance operations that require constant dialogue and technical support, especially policy work. Similarly, a long track record in a particular country or region can be critical to credibility and can give an organization a local comparative advantage.
- **Develop and broadly disseminate agency-wide microfinance/financial-sector policies** that adhere to international standards and are coherent with the agency's broader development goals.
- **Provide training so that staff working on microfinance understand and are able to apply basic principles** of good practice (both at the headquarters and field-office level).
- **Establish strong technical contacts** (individuals or teams of technical specialists) that prioritize the dissemination of good practices among nonspecialist colleagues at headquarters and in the field and focus on quality assurance at all stages of the project cycle.
- **Place microfinance specialists within a financial/private-sector development** unit or department.
- **Systematically collect key performance information on the agency's microfinance portfolio** and conduct periodic portfolio reviews for a deeper probe into the portfolio's performance.
- **Set up knowledge networks** to enable staff to exchange, disseminate, and retain knowledge within the agency.
- Ensure that **lessons learned from past projects translate into better practice on the ground**, real exchange among staff, and improved learning.
- **Consider designating specific funding for knowledge generation and dissemination** that can have a major impact on aid effectiveness and should be incorporated into individual projects and programs. Also, include knowledge management as an explicit responsibility in staff's terms of reference or job descriptions.
- If possible, **use a range of instruments**, including grants, loans, loan guarantees and equity, and semi-equity participation in ways that can either complement other funders' instruments or successfully unleash domestic capital markets.

- **Avoid credit components.** If credit components cannot be avoided, at the very least, these components should be designed by people with financial and microfinance expertise and implemented in line with good practice (e.g., clearly separated from grant components and other types of support).

How can donors be effective in tough post-conflict and post-disaster situations?

Conflicts and natural disasters devastate local economies and displace large numbers of people, many of whom are poor and who have lost family members, assets, and means of livelihood. Donor money often pours in after disasters—both man-made and natural. Although financial assistance is much needed, sudden, large inflows of money often make it harder for donors to be effective.*

It is tempting to turn to microfinance as a solution. But credit is not necessarily the best first response. Caution is needed to avoid thrusting highly vulnerable people into debt or to establish unsustainable schemes that risk distorting markets well into the future. For microfinance to work, a minimum of political stability, stable populations, and sufficient economic activity in a cash economy is required.

The early stages of post-conflict and post-disaster situations call for relief services. In extreme cases, where no relief agencies are immediately available, MFI involvement in relief should be clearly defined and temporary. A few emerging guidelines for donors include the following:

- Respect good practices from the outset of programs—especially market pricing of financial services, rigorous and transparent loan appraisal, and strict loan collection.
- For existing programs, provide technical assistance to help manage the crisis, including possible rescheduling of loans.
- Select experienced partners, including local financial institutions that hold the public’s trust and specialized international NGOs that demonstrate a clear and deep understanding of the local context.
- Take a long-term approach with patient funding and avoid disbursement pressure—it will likely take longer for microfinance to be sustainable in extreme situations.
- Support partners to develop natural disaster response policies and early warning systems.
- Promote diverse financial services, especially savings, to help poor and low-income clients protect themselves from crisis such as sudden illness, death, or loss of employment.

* Duflos, Ledgerwood, Helms, and Moyart. “Country Level Effectiveness and Accountability Review: Sri Lanka.” Washington, D.C.: CGAP, 2006.

ALIGNING OPERATIONS TO COMPARATIVE ADVANTAGE AND COLLABORATING MORE EFFECTIVELY

The key to effectiveness is to identify and act on comparative advantage. Once donors identify their comparative advantage in promoting financial services for the poor, they should align their actions with their strengths. Possible action scenarios include expanding microfinance as a strategic priority, consolidating widespread microfinance funding, delegating direct involvement in microfinance, or phasing out microfinance operations altogether.

Possible scenarios for supporting microfinance include the following:

- **Expand.** The donor makes microfinance a strategic priority and invests significantly in developing an agency-wide vision and strategy, technical staff capacity, systems for accountability, and knowledge management.
- **Consolidate.** The donor decides to retain the same volume of microfinance spending and specialize in particular niche markets (geographical or technical) where it has a comparative advantage. The concentration of its portfolio yields greater impact for the same amount of funding.
- **Delegate.** The donor decides that it has a limited comparative advantage, but wishes to remain involved in microfinance. It forges co-funding or other types of agreements where the design, implementation, monitoring, and evaluation of microfinance projects are delegated to an agency with a clear comparative advantage in helping to build inclusive financial systems.
- **Phase out.** Based on its limited or nonexistent comparative advantage, the donor decides to stop developing new microfinance operations and winds down its existing portfolio. Resources previously used for microfinance are reassigned to other development sectors where the agency can be more effective.

Donors can achieve far more collectively than they can individually.

As donors identify their respective comparative advantage, they can build on one another's strengths and form alliances to harmonize their collective approach. Collaboration permits more consistent application of good practice standards; a greater range of funding instruments and partners; and reduced transaction costs to partners, donors, and government. Donors can achieve far more collectively than they can individually.

Options for collaboration and partnerships range along a broad spectrum. At one end, individual donors can agree on a common strategy for working in a particular country. Each agency can then engage with specific financial system stakeholders based on its own strengths. At the other end of the spectrum, donors can pool resources and conduct joint programming with har-

monized procedures and one voice. Many other collaborative approaches lie in between.

Collaboration includes not only donors, it is needed among all stakeholders. Regardless of the model chosen, preliminary experience suggests that the foundation of success and greater collaboration is a clearly articulated vision shared by all donors and investors. It is hoped that these guidelines can help move donors forward in crafting that shared vision, both internationally and at the country level.

PART V FRONTIER ISSUES

The donor community and the larger microfinance world have learned much over the past few decades about the best ways to support the emergence of inclusive financial systems. However, many core issues remain unresolved. Although these issues are numerous, this section describes a few that pose particularly stubborn dilemmas that have proven difficult to resolve and/or that represent an enormous opportunity. This section also outlines some emerging lessons learned—these will need to be tested, confirmed, and refined into guidelines going forward.

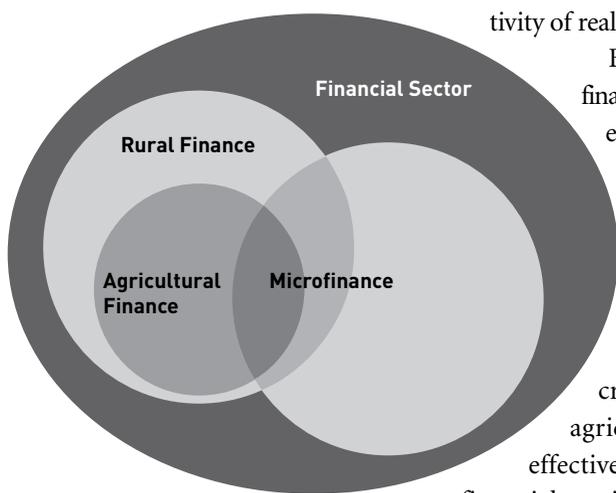
REACHING THE REMOTE RURAL POOR

Delivering financial services to rural areas presents several challenges: dispersed and uneven demand, high information and transaction costs because of poor infrastructure and lack of client information, and weak institutional capacity of rural finance providers, to name a few. In addition, rural areas often depend on agriculture. The seasonality of productive activities leads to uneven income, there are risks inherent in farming (e.g., weather, pests, price fluctuation, access to markets), and many rural poor lack usable collateral. Also, the risk of political intervention, such as debt forgiveness or interest rate caps, is high in rural areas given the economic priority of agriculture in most developing countries.

Moreover, the key obstacles of rural finance must be understood within the much broader context of natural-resource-based livelihood issues and the productivity of real sectors, for example, fisheries, timber, etc.

But not all the news is bad—in several countries, financial institutions, input suppliers, produce buyers, and agroprocessing firms are experimenting with innovative models of credit delivery. Most successful models have diversified clientele engaged in a variety of economic activities or balance urban and rural clients.

Many donors equate rural finance with agricultural credit and assume that credit is the binding constraint to achieving agriculture-related project objectives. A more effective approach encompasses the full range of financial services required by farmers and rural households. Donors can do the following:



- Help develop an appropriate enabling environment, including improving the court system and property rights, removing policy biases against the agricultural sector, and investing in communications and physical infrastructure, etc.
- Build on existing players rather than create new and costly delivery mechanisms that might never be viable.
- Fund innovations in delivery mechanisms, technology, and products, including partnerships among different types of service providers, links between remittances and other financial services, and systems that build on trader and processor client knowledge.
- Find new ways to support and strengthen member-owned financial institutions, including credit and savings cooperatives, which are often omnipresent in rural areas.
- Use grants to build institutional capacity and promote innovation, rather than subsidizing interest rates to end clients.
- Refuse political pressure to include targeted or subsidized credit in agricultural projects.
- Encourage greater interaction between donor microfinance/finance staff and rural development/agricultural development staff to develop innovative strategies to improve rural livelihoods, and ensure that appropriate expertise is applied to all projects that include rural finance.

MEASURING AND IMPROVING ACCOUNTABILITY ON SOCIAL PERFORMANCE

The growing interest in tracking the social performance of retail financial institutions that serve the poor (i.e., how well these institutions are doing at their social mission) faces three key challenges:

1. Although standard financial ratios and benchmarks have been developed to measure financial performance, comparable, widely accepted, and cost-effective indicators of the different dimensions of social performance have not yet been agreed.
2. Many retail financial service providers lack the capacity or knowledge about how to translate their social mission into their operations; design financial services most likely to achieve their social mission; and develop systems to collect, analyze, and manage data to track their social performance.
3. Funding to develop and apply these methodologies is in short supply.

Nonetheless, work is under way to develop a set of cost-effective tools and indicators to measure poverty levels of clients and a few other dimensions of social performance. Also, training curricula have been developed to build the capacity

of retail financial service providers to integrate social performance management and measurement into their operations. Finally, several microfinance rating agencies are developing social rating methodologies.

Donors and investors can help build capacity to measure social performance in the following ways:

- Provide support for developing and refining the common social performance tools being created.
- Collaborate with other funders to support tool and methodology refinement to avoid proliferation of a competing, and possibly confusing, set of tools.
- Coordinate with other funders to help scale up training programs to build the capacity of retail financial service providers, donors, and investors to measure social performance.
- Encourage retail financial service providers to track their social performance once the tools have been refined for widespread adoption.

APPLYING DELIVERY TECHNOLOGY TO REDUCE COSTS

Technology promises to help financial institutions reduce transactions costs, increase security by minimizing the use of cash, and reach larger numbers of poorer and harder-to-reach clients. Transforming corner grocers, petrol stations, and lottery outlets into service points in remote areas can be much less expensive than investing in branch infrastructure. Examples of nontraditional delivery channels include ATMs, point-of-sale networks (networks of devices that use debit or credit cards for electronic payments and transactions), and mobile phone banking. These technologies allow customers to make payments, transfers, cash withdrawals, and deposits without having to travel to branch offices.

However, challenges remain: customer adoption and convenience is still unproven, financial institutions are not convinced yet about the business model of serving the poor through technology delivery channels, and policy makers need to better understand the appropriate regulatory environment for technology-enabled delivery of financial services. So far, relatively few financial institutions have begun experimenting with new delivery technologies, and it is not yet certain whether they are profitable. Moreover, financial institutions can effectively employ delivery technologies only when core information systems are strong, which is often not the case.

Possible areas of support for donors and investors include the following:

- Support experimentation and learning about the emerging delivery technologies and their ability to profitably reach poorer and more remote clients.
- Work with governments to ensure regulations are conducive to the application of new delivery technologies—specifically, rules governing the use of electronic payments, account opening requirements, and agency relationships.

- Support consumer (and possibly financial institution staff) education about the use and safety of different delivery technologies.
- Ensure funding for technology is complemented by capacity building in human resources, risk management, and governance.

In supporting technology projects, donors and investors should seek independent, specialized advice; understand whether the proposed delivery channel is the best for the specific institution; ask tough questions about the viability of the investment and the stability of core information systems software; be realistic about upfront and ongoing costs (which can be substantial); and avoid re-inventing the wheel.

TAPPING DOMESTIC FUNDING MARKETS

The main objective of improving access to finance should be to build domestic capital markets that can serve local financing demands and successfully intermediate funds. Today, most domestic financial systems in developing countries have excess liquidity, although that liquidity is not widely intermediated and often circulates only among a tiny elite. Many financial institutions that serve poor and low-income people (such as large savings banks, postal banks, and other community banks and cooperatives) already capture large volumes of deposits locally. Beyond savings, other potential sources of domestic financing include debt from commercial banks, certificates of deposit, and bonds as well as equity from domestic individuals or funds and issuing shares on the stock exchange (where they exist). Despite success with mobilizing deposits among some institutions, most specialized MFIs are far from integrating into domestic markets.

Donors and social investors of all kinds face a dilemma: how can they stimulate but not replace domestic markets? The microfinance community is just beginning to tackle this question. There is certainly a role for external funding—for instance, to bridge temporary illiquidity gaps, to support younger but promising MFIs that do not yet have access to markets, and to offer longer-term funds not yet available on domestic markets. But international funders (notably those that incorporate subsidy into their support) risk crowding out domestic funding, especially deposits. And the newer generation of more commercially minded social investors can expose MFIs to serious foreign exchange risks when they lend in hard currency. For those donors and investors with the appropriate instruments and technical skills, emerging suggestions include the following:

- Encourage and build capacity of financial service providers for pro-poor savings mobilization.
- Explore using guarantees and other financial innovations that could link microfinance to domestic funding markets.
- Provide funding in local currency whenever possible; otherwise use structures that enable MFIs to be protected from currency movements and ensure that

MFIs borrowing in foreign currency fully understand the risks entailed in such transactions.

- Support broader capital markets development.
- Improve availability of information on the performance and risk profile of microfinance providers to attract local funders.
- Build knowledge and methods for better understanding the true liquidity needs of financial institutions that serve the poor in a given country context.

GRADUATING THE POOREST INTO MICROFINANCE

Widespread experience with microcredit has found that it often does not reach the poorest—those at the very bottom of income distribution, typically with incomes below 50 percent of a country’s poverty line—and can even harm the poor who do not have capacity to absorb debt. Many of the poorest need non-financial support or safety net services, such as food, skills training, nutrition and health assistance, and asset transfer, before they are in a position to repay loans. These services are provided on a grant basis because the poorest are not able to pay the costs of delivery. Traditionally, these programs have not attempted to prepare their clients to become microentrepreneurs, to save, or to access other financial services.

A few organizations, however, have linked provision of social safety net services and microfinance and have successfully graduated the very poorest from recipients of social services to clients of conventional MFIs. In these programs, services are provided for a finite period, thus enabling recipients to develop the skills required to operate a very small enterprise successfully and learn how to save small amounts of money in financial institutions. After a fixed period, recipients are expected to graduate to a conventional microfinance program.

There are various models for providing such services. These models involve a range of partners from government social safety net programs, MFIs, and NGOs that specialize in business development services. To avoid undermining the culture of strict repayment discipline for loans and therefore the sustainability of the MFI, there must be a clear distinction between grant and microlending components.

Substantial further experimentation and testing is needed before programs that link safety net support and microfinance can be mainstreamed. Possible support areas for donors include the following:

- Provide grants for social safety net support and skills training programs.
- Experiment with different models for preparing the poorest for microfinance and linking these clients to MFIs.
- Develop appropriate ways to measure the cost effectiveness of nonfinancial service graduation programs.
- Create barriers between grant and loan programs

Intervention in these frontier areas poses particularly difficult challenges for donors and investors and requires new thinking and support for innovation. However, innovation should not be seen as justification for projects that do not follow good practice guidelines. Many financial institutions, support networks, and other actors regularly make breakthroughs on these issues. It is hoped that the *Guidelines* in these and other areas can be continuously updated to reflect the state of the art.

Glossary of Terms

apex lending institution A second-tier or wholesale organization that channels funding (grants, loans, guarantees) to multiple MFIs in a single country. Funding may be provided with or without supporting technical services.

business development services (BDS) Nonfinancial services used by entrepreneurs to help them operate and expand their businesses. Examples include training, technical assistance, infrastructure, and market development and intelligence.

CGAP The Consultative Group to Assist the Poor is a global resource center for microfinance standards, operational tools, training, and advisory services. Its members—including bi- and multilateral development agencies and private funders of microfinance programs—are committed to building more inclusive financial systems for the poor. For more information on CGAP and its work, visit www.cgap.org.

community-managed loan fund Funds that are operated by group members, with no professional management or supervision of lending and collection. They are often referred to as revolving funds, self-managed village banks, self-help groups, or accumulating savings and credit associations.

credit bureau A database of information about consumers, including demographics, payment patterns of various types of credit obligations, and records of bad debt. Lenders and other businesses use credit bureaus to screen and evaluate parties to whom they are considering extending credit.

credit component Credit included as part of a larger project focusing, for instance, on agriculture, health, post-conflict rehabilitation, or social services. Such credit is often targeted at a particular group of people for the purpose of purchasing an input or changing behavior. The loans may be made by formal financial institutions, by community groups, or by the project itself.

destitute In this document, “destitute” describes people who are too poor to use formal financial services effectively and need different kinds of development assistance (for instance, food or employment).

directed credit Government credit assistance channeled to specific target groups (e.g., farmers, women, etc.) via loans or loan guarantees, often on a subsidized basis.

donors and investors In the *Guidelines*, the term “donors and investors” encompasses a range of funding agencies, including bilateral donors, foundations, multilateral development banks, and socially oriented private investors. The guidelines are also relevant for other organizations that fund microfinance or manage microfinance programs on behalf of donors, such as international NGOs, project management units, and apex lending facilities.

exit strategy A plan that allows for a donor or investor to disengage from an institution while leaving the institution in a position to continue sustainable operations without further inputs from the donor or investor. Exit strategies are very different for public donors and private investors, and tailored strategies need to be defined for each situation.

financial institution Any public or private institution whose principal business is collecting funds from the public or other institutions and investing them in financial assets, such as loans, bonds, or deposit accounts, rather than tangible property.

Financial Sector Assessment Program (FSAP) The FSAP, a joint IMF-World Bank effort introduced in May 1999, promotes the soundness of financial systems in member countries. Supported by local and international experts from a range of agencies and standard-setting bodies, an FSAP team identifies the strengths and vulnerabilities of a country's financial system, determines how key risks are being managed, assesses the sector's developmental and technical assistance needs, and helps prioritize policy responses. For more information, go to www.imf.org/external/NP/fsap/fsap.asp.

guarantee/guarantee instruments A guarantee is a financial contract in which a lender (e.g., a local bank) extends credit to a borrower (e.g., an MFI), based on a promise by a guarantor (e.g., a donor) to absorb a specified portion of losses if the borrower fails to pay as promised. By reducing the lender's risk, the guarantor hopes to encourage the lender to make loans that the lender would otherwise have rejected as too risky.

inclusive financial systems A financial system that provides services to all kinds of clients, not just microentrepreneurs or employed people. Inclusive financial systems are those where the goal of widespread access to finance is reflected within levels of the financial system: micro, meso, and macro.

macro level The macro level is one of the three levels of a financial system and comprises government policies and systems, including laws and regulations and enforcement bodies, such as bank supervisors.

mandated portfolio quotas A government requirement that banks invest or lend a specified amount of their assets for defined social purposes.

market infrastructure The market infrastructure of a financial system consists of services and systems that support the functioning of the industry, not just a single institution. It includes transfer and payments systems, credit bureaus, rating agencies, auditors, professional networks, trade associations, information technology, and technical service providers. These actors make up what is referred to as the "meso" level in this document.

meso level The meso level is one of the three levels of a financial system and comprises the financial market infrastructure, such as auditors, rating agencies, networks and associations, credit bureaus, transfer and payments systems, and information technology and technical service providers.

micro level The micro level is one of the three levels of a financial system and comprises retail financial and nonfinancial institutions, including private and government-owned banks, savings and credit cooperatives, postal banks, member-owned community organizations, finance companies, and other suppliers (such as moneylenders, agricultural traders, etc.).

microfinance institutions (MFIs) Financial institutions that target poor and low-income persons as their main market niche. MFIs encompass various types of institutions, ranging from formal (institutions licensed by and prudentially supervised by the country's banking authorities, e.g., banks and licensed nonbank financial institutions, such as finance companies) to semi-formal (registered with and officially recognized by some public authority, but not prudentially supervised by the banking authorities, e.g., cooperatives, NGOs, village savings banks) to informal (not registered with or officially recognized by any government authority, e.g., community savings groups, unregistered moneylenders or savings collectors).

national stakeholders The full range of actors involved in or affected by microfinance in a given country, including governments, private business, not-for-profit associations, and civil society.

network A microfinance network is a group of institutions (usually international or regional) with the goal of fostering retail institutions, developing standards, wholesaling funds, providing technical services, developing and spreading knowledge, and/or leading policy reform efforts. There is a lot of

overlap between networks and microfinance associations (MEAs). MEAs are member-based organizations, with a membership primarily made up of independent MFIs operating in similar markets.

nongovernmental organization (NGO) A private not-for-profit organization devoted to addressing social issues or common member interests.

Pink Book The informal name for the 1995 donor guidelines on microfinance, *Guiding Principles for Selecting and Supporting Intermediaries*, produced by the Committee of Donor Agencies for Small Enterprise Development and the Donors' Working Group on Financial Sector Development.

poor In this document, "poor" refers to people in the lower part of the income distribution, below the middle class, and defined as those who have insufficient resources to meet some defined level of consumption. The "very poor" or "extreme poor" are usually considered to be those individuals in the bottom 50 percent of those below the poverty line and/or living on a dollar a day or less. "Low income" people occupy the lower ranges of the income spectrum, including not just the poor but also wealthier, but still vulnerable, people who have relatively low resources, even though they do have enough to satisfy defined basic consumption needs.

Poverty Reduction Strategy Papers (PRSPs) Papers prepared by member countries of the International Monetary Fund through a participatory process that involves domestic stakeholders and external donors and investors, including the World Bank and the IMF. PRSPs describe a country's macroeconomic, structural, and social policies and programs over a three-year or longer horizon, their impact on broad-based growth and poverty reduction, and associated external financing needs and funding sources.

project implementing unit (PIU) A team that is assembled and paid to carry out operations of a project (for instance, microlending), but that is not organized as a permanent institution with its own legal identity (for instance, an MFI).

prudential vs. nonprudential regulation/supervision Financial regulation or supervision is "prudential" when it is aimed at protecting the financial health of deposit-taking institutions, thereby lowering the risk of financial system crisis and losses by small, unsophisticated depositors. "Nonprudential" rules and supervision also govern the behavior of financial institutions, but are aimed at limited objectives, such as transparency or fair treatment of consumers, rather than the more complex, intrusive, and expensive task of protecting the overall financial health of the regulated institutions.

sector-wide approaches (SWAps) A funding modality whereby all significant funding for a sector (e.g., education, health, agriculture) supports a single government expenditure program with strong government ownership of the design of the program's budget and activities.

social performance Effective translation of an institution's social goals into practice (actions, corrective measures, outcome), where the social value of microfinance relates to improving the lives of poor and excluded clients and their families and widening the range of opportunities for communities. To create this value, the social objectives of an MFI may include serving increasing numbers of poor and excluded people sustainably, improving the quality and appropriateness of financial services available to the target clients, creating benefits for the clients of microfinance, their families, and communities relating to social capital and social links, etc.

sustainability Refers to the ability of a provider to continue and expand its operations without need of further subsidies. It involves two elements: (1) operating revenue (excluding subsidies) is sufficient to cover all financial and administrative costs; and (2) loan delinquency or default does not exceed the levels industry experience has shown to be necessary to avoid eventual collapse of repayment discipline among clients.

ANNEX 1

Recommended Reading

CGAP PUBLICATION SERIES

Briefs. CGAP Briefs are two-page documents that focus on current issues in microfinance.

Case Studies in Donor Good Practice. The case studies highlight examples of donor good practice in microfinance.

Consensus Guidelines. Developed by CGAP in cooperation with other organizations working in microfinance, the Consensus Guidelines are intended to establish standards and accepted terms and definitions in microfinance. These guidelines are published in final form only after consensus is reached among players across the whole spectrum of the industry.

Country-level Effectiveness and Accountability Reviews (CLEARs). The overall objective of the CLEARs is to help donors improve their effectiveness in building financial systems that work for the poor through both individual and collective actions. For more information visit: www.cgap.org/clear.

Country-level Reports. These reports provide in-depth country-level analysis on legal and regulatory environment, savings, and donor effectiveness.

Donor Briefs. Donor Briefs offer concise two-page presentations of issues affecting microfinance programming and operations by donors.

Focus Notes. The Focus Note Series is CGAP's primary vehicle for dissemination to governments, donors, and private financial institutions on best practices in microfinance.

Occasional Papers. Occasional Papers are technical guides for practitioners on key microfinance operational topics.

CGAP Phase III Strategy, 2003–2008. This strategy paper sets out the priorities guiding the third phase of CGAP. It defines the role of microfinance in the development agenda and discusses the key challenges for expanding financial services to the poor on a much larger and more sustainable scale.

Donor Peer Review Letters. The Microfinance Donor Peer Reviews, facilitated by CGAP on behalf of development leaders and conducted from May 2002 to November 2003, examined the *modus operandi* of 17 bilateral and multilateral agencies. The letters outline agencies' strengths and challenges with respect to applying good practice and present specific recommendations for improving the effectiveness of microfinance operations. Available at www.cgap.org/projects/donor_peer_reviews.html

Technical Guides. Series of practical handbooks specifically tailored to address gaps in microfinance technical knowledge for microfinance institutions and funding agencies.

GENERAL MICROFINANCE RESOURCES

Armendariz, Beatriz, and Jonathan Morduch. 2005. *The Economics of Microfinance*. Cambridge, Mass.: The MIT Press.

Helms, Brigit. 2006. *Access for All*. Washington, D.C.: The World Bank.

Ledgerwood, Joanna. 1998. *Microfinance Handbook: An Institutional and Financial Perspective*. Washington, D.C.: The World Bank.

Robinson, Marguerite. 2001. *The Microfinance Revolution*. Volume 1. Washington, D.C.: The World Bank and the Open Society Institute.

Robinson, Marguerite. 2002. *The Microfinance Revolution*. Volume 2. Washington, D.C.: The World Bank and the Open Society Institute.

Microfinance Gateway, www.microfinancegateway.org. The Microfinance Gateway is a comprehensive source of information on microfinance. It contains more than 5,000 publications on microfinance and related topics, provides summaries and reading recommendations for selected documents, and features glossaries and upcoming events. It also provides many useful links and hosts several resource centers, including:

Microinsurance Focus Resource Center provides practical case studies, tools, current articles and resources to practitioners and others interested in this emerging field.

Technology Resource Center was designed to help microfinance institutions select the best information system, learn how to implement it, and find funding for their technology or innovation.

Microfinance Regulation and Supervision Resource Center, created jointly by CGAP and the IRIS Center at the University of Maryland, pulls together in one central location a growing collection of information and resources on recent experiences in regulating and supervising.

Savings Information Resource Center collects, organizes, and disseminates the vast amount of information on savings.

UNDERSTANDING THE NEEDS OF POOR CLIENTS

Branch, Brian, and Janette Klaehn. 2002. *Striking the Balance in Microfinance: A Practical Guide to Mobilizing Savings*. Washington, D.C.: World Council of Credit Unions.

Littlefield, Elizabeth, Jonathan Morduch, and Syed Hashemi Mesbahuddin. 2003. "Is Microfinance an Effective Strategy to Reach the Millennium Development Goals?" CGAP Focus Note 24. Washington, D.C.: CGAP, January.

Rutherford, Stuart. 2000. *The Poor and Their Money*. New Delhi: Oxford University Press.

Savings Guidelines Experts Working Group. 2005. *Developing Deposit Services for the Poor*. Microfinance Consensus Guidelines. Washington, D.C.: CGAP.

Sebstad, Jennifer, and Monique Cohen. 2000. *Microfinance, Risk Management, and Poverty*. Washington, D.C.: U.S. Agency for International Development.

MICRO LEVEL: PROMOTING STRONG RETAIL INSTITUTIONS

CGAP. 2006. *Format for Appraisal of Microfinance Institutions*. CGAP Technical Guide. Washington, D.C.: CGAP.

Christen, Robert Peck. 2005. *Due Diligence Guidelines for the Review of Microcredit Loan Portfolios*. CGAP Technical Tool. Washington, D.C.: CGAP, June.

Richardson, David C. 2002. *PEARLS Monitoring System*. Madison, Wisc.: The World Council of Credit Unions.

Rosenberg, Richard, Patricia Mwangi, Robert Peck Christen, and Mohamed Nasr. 2004. *Financial Statement Disclosure Guidelines*, 2d edition. Microfinance Consensus Guidelines. Washington, D.C.: CGAP.

Saltzman, Sonia B, Rachel Rock, and Darcy Salinger. 1998. *Performance and Standards in Microfinance: ACCION's Experience with the CAMEL Instrument*. Washington, D.C.: ACCION International.

SEEP Network. 2004. "Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis and Monitoring." Draft paper.

SPEED-USAID. 2003. *MFI Performance Monitoring Tool*. Version 1.04. (CD-ROM) Kampala, Uganda: SPEED-USAID.

MESO LEVEL: SUPPORTING INDUSTRY INFRASTRUCTURE

Committee of Donor Agencies for Small Enterprise Development. 2001. "Guiding Principles for Donor Intervention." BDS Guidelines. Washington, D.C.: World Bank, Business Development Services for Small Enterprises.

- SEEP. 2004. "Recommendations on Donor Guidelines to Support Microfinance Associations." Washington, D.C.: German Agency for Technical Cooperation.
- SEEP. 2004. "Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis and Monitoring." Draft paper. Washington, D.C.
- Tenn, Sharyn, and Patrick McAllister. 2006. "Effective Donor Strategies to Support Microfinance Associations." Washington, D.C.: SEEP Network.

OTHER

- Business Development Services. www.bdsknowledge.org. This interagency exchange provides information on emerging practices for making markets work for the poor, with particular reference to supporting services for women and men working in small enterprises.
- Microfinance Rating and Assessment Fund* is a joint initiative of the Inter-American Development Bank (IDB), the Consultative Group to Assist the Poor (CGAP), and the European Union. The primary objectives of the Rating Fund are market building for MFI rating and assessment services and improved transparency of MFI financial performance. www.ratingfund.org.
- MIX (Microfinance Information eXchange). www.themix.org. The MIX is a nonprofit organization whose mission is to help build the microfinance market infrastructure by offering data sourcing, benchmarking and monitoring tools, as well as specialized information services. The MIX publishes *The MicroBanking Bulletin*.

MACRO LEVEL: FOSTERING A CONDUCTIVE POLICY ENVIRONMENT AND ENSURING THE APPROPRIATE ROLE OF GOVERNMENT

- Christen, Robert Peck, and Richard Rosenberg. 2000. "The Rush to Regulate: Legal Frameworks for Microfinance." Occasional Paper 4. Washington, D.C.: CGAP, April.
- Christen, Robert Peck, Timothy R. Lyman, and Richard Rosenberg. 2003. *Guiding Principles on Regulation and Supervision in Microfinance*. Microfinance Consensus Guidelines. Washington, D.C.: CGAP.
- Duflos, Eric, and Kathryn Imboden. 2004. "The Role of Governments in Microfinance." Donor Brief 19. Washington, D.C.: CGAP, June.
- Helms, Brigit, and Xavier Reille. 2004. "Interest Rate Ceilings and Microfinance: The Story So Far." Occasional Paper 9. Washington, D.C.: CGAP, September.

ENSURING EFFECTIVENESS OF DONORS

- Committee of Donor Agencies for Small Enterprise Development and Donors' Working Group on Financial Sector Development. 1995. *Micro and Small Enterprise Finance: Guiding Principles for Selecting and Supporting Intermediaries*. Washington, D.C.: World Bank. (Also known as the Pink Book.)
- Duflos, Eric, Brigit Helms, Alexia Latortue, and Hannah Siedek. 2004. "Global Results: Analysis and Lessons." CGAP Aid Effectiveness Initiative. Washington, D.C.: CGAP.
- Helms, Brigit, and Alexia Latortue. 2004. "Elements of Donor Effectiveness in Microfinance: Policy Implications." Aid Effectiveness Initiative. Washington, D.C.: CGAP.

FRONTIER ISSUES

Reaching the remote and rural poor

- Christen, Robert, and Douglas Pearce. 2005. "Managing Risks and Designing Products for Agricultural Microfinance: Features of an Emerging Model." Occasional Paper 11. Washington, D.C.: CGAP, August.

- Kloeppinger-Todd, Renate. 2005. *Meeting Development Challenges: Renewed Approaches to Rural Finance*. Washington, D.C.: World Bank.
- Nagarajan, Geetha, and Richard L. Meyer. 2005. "Rural Finance: Recent Advances and Emerging Lessons, Debates, and Opportunities." Reformatted version of Working Paper AEDE-WP-0041-05, Department of Agricultural, Environmental, and Development Economics, Columbus, Ohio: Ohio State University.
- Pearce, Douglas. 2003. "Financial Services for the Rural Poor." Donor Brief 15. Washington, D.C.: CGAP, October.

Measuring and improving accountability on social performance (Examples of Social Performance Work)

- Imp-Act* is a global program designed to improve the quality of microfinance services and their impact on poverty through the development of impact assessment systems. www.imp-act.org.
- The *SEEP Working Group on Client Assessment* is developing practical social performance indicators for use by practitioners (financial institutions and networks that make up its membership). www.seepnetwork.org.
- The Social Performance Task Force, comprised of donors, investors, retail financial service providers, and microfinance networks, works to promote the practice of social performance. To read the Social Performance Task Force statement, see www.triasngo.be.
- The Social Performance Indicators Initiative is implemented by members of the *CERISE network (Comité d'échanges, de réflexion et d'information sur les systèmes d'épargne crédit)* based in France. www.cerise-microfinance.org.
- USAID has been working with the *Center for Institutional Reform and the Informal Sector (IRIS)* to develop and field test tools for assessing the poverty level of its microenterprise clients. Tools will be finalized in summer 2006. www.povertytools.org.

Applying delivery technology to reduce costs

- Ivatury, Gautam. 2006. "Using Electronic Payments to Build Inclusive Financial Systems." Focus Note 32. Washington, D.C.: CGAP, January.
- Ivatury, Gautam, and Nicole Pasricha. 2005. "Funding Microfinance Technology." Donor Brief 23. Washington, D.C.: CGAP, April.

Tapping domestic funding markets

- de Sousa-Shields, Marc, and Cheryl Frankiewicz. 2004. *Financing Microfinance Institutions: The Context for Transitions to Private Capital*. Micro Report, no. 8. Accelerated Microenterprise Advancement Project. Washington, D.C.: U.S. Agency for International Development.
- Emerson, Jed, and Josh Spitzer. 2006. "Blended Value Investing: Capital Opportunities for Social and Environmental Impact." Geneva: World Economic Forum, March.
- Featherston, Scott, Elizabeth Littlefield, and Patricia Mwangi. 2006. "Foreign Exchange Risk in Microfinance: What Is It and How Can It Be Managed?" Focus Note 31. Washington, D.C.: CGAP, January.
- Ivatury, Gautam, and Julie Abrams. 2005. "The Market for Microfinance Foreign Investment: Opportunities and Challenges." Focus Note 30. Washington, D.C.: CGAP, August.

Graduating the poorest into microfinance

- Hashemi, Syed, and Richard Rosenberg. 2006. "Graduating the Poorest into Microfinance: Linking Safety Nets and Financial Services." Focus Note 33. Washington, D.C.: CGAP, January.

ANNEX 2

Minimum Financial Performance Indicators for Retail Financial Institutions¹²

1. Outreach. How many clients are being served?

Indicator:

number of active clients or accounts

2. Depth of outreach. How poor are the clients?

*Indicator:*¹³

average outstanding balance per client OR account as a proportion of Gross National Income per capita

3. Portfolio quality. How well is the financial institution collecting its loans?

Indicator:

portfolio at risk > 30 days and write-off ratio OR annual loan-loss rate

4. Financial sustainability. Is the financial institution profitable enough to maintain and expand its services without continued injections of subsidized donor funds?

Indicator for unsubsidized institutions:

return on assets OR return on equity

Indicator for subsidized institutions:

adjusted return on assets OR financial self-sufficiency

5. Efficiency. Is the financial institution providing services at the lowest possible cost to clients?

Indicator:

cost per client OR operating expense ratio

¹² Rosenberg, Richard. "Core Performance Indicators for Microfinance (Draft). Washington D.C.: CGAP, 2005.

¹³ This indicator will be strengthened in the near future as more precise social performance indicators become available and increased consensus is reached on their use.

ANNEX 3

Persons Who Provided Feedback on the *Guidelines*

1ST EDITION

Balkenhol, Bernd, ILO
Boulter, Richard, DFID
Braun, Gabriela, GTZ
Castrén, Tuukka, Ministry of
Foreign Affairs, Finland
CGAP staff
Como, Odoardo, EC
Croulet, Ross, AfDB
Cuevas, Carlos, WB
DeGiovanni, Frank, The Ford
Foundation
Dommel, Henri, IFAD
Dunford, Chris, Freedom from
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