

**BUILDING INCLUSIVE FINANCIAL SYSTEMS:
DONOR GUIDELINES ON GOOD PRACTICE IN
MICROFINANCE**

December 2004

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EXECUTIVE SUMMARY

These Guidelines seek to raise donor staff awareness of good practice and improve the effectiveness of donor operations in microfinance. The lessons learned during 30 years of support to the sector are translated into practical, operational guidance for donor staff.

CGAP's 28 member donors have defined a vision for the future of microfinance: a world in which poor people everywhere enjoy permanent access to a wide range of financial services, delivered by different types of institutions through a variety of convenient mechanisms. To improve their financial lives, **poor clients** require responsive financial services beyond microenterprise credit—services that encompass savings, transfers, payments and insurance. Financial services are not, however, the magic bullet for all poor people. The destitute are often in need of other development interventions, such as 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 donor effectiveness in building financial systems is to complement, not replace, private capital and to accelerate innovative market solutions. Concessional finance has a role in building the institutional capacity of service providers and underwriting the development of experimental services (the micro level), supporting infrastructure such as rating agencies, credit bureaus, and audit capacity (meso level), and fostering an enabling policy environment (macro level).

The backbone of financial systems remains **micro-level**, or retail, institutions that provide services directly to clients. A wide range of financial and non-financial institutions are required to serve the needs of poor people. Financial sustainability is essential to reach significant numbers of poor people and to realize long-term social returns.

The **meso level** refers to the overall infrastructure of the financial system, comprising quality auditors, rating agencies, networks and associations, credit bureaus, transfer and payments systems, information technology and technical service providers. Donor support at this level aims to extend these services to microfinance so as to mainstream rather than marginalize it.

At the **macro level**, a conducive and stable macroeconomic and policy environment is necessary to underpin a pro-poor financial system. Government entities have a constructive role in supporting interest rate liberalization, controlling inflation and providing prudential regulation and supervision of institutions that take deposits. Donors should not support the direct provision of financial services by governments.

All donors cannot work at all levels of the financial system. Rather, each should act upon its **comparative advantage**. Five elements of donor effectiveness can help agencies define their specific strengths and identify partners that complement their capacities: (1) strategic clarity and coherence, (2) strong staff capacity, (3) accountability for results, (4) relevant knowledge management, and (5) appropriate instruments.

Despite significant learning about how to be effective in microfinance, **frontier issues** like rural finance, product development in microinsurance and remittances, social performance measurement, and others require further experience to define good practice.

FOREWORD

Financial services for the poor, or microfinance, can be a powerful tool to fight poverty. Access to financial services such as savings, credit, transfers, payments, and insurance can help poor people take control of their financial lives. When good practice is applied, access may empower them to make critical choices about investing in businesses, sending their children to school, improving health care for their families, covering the cost of key social obligations such as marriages, and protecting themselves from crises like sickness, death, and natural disasters. Microfinance should not, however, be seen as a panacea for poverty reduction; other social and economic investments are also required.

The donor community spends an estimated US\$800 million–US\$1 billion per year on microfinance. Donors value microfinance particularly because access to financial services by the poor can contribute to poverty reduction and achievement of the Millennium Development Goals (MDGs) by 2015. The MDGs prescribe concrete development outcomes related to multiple dimensions of poverty, including income, health, education, and improving the international development system.

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 (see box 1). These Principles were drawn up by CGAP, a consortium of 28 public and private member donors and a clearinghouse for microfinance. The guidelines contained in this document translate the Key Principles into concrete operational guidance for donor staff.

The Microfinance Donor Peer Reviews launched by CGAP donor members in 2002 collectively addressed aid effectiveness from the perspective of internal agencies’ procedures, processes and systems.¹ In February 2004, the heads of the participating 17 agencies discussed the outcome of the Peer Reviews and underscored the importance of improved aid effectiveness in building inclusive financial systems.² They accordingly agreed on a Joint Memorandum and a program of work to codify good practice. These *Donor Guidelines on Good Practice in Microfinance* build on this high-level commitment to good practice and donor harmonization.

¹ See Part IV of these Guidelines for a description of the CGAP Aid Effectiveness initiative. The following agencies participated in the initiative: 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 Organization, Kreditanstalt für Wiederaufbau, 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 U.S. Agency for International Development.

² The term “**inclusive financial systems**” refers to the integration of microfinance into formal financial systems to ensure permanent access to financial services by significant numbers of poor people. This delivery of all forms of financial services by a large range of institutions requires the development of the system on all three levels: micro (retail-level financial institutions and other providers), meso (financial infrastructure) and macro (enabling policy environment).

Box 1. Summary of the Eleven Key Principles of Microfinance

Prepared by CGAP and endorsed by the G8 in 2004

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 role 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.** Donor subsidies should be temporary start-up support designed to get an institution to the point where it can tap private funding sources, such as deposits.
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).

OBJECTIVES AND STRUCTURE OF THE GUIDELINES

Existing donor principles for microfinance (known as the “Pink Book”) were jointly developed in 1995 by the Donors’ Working Group on Financial Sector Development and the Committee of Donor Agencies for Small Enterprise Development.³

The Pink Book has stood the test of time with regard to funding retail-level microfinance institutions.⁴ 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 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 other forums, have enabled donors to learn much about what does and does not work in supporting pro-poor financial systems. Yet a great deal remains to be learned. With most poor people lacking access to basic financial services, microfinance—and donor support for it—has yet to reach its full potential. In fact, agreement among technical staff on basic good practice is still not consistently reflected in donor operations on the ground. This reality led CGAP to facilitate a process to draft updated good practice guidelines that would incorporate new learning.⁵

The new Guidelines seek to raise donor staff awareness of good practice and improve the effectiveness of donor operations in microfinance. The key question addressed by the Guidelines is: What is the best use of subsidies? To answer this question, the Guidelines compile lessons learned over the past several years about basic conditions for successful microfinance, with an emphasis on donor support to the sector realized primarily in partnership with private partners.

Drawing on these lessons, the Guidelines provide practical, operational guidance for donor staff in the field and at headquarters who conceptualize, design, implement, and monitor programs related to improving poor people’s access to financial services. The intent is not to dictate “one way” to support microfinance, but rather to support a diversity of approaches and priorities within a framework of basic good practice principles. The Guidelines also highlight issues that remain unresolved and require further experience before consensus on good practice can be reached.

The Guidelines were developed by and for CGAP members, which include bilateral donors, foundations and multilateral development banks, all of which are collectively referred to as “international development partners” The Guidelines are also applicable to many other organizations

³ Committee of Donor Agencies for Small Enterprise Development, 1995, *Micro and Small Enterprise Finance: Guiding Principles for Selecting and Supporting Intermediaries* (also known as the “**Pink Book**”) Donors’ Working Group on Financial Sector Development, World Bank, Washington DC.

⁴ **Microfinance institutions** (or MFIs) are financial institutions that focus on providing microfinance services. MFIs encompass various types of institutions, ranging from formal (banks) to semi-formal (cooperatives, NGOs, village savings banks) to informal (savings and credit groups).

⁵ A subcommittee of the CGAP Executive Committee was established to lead the process in consultation with all CGAP member donors and stakeholders. Subcommittee members were Brian Branch, World Council of Credit Unions (WOCCU); Frank DeGiovanni, Ford Foundation, and David Stanton, U.K. Department for International Development. For more information on CGAP, visit www.cgap.org.

that fund microfinance or design and manage microfinance programs on behalf of donors, such as international non-governmental organizations (NGOs), project management units (PMUs), apex facilities, social and commercial investors and consultants. As used in these Guidelines, then, the term “donor” encompasses all these development partners.

The Guidelines have four parts. Part I introduces a new vision of inclusive financial systems that work for the poor majority and discusses the role of donors. Part II addresses the financial service needs of poor clients (the demand side). Part III looks at the financial system (supply side) on three levels: micro (retail-level financial institutions and other organizations, such as retailers, agricultural traders, marketing intermediaries, and input suppliers that provide financial services directly to poor clients), meso (industry infrastructure), and macro (enabling policy and the role of governments).⁶ Both the second and third parts provide lessons learned and practical operational guidelines. Finally, Part IV explores basic principles for improving donor effectiveness, harmonization, and collaboration in microfinance, drawing on aid effectiveness work currently being implemented by CGAP member donors. It also lists a number of “frontier issues” on which less consensus existed at the time of publication. These issues require more work before good practices can be defined.

⁶ “**Financial institution**” refers to any institution (public or private) that collects funds (from the public, donors, or other institutions) and invests them in financial assets such as loans, bonds, or deposits, rather than tangible property. In a financial system the **industry infrastructure** comprises quality auditors, rating agencies, professional networks, trade associations, credit bureaus, transfer and payments systems, information technology and technical service providers. These actors make up what is referred to as the meso level in this document.

PART I. INTRODUCTION

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, UN Secretary General, 2003

Financial services can play a critical role in reducing poverty. Permanent access to financial services can enable poor people to increase incomes, build assets, and reduce their vulnerability to external shocks. 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 highly participatory process involving multiple stakeholders, CGAP's 28 member donors have defined a vision for the future of microfinance. The new vision is one in which poor people everywhere in the developing world enjoy permanent access to a wide range of financial services, delivered by different types of financial and non-financial institutions through a variety of convenient mechanisms. Financial services for the poor encompass savings, credit, payment and transfer services, and insurance. Providers include non-governmental microfinance institutions, savings and credit cooperatives, commercial banks, community-based organizations with bank linkages, insurance companies, state banks and others. These Guidelines attempt to codify what is already known about basic principles of good practice, consolidating a body of operational knowledge that can lead to the realization of this vision.

Inclusive Financial Systems

The new vision recognizes that large-scale sustainable microfinance can be achieved only if financial services for the poor are integrated into all three levels of a financial system: micro, meso, and macro.⁷ In general, integration allows 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. Ultimately, integration into the financial system could open financial markets to the majority of people living in developing countries, including poorer and more geographically remote clients than are currently reached.

Success in building inclusive financial systems hinges on the contributions of a wide range of actors and their ability to work together effectively. In addition, financial systems for the poor depend on existing conditions, such as infrastructure, access to markets, production technology, and availability of information to mitigate risk. The backbone of financial systems remain retail-level institutions that provide services directly to clients (micro level).

In addition, a supporting infrastructure comprising quality auditors, rating agencies, professional networks, trade associations, credit bureaus, transfer and payments systems, information technology,

⁷ Although these Guidelines refer to the "**financial system**" as comprising all three levels (micro, meso and macro), many individual actors at each level are not exclusively dedicated to financial sector work (e.g., auditors, agroprocessors, technical service providers). The "**financial sector**" is defined more narrowly to include only those actors directly involved in providing financial services or supervising financial institutions.

technical service providers and trainers is required to reduce transactions costs, increase outreach, build capacity, and foster transparency among retail institutions.⁸ This infrastructure, known as the “meso” level, can transcend national boundaries and include regional or global actors.

Finally, a conducive and stable macroeconomic and policy environment is necessary to underpin a pro-poor financial system. Central banks, ministries of finance, and other national government entities constitute the main “macro”-level players.

It is important to note that all aspects of an inclusive financial system may be difficult to apply in all countries. As in every other area of development, one of the most important starting points should be the country context. For instance, in countries with dysfunctional or non-existent financial systems, the entry point for building permanent access to financial services for poor people will differ from the entry point in countries with flourishing financial systems. Unequal access to financial services is also present in countries with sound financial systems, and interventions may be required to remedy market failures and expand access. A functioning financial system should be seen as a necessary, but certainly not sufficient, condition to assure permanent access to financial services for poor people.

The Role of Donors

International development partners have played an important role in supporting the emergence and development of microfinance. However, because donor programs on the ground do not consistently reflect their commitment to good practice, they have not always achieved the desired impacts. In some cases, these programs have actually retarded the development of inclusive financial systems by distorting markets and displacing local commercial initiative with cheap or free money. Donors need to recognize that they play only a supportive role and that their partners on the ground actually deliver financial services. At the very least, these Guidelines seek to enforce a sort of Hippocratic oath for donors to “do no harm.”

As microfinance evolves and becomes more complex, donors face an even greater challenge: enhancing professionalism and applying good practice. They must engage with a much broader range of actors at the micro, meso, and macro levels, and allow private and public sector partners to fulfill their appropriate roles. The role of donors in the future of microfinance will, moreover, change in response to new challenges, such as expanding and deepening access, that the private financial system may not automatically address. All donors cannot necessarily work 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 donor interventions at different levels will depend on the stage of development of the larger financial system.

One of the fundamental challenges faced by donors is how to deploy the range of instruments at their disposal to best support the emergence of inclusive financial systems. These instruments range from grants by bilateral donors and foundations for technical assistance, loan funds, institutional capacity building, and development of industry infrastructure; to soft loans from multilateral development banks to governments for a range of activities including strengthening the enabling environment, supporting the development of industry infrastructure, and providing financial institutions with technical assistance and

⁸ A **microfinance network** is a group of institutions (usually international or regional) generally centered around a network support organization with the goal of fostering the launch of new institutions, developing standards, wholesaling funds, providing technical services, implementing knowledge management and/or leading policy reform efforts. A **credit bureau** is a repository or database that keeps information about consumers, including demographics, payment patterns of various types of credit obligations, and records of bad debt.

loans priced at or near market rates); and commercially-priced loans, quasi-equity and equity public sector banking institutions.

Donors increasingly engage with national governments to integrate financial sector reforms, including financial deepening, within such country-level mechanisms as Financial Sector Assessment Programs (FSAPs), Poverty Reduction Strategy Papers (PRSPs), sector-wide approaches (SWAps) and budget support.⁹ The donors most involved in such reforms, such as the International Monetary Fund (IMF), World Bank, and other multilateral development banks, should highlight access to financial services within this broader framework. It is up to donors, working through national stakeholders like governments, civil society, and the private sector, to maximize the coherence of microfinance-related activities within this larger picture, using the good practice guidelines outlined in this document. One outcome of this country-level process could perhaps be a set of rules of engagement or a code of conduct among international development partners.

PART II. UNDERSTANDING THE NEEDS OF POOR CLIENTS

The microfinance community has made great strides in learning about how poor people use financial services and the impact these services have on their lives.¹⁰ 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 generally do not engage directly with the ultimate clients of microfinance services (although some international and local NGOs may do so). However, it is important that donor staff understand the financial reality of the poor to ensure that donor operations consistently meet client demand.

This section outlines some of the key lessons learned about microfinance clients. Many of these lessons are counterintuitive and debunk firmly held beliefs (some would say myths) about the poor.¹¹

Lessons Learned

- Poor clients need and are willing to pay for a variety of financial services (e.g., credit, savings, 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.
- Financial institutions and other financial service providers, not donors, are best placed to understand client needs and design appropriate services because they have direct contact with poor clients on a daily basis.

⁹ **FSAPs** are joint International Monetary Fund (IMF)-World Bank reviews aimed at promoting the soundness of the financial systems of IMF member countries; **PRSPs** are prepared by IMF member countries through a participatory process and describe a country's macroeconomic, structural and social policies to reduce poverty over the medium term, including external financing needs; **SWAps** are 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 development process.

¹⁰ The Guidelines do not attempt to define the **poor**. Rather, they try to capture the whole range of people currently excluded from access to financial services. Each donor agency will define its own group of potential or existing microfinance clients.

¹¹ Additional resources on understanding client needs are found in annex 2.

- The destitute have very limited absorption capacity for debt, thus microcredit may not be the most appropriate solution for them.¹² 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 the destitute and the extremely vulnerable better alternatives than microcredit (e.g., feeding programs, wage employment in small and medium enterprises).
- Consumer protection initiatives (e.g., ensuring the transparency of financial disclosure, consumer education) can protect microfinance clients from predatory lenders.

Operational Guidelines

- **Verify that credit is a binding constraint** to the achievement of donor goals, especially in projects where microfinance is not the main component. 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 non-financial services would be more appropriate. They also often neglect to take informal financial arrangements into consideration in project design. 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 from clients, and institutional collapse.
- Conduct due diligence to **ensure that financial intermediaries/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 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 studies by financial institutions or other appropriate market players that determine the specific needs of potential clients.
- Support **consumer protection** laws aimed at safeguarding poor clients from predatory lenders.

PART III. BUILDING INCLUSIVE FINANCIAL SYSTEMS

The key to donor effectiveness is to find ways to complement, not replace, private capital and international social capital to accelerate innovative market solutions.¹³ In many countries, dependence on funding from donors and governments—including government-financed development banks—should diminish in relative terms as local financial institutions and private capital markets mature.

However, concessional finance is still needed at all levels of the system. Subsidies can be used to build institutional capacity of service providers and support them in the development of experimental services (micro-level). Subsidized funding can also be used to build an infrastructure of rating agencies, credit bureaus and audit capacity (meso level) that offer services to the retail level. In addition, donors should

¹² In this document, the term “**destitute**” is used to describe people who are too poor to use financial services effectively and need different kinds of development assistance (e.g., safety nets, food programs, employment programs).

¹³ **International social capital** refers to private capital that seeks investment opportunities based on a combination of social and financial criteria.

foster an enabling policy environment (macro level) that allows both micro- and meso-level actors to flourish.

The added value of donors lies in their unique ability to promote innovation through research and development, forge linkages, promote increased transparency and competition among retail providers of financial services and build capacity at all levels. These kinds of interventions do not generally require large amounts of funding, but intensive technical inputs. In all cases, the purpose of subsidized funding should be to reduce the real or perceived risks and transactions costs of local, mostly private sector, actors, and to engage these actors more fully in the sector.

In some cases, longer-term subsidies may be required by institutions that target sparsely populated and otherwise difficult-to-reach populations, since serving these client segments makes institutional viability harder to achieve. Also, there may be cases where well-run financial institutions are unable to obtain sufficient funds for onlending because of imperfections in local capital markets. In many markets, however, donor funds for onlending can damage and distort local markets.

This section describes lessons learned and offers operational guidelines for donor support at the three levels of the financial system: the micro-level (retail financial institutions), the meso-level (financial industry infrastructure), and the macro-level (policy environment).¹⁴

Micro Level: Promoting Strong Retail-level Institutions¹⁵

Donors have a long history of supporting the delivery of credit to specific target groups. They have also helped build individual microfinance institutions, primarily (but not exclusively) NGO microcredit organizations. But the range of retail-level financial institutions with potential to serve poor people is much broader than NGOs and includes private and state-owned commercial banks, postal banks, credit unions, savings and credit cooperatives, member-owned community organizations and other non-bank intermediaries like finance or insurance companies. Furthermore, non-financial institutions are often important providers of financial services.

Even though there is general agreement among donors that a wide range of institutions should be supported, there is some debate about whether donors should pick “winners” and support promising institutions on an individual basis, or whether they should offer broader capacity-building and other services competitively to a range of institutions. Some donors pursue both strategies. In either case, donors should not crowd out the market. Care should be taken to encourage specialization among financial institutions and to support collaboration, while at the same time 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 “meso” section provides guidance on interventions that support multiple institutions simultaneously.

Lessons Learned

- 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.

¹⁴ Additional resources on the different levels of the financial system are found in annex 2.

¹⁵ These Guidelines draw heavily from the existing “Pink Book.” In fact, much of the specific Pink Book guidance remains valid for the micro level, particularly for traditional microfinance institutions such as NGOs and NGOs that have transformed into licensed financial intermediaries.

- Credit components, designed as inputs to larger donor projects with limited life spans, often perform poorly and run the risk of failing to provide permanent access to financial services.¹⁶
- A wide range of national financial and non-financial institutions are 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 donor support of financial institutions. Donors generally do not make good owners of financial institutions, and they rarely have the appropriate expertise and capacity to provide adequate board oversight.
- Financial sustainability is essential to reach significant numbers of poor people and to realize long-term social returns.¹⁷ This means, among other things, charging interest rates consistent with full cost recovery to ensure profitability and growth. Over time, competition and increased accountability for results will drive costs (and thus interest rates) down.
- The time required to achieve financial sustainability is highly variable. Current guidelines suggest that financial sustainability can be achieved within a period of 5 to 10 years. However, this timeframe can vary depending on country context, local market conditions, and clients served. It is important to specify a time horizon for each institution to encourage the most effective use of donor subsidies.
- Improving the efficiency of microfinance operations translate 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 and technological improvements.
- Institution building requires a long-term commitment by donors. This commitment should be balanced by a defined time limit for funding support. Ad-hoc technical assistance and abrupt donor 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 institutions can undermine or crowd out national or international commercial capital markets and/or domestic savers.

Operational Guidelines

- **Find institutions that share a donor's vision** on 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 institution.** 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 that the donor agency cannot effectively provide or hire.
- **Do not 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 should take the lead, not donors.
- **Support financial institutions progressively to intermediate commercial funds** and/or deposits (when permitted by law) without supplanting local equity or loan markets. However, avoid

¹⁶ Also known as credit lines, revolving funds, and community development funds, **credit components** constitute a funding input to larger donor projects (e.g., in agriculture, education, health, etc.) and range from large credit lines to small revolving funds. Such credit is often targeted at a particular group of people for the purpose of purchasing an input or changing behavior.

¹⁷ **Sustainability** in microfinance entails meeting the operating and financial cost of providing financial services on a permanent basis, independent of donor or government subsidies.

encouraging NGOs to transform into formal financial institutions unless they have sufficient potential to do so. Donors need to analyze the costs and benefits of transformation in order to determine the appropriateness of supporting this long and arduous process.

- **Do not intervene with the pricing policies of financial institutions**, for instance, by compelling financial institutions to charge below-market interest rates on loans to clients (or rates lower than those necessary to cover costs in the medium term). Encourage institutions to be transparent about their pricing.
- **Assess financial institutions properly**, looking at such factors as vision, mission, strategy, ownership structure, governance, human resource capacity, quality of services, outreach, 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 like savings and credit cooperatives.
- **Use performance-based funding.**¹⁸
 - Employ performance-based contracts with agreed performance targets (including donor exit strategies).
 - Include a few core indicators to track performance (general outreach, outreach to the poor, portfolio quality, profitability/sustainability, efficiency). Avoid overburdening financial institutions with too many indicators.
 - Require regular financial reporting. Ensure that reporting requirements are harmonized with those needed by management and governing bodies, other funders and supervisors.
 - Tie renewal or continuation of 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 donor's responsibilities under the contract (e.g., predictable funding patterns, timely disbursement, prompt responses to reports).
- **Build exit strategies** that define the life of the relationship into contracts from the beginning of a project, including a timeframe to achieve financial sustainability.
- When cost-effective methods to measure social performance have been established, and when social performance is a key goal of the donor in question, **include regular social performance monitoring** in the performance measurement system.¹⁹
- **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.

¹⁸ See annex 2 for sample indicators that donors can use to track performance and CGAP, 2003, *Consensus Microfinance Guidelines: Definition of Selected Financial Terms, Ratios, and Adjustments for Microfinance*. Washington, D.C.: CGAP Consensus Guidelines

¹⁹ As of late 2004, there was a lack of clear understanding and consensus on appropriate **social performance** and impact indicators for microfinance (beyond, for example, simple measures such as loan or savings size compared to national GDP). A number of efforts are under way to define this concept more clearly and develop relevant indicators (see annex 2 for more information).

- **Take informed risks on promising but unproven institutions** with the potential to reach large numbers of unserved clients. Let commercial, private sector funders support the strongest institutions with the capacity to absorb market-rate investments.
- **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. Loans *may* be priced at lower rates to assist financial institutions to serve sparsely populated or otherwise difficult-to-reach populations, as long as these institutions charge a rate that allows them to cover all their costs.
- **Structure guarantee instruments** (e.g., guarantees to national banks that onlend to microfinance institutions) with incentives to **forge permanent linkages** between the two parties. Risk sharing with the bank in question is the key to ensuring that the amount of resources devoted to microfinance over the medium term exceeds the amount that would be available without a guarantee.²⁰
- **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).
- **Gradually phase out grants and subsidized loans** as national 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. Examples include collaboration between formal financial institutions and various types of smaller financial institutions, and linkages between financial institutions and non-financial providers, such as retailers and agricultural input suppliers. Facilitate mergers and consolidation in countries where too many financial institutions exist relative to market demand.

Meso Level: Supporting Industry Infrastructure

The meso level refers to the overall infrastructure of the financial system. This infrastructure can facilitate or obstruct the emergence of financial intermediaries. Limited availability or lack of specialized knowledge among credit bureaus, rating agencies, auditors, payments systems and other services can seriously constrain the ability of retail financial institutions to expand their services to poor clients. An emerging area of infrastructure is access to international and domestic financial and capital markets, for instance, investment funds, bond issues, securitization, etc.

Whatever the intervention, donor support should emphasize local ownership to guarantee the continued existence of the service after donor support phases out. Donor support at the meso level should aim to extend these services to the microfinance sector, helping to mainstream rather than marginalize it. The meso level is a relatively new area for donor funding and thus 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.

²⁰ A credit **guarantee** is a financial instrument that encourages financial institutions, in particular, commercial banks, to lend to microfinance institutions, enterprises or individuals that have good prospects of success, but are unable to provide sufficient collateral or do not have a sufficient record of financial transactions to prove their creditworthiness.

- The majority of apex institutions (sometimes referred to as second-tier or wholesale institutions) have produced disappointing results, often because they were set up in countries without a critical mass of good financial institutions with the capacity to absorb apex funding.²¹
- Investments in industry infrastructure benefit most financial institutions.
- Weak institutional and human capacity are among the key constraints at all levels (micro, meso, and macro).
- National-level microfinance associations can potentially support capacity building of retail institutions, promote transparency and influence the policy agenda in a specific country.²²
- 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.²³
- Advances in technology are crucial to increase market knowledge and spur investments that reduce transaction costs.
- Some ongoing subsidies may be required to support financial infrastructure, especially those that clearly accelerate the development of support services 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.

Operational Guidelines

- **Comply with “Blue Book” standards on business development services** when supporting private service providers to stimulate market development and with the *CGAP Microfinance Consensus Guidelines on Definitions of Selected Financial Terms, Ratios, and adjustments for Microfinance* when promoting increased transparency and higher quality information flows.²⁴
- **Work with existing service providers**, including “mainstream” organizations, at the national, regional and global level to build their capacity to offer market-based, demand-driven services. Avoid creating separate support structures that do not match the level of retail-level activity.
- **Funding or creating apex institutions** requires rigorous financial and operational analysis of the apex and potential recipients of funds, a strong strategic focus, minimized disbursement pressure, political independence and performance-based disbursement. Donors should ensure that sufficient retail-level capacity exists to absorb funds before supporting an apex.
- **Consider technical assistance for organizational and institutional development**, as well as appropriate product development among service providers at the meso level.

²¹ **Apex institutions** are wholesale mechanisms that channel funds, with or without supporting services, to retail microfinance institutions in a single country or integrated market.

²² **Microfinance associations**, which can be either national or regional in scope, are member-based associations made up of independent microfinance institutions operating in similar markets.

²³ The definition of relevant financial performance indicators can be found in the CGAP, 2003, *Consensus Microfinance Guidelines: Definition of Selected Financial Terms, Ratios, and Adjustments for Microfinance*. Washington, D.C.: CGAP Consensus Guidelines, August 2003.

²⁴ **Business Development Services** refer to a wide range of services used by entrepreneurs to help them operate efficiently and expand their businesses. The **Blue Book**, *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 for donors to use when supporting private service providers to stimulate market development.

- **Support research and development** of technology for points of service, transfer and payments mechanisms, credit bureaus, etc. Try to avoid developing software that already exists. Rather, collaborate to create standards in managing information.
- **Fill human resource gaps** through training programs, dissemination of standards and technology sharing. To ensure long-term capacity, donors should also promote the integration of a microfinance curriculum into formal education.
- **Support international networks and country-level associations** as a means to build the capacity and voice of multiple financial institutions, as well as to disseminate microfinance knowledge. Apply the same rigorous appraisal and performance-based funding that are applied to retail-level financial institutions. Proof that members value network services (e.g., cost sharing and other means of supporting network services) should be built into all donor support.
- **Facilitate funding of global or multi-country networks or programs** that span the different levels of the financial system (micro, meso, macro). Seek linkages between these networks and other, country-level associations, but avoid undermining the development of country-level networks or 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**.

Macro Level: Fostering a Conducive Policy Environment and Ensuring the Appropriate Role of Government

Historically, governments have used credit schemes as a way to transfer resources to specific target populations. Such programs continue to exist today, often with 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 approach has not always produced the desired effect: some government programs still undermine microfinance markets.

However, there is increasing clarity that governments do have a constructive role in building financial systems that work for the poor. Governments are the only actors that can ensure an enabling environment that promotes competition among a wide range of financial service providers, while also protecting consumers from predatory or fraudulent practices. Governments are the main partners of many donor agencies and play a similar role in financial systems development. Therefore, especially for the micro and meso levels, these Guidelines also apply to governments. The key to donor support at the macro level is ensuring that the policies they encourage governments to promote reflect the true needs of retail-level financial institutions and their clients.

Lessons Learned

- A government's primary role is as an enabler, not a direct provider, of financial services.
- A government's most critical contribution is to maintain macroeconomic stability.
- 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.
- Government-run credit programs generally distort markets, as 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 funding organizations rarely perform well.

- In special situations, such as market failures that the financial system cannot overcome by itself, government funding for sound and independent microfinance institutions may be warranted, *if* other funds are lacking. In such cases, clear “firewalls” must be put in place to separate political considerations from the provision of financial services.
- Governments have the responsibility to ensure 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.
- Work at the policy level requires donor staff with specialized technical capacity and operational experience. Policy changes, especially legal reform, are more permanent than other levels of intervention. They are often irreversible and affect the sector as a whole (for better or worse).

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, financial sector reforms) to promote the legitimacy of inclusive financial systems.
- **Do not support direct provision of financial services by a government**, government-mandated portfolio quotas, directed credit, borrower loan guarantees or operational subsidies.²⁵ 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 in the case of multilateral development banks, ensure that proper procedures and controls 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 to **reduce barriers to market entry** to increase competition, ultimately improving 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** without pushing for premature or restrictive legislation (“do not rush to regulate”). Before recommending prudential regulation, make sure it is really necessary to protect the safety of savings, that there is a critical mass of retail-level institutions qualified for such regulation, and that supervisory capacity exists.
- In cases where non-bank institutions like 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 key 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.

²⁵ **Mandated portfolio quotas** are government requirements for banks to invest or lend a specified amount or percentage of their assets for social purposes; **directed credit** is government credit assistance to specific target groups (e.g. farmers, women, etc.) via loans or loan guarantees, often on a subsidized basis.

- **Promote the development of socioeconomic statistics** by government or other relevant bodies to facilitate market research by financial institutions.

PART IV. ENSURING DONOR EFFECTIVENESS

Effectiveness ultimately depends on the ability of donors to respond to the needs of various actors within the financial sector 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 duplication 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.

Elements of Effectiveness

The Microfinance Donor Peer Reviews conducted from May 2002 to November 2003 examined the *modus operandi* of 17 bilateral and multilateral agencies, yielding five core elements of donor effectiveness: (1) strategic clarity and coherence, (2) strong staff capacity, (3) accountability for results, (4) relevant knowledge management, and (5) appropriate instruments. These elements help shape an individual agency's ability to apply good practice to its microfinance operations, thus achieving greater impact on the lives of poor people. A minimum level of performance in each of the five elements is critical for donor effectiveness in microfinance and, in all probability, other areas of development as well.

- **Strategic Clarity and Coherence.** The coherence of an agency's vision of microfinance, and the relationship between this vision and accepted standards of good practice, affects the quality of implementation and results. Strong policies are not enough; management and staff must internalize these policies to be effective.
- **Staff Technical Capacity.** Staff with solid microfinance technical expertise is a precondition for quality microfinance operations. One proven strategy is to establish strong technical focal points (individuals or teams of technical specialists) that prioritize the dissemination of good practices among non-specialist colleagues at headquarters and in the field. Non-microfinance specialist staff who handle microfinance programs should possess basic technical knowledge.
- **Accountability for Results.** Transparency about the performance of microfinance programs is critical to aid effectiveness. Only with accurate information can agencies make sound decisions on whether to continue, extend, terminate or replicate a program. Depending on a donor agency's strategy and mission, accountability includes a thorough assessment of the financial and social performance of its microfinance portfolio on a regular basis.
- **Knowledge Management.** When knowledge management enables agencies to learn from their own and others' experience, it greatly contributes to effectiveness. Additional funding for knowledge generation and dissemination can have a major impact on aid effectiveness and should be incorporated into individual projects and programs.
- **Appropriate Instruments.** Depending on an agency's expertise and strategy, donors should flexibly manage a wide range of funding instruments and work directly with private sector players. Many agencies have recognized that credit components (also known as credit lines, revolving funds, and community development funds) within larger multi-sector programs do not produce intended results and should be avoided. At the very least, when unavoidable, these components should be implemented in line with good practice (e.g., clearly separated from grant components and other types of support). Donors should collaborate in support of government-owned strategies for

financial sector development, making aid more coherent and manageable for ministries, departments, banks and civil society.

Comparative Advantage, Harmonization and Collaboration

Building financial systems that work for the poor—the majority of the world’s population—is a daunting task. Required donor engagements include working with diverse types of financial intermediaries at the micro level (e.g., banks, cooperatives, postal systems), helping build industry infrastructure at the meso level, and entering into policy dialogue with governments and other stakeholders at the macro level. Not every agency, however, can or should work on all levels.

Donors should identify their comparative advantage in promoting financial services for the poor. In fact, donor leaders increasingly realize the need to align their actions with their strengths. Combined with other agency-specific considerations, the five elements of effectiveness can help guide donor actions in a given country context and/or type of intervention. For example, decentralization of decision making and technical expertise is an important success factor 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 give an agency a local comparative advantage. Possible action scenarios might include **expand** microfinance as a strategic priority, **consolidate** the current volume of microfinance funding, **delegate** direct involvement in microfinance, or **phase out** microfinance operations altogether.

As donor agencies 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 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 harmonized procedures and one voice. Many other collaborative approaches lie in between. Collaboration does not include 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. It is hoped that these Guidelines can help move donors forward in crafting that shared vision, both internationally and at the country level.

Frontier Issues

The donor community and 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 frontier issues remain unresolved, such as:

- extending rural (especially agricultural) finance in sparsely populated areas
- expanding services like microinsurance, leasing, and remittances to poor customers
- improving social performance measurement and monitoring
- defining the lower limits of viable microfinance and when other interventions, including grants, might be more appropriate
- developing replicable strategies for unlocking country-level capital markets for microfinance
- identifying the role of donors relative to international equity and loan funds
- finding cost-effective and sustainable ways to combine non-financial development services with financial services

Intervention in these areas pose particularly difficult challenges for donors. However, innovation in these and other frontier areas should not be seen as a justification for projects that do not follow good practice guidelines. Many financial institutions, support networks and other actors are regularly making breakthroughs on these issues. It is hoped that donor guidelines in these and other areas can be continuously updated to reflect the state of the art.

GLOSSARY OF TERMS

apex institutions. Wholesale mechanisms that channel funds, with or without supporting services, to retail microfinance institutions in a single country or integrated market.

Blue Book. A 2001 publication of the Committee of Donor Agencies for Small Enterprise Development, entitled *Business Development Services for Small Enterprises: Guiding Principles for Donor Intervention*, for donors to use when supporting private service providers to stimulate market development. See “Donor Committee and Donor Committee Guidelines” section of the web site www.bdsknowledge.org.

business development services (BDS). A wide range of services used by entrepreneurs to help them operate efficiently and expand their businesses.

credit bureau. A repository or database that keeps information about consumers, including demographics, payment patterns of various types of credit obligations, and records of bad debt.

credit components. Also known as credit lines, revolving funds, and community development funds, credit components are a funding input to larger donor projects (e.g., in agriculture, education, health, etc.) and range from large credit lines to small revolving funds. Such credit is often targeted at a particular group of people for the purpose of purchasing an input or changing behavior.

destitute. In this document, the term “destitute” describes people who are too poor to use financial services effectively and need different kinds of development assistance (e.g., safety nets, food programs, employment programs, etc.).

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.

donor. In these Guidelines, the term “donor” encompasses a range of international development partners, including bilateral donors, foundations and multilateral development banks. The Guidelines are also relevant for other organizations that fund microfinance or manage microfinance programs on behalf of donors, such as international non-governmental organizations (NGOs), project management units (PMUs), apex facilities and social and commercial investors.

Financial Sector Assessment Programs (FSAPs). The FSAP, a joint IMF-World Bank effort introduced in May 1999, promotes the soundness of financial systems in member countries. Supported by experts from a range of national agencies and standard-setting bodies, the program seeks to identify the strengths and vulnerabilities of a country's financial system, determine how key sources of risk are being managed, ascertain the sector's developmental and technical assistance needs and help prioritize policy responses.

inclusive financial systems. Integration of microfinance into formal financial systems to ensure permanent access to financial services by significant numbers of poor people. This delivery of all forms of financial services by a large range of institutions requires the development of the system on all three levels: micro (retail-level financial institutions and other providers), meso (financial infrastructure) and macro (enabling policy environment).

financial institution. Any institution (public or private) that collects funds (from the public, donors, or other institutions) and invests them in financial assets such as loans, bonds, or deposits, rather than tangible property.

guarantee/ guarantee instruments. A credit guarantee is a financial instrument that encourages financial institutions, in particular, commercial banks, to lend to microfinance institutions, enterprises or individuals that have good prospects of success, but are unable to provide sufficient collateral or do not have a sufficient record of financial transactions to prove their creditworthiness. A guarantee absorbs a specified percentage of all losses that may occur. Borrower loan guarantees are directed at individuals or enterprises and tend to work better for small- and medium-sized firms than microenterprises.

industry infrastructure. The industry infrastructure of a financial system consists of quality auditors, rating agencies, professional networks, trade associations, credit bureaus, transfer and payments systems, information technology and technical service providers. These actors make up what is referred to as the “meso level” in this document.

international development partner. In these Guidelines, the term “international development partner” encompasses all bilateral and multilateral development banks, foundations, and other parties that fund or manage microfinance programs, such as NGOs, PMUs, apex facilities and social and commercial investors.

microfinance association (MFA). Member-based associations, national or regional in scope, made up of independent microfinance institutions operating in similar markets.

microfinance institutions (MFIs). Financial institutions that focus on providing microfinance services. MFIs encompass various types of institutions, ranging from formal (banks) to semi-formal (cooperatives, NGOs, village savings banks) to informal (savings and credit groups).

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

micro, meso, macro levels. The three levels of a financial system: retail financial institutions and other financial service providers (micro level), financial industry infrastructure (meso level), and the policy environment (macro level).

national stakeholder. The array of partners that donors engage at the country level, including governments, the private sector and civil society.

networks. A microfinance network is a group of institutions (usually international or regional) generally centered around a network support organization with the goal of fostering the launch of new institutions, developing standards, wholesaling funds, providing technical services, implementing knowledge management and/or leading policy reform efforts.

NGO (non-governmental organization). A non-profit agency not affiliated with any government, devoted to managing resources and implementing projects with the goal of addressing social problems.

Pink Book. The Pink Book is the commonly used term for existing donor guidelines in microfinance, *Guiding Principles for Selecting and Supporting Intermediaries*, published by the Committee of

Donor Agencies for Small Enterprise Development and the Donors' Working Group on Financial Sector Development in 1995.

poor. In this document, the term “poor” refers to everyone excluded from access to financial services who might potentially be able to use financial services effectively.

Poverty Reduction Strategy Papers (PRSPs). Papers prepared by member countries of the International Monetary Fund (IMF) through a participatory process that involves domestic stakeholders as well as external development partners, 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 to promote broad-based growth and reduce poverty, as well as associated external financing needs and major sources of financing.

Sector-wide Approaches (SWAs). 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 development process.

sustainability. Sustainability in microfinance means meeting the operating and financial cost of providing financial services on a permanent basis, independent of donor or government subsidies.

ANNEX 1. ADDITIONAL RESOURCES

This annex contains references to documents and other resources related to the main topics of these Guidelines.

General

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* (also known as the "Pink Book"). World Bank, Washington, DC.

Committee of Donor Agencies for Small Enterprise Development (2001). *Guiding Principles for Donor Intervention*. The World Bank. Washington DC.

CGAP. 2002–2004. *CGAP Microfinance Donor Brief Series*. Washington, DC: CGAP.

CGAP. 2002–2004. *CGAP Microfinance Donor Case Study Series*. Washington, DC: CGAP.

CGAP. 2003. *CGAP Phase III Strategy, 2003-2008*. Washington, DC: CGAP.

CGAP. 2003. *Definition of Selected Financial Terms, Ratios, and Adjustments for Microfinance*. Consensus Microfinance Guidelines. Washington, DC: CGAP.

———. n.d. Donor Information Resource Center (DIRECT), www.cgap.org/direct. The online center offers easy-to-use information on microfinance good practices for donor staff. It provides a wide range of information products that address critical issues in microfinance, including: (1) short two-page briefs; (2) 15-minute PowerPoint presentations with speaker notes; (3) 3-hour training modules; (4) case studies, and (5) links to other resources. All materials are cross-referenced and indexed for ease of reference.

———. n.d. The Microfinance Gateway, www.microfinancegateway.org. The Microfinance Gateway is a comprehensive source of information on microfinance. It lists publications of CGAP and other microfinance-related organizations, provides summaries and reading recommendations for selected documents, and features glossaries and information on upcoming events. It also provides links to relevant implementers, consultants, research and donor institutions, journals and publications.

Helms B., and A. Latortue. 2004. *Elements of Donor Effectiveness in Microfinance: Policy Implications*. Aid Effectiveness Initiative. CGAP, Washington, DC.

Clark, Heather, and Blaine Stephens. 2002. *Microfinance Distance-Learning Course*. (Workbook with interactive CDs.) New York: United Nations Capital Development Fund.

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

Robinson, M. *Microfinance Revolution*. 3 volumes. Washington, DC: The World Bank and the Open Society Institute.

Vol. 1. Sustainable Finance for the Poor (2001)

Vol. 2. Lessons from Indonesia (2002)

Vol. 3. The Emerging Industry (forthcoming 2005)

Rosenberg, Richard. 1999. Measuring Microcredit Delinquency: Ratios can be Harmful to your Health. *CGAP Occasional Paper*, no. 3 (June).

SEEP Network. 2004. *Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis and Monitoring (Draft)*. Washington, DC: SEEP, www.seepnetwork.org.

Understanding the Needs of Poor Clients

CGAP. Working Group on Microinsurance. 2003. Preliminary Donor Guidelines for Supporting Microinsurance. CGAP, Washington, DC.

Hirschland, M. 2002. Developing Deposit Services for the Poor: Preliminary Guidelines for Donors. CGAP, Washington, DC.

Littlefield, Elizabeth, Jonathan Morduch and Syed Hashemi Mesbahuddin. 2003. Is Microfinance an Effective Strategy to Reach the Millennium Development Goals? *CGAP Focus Note*, no. 24 (January).

MicroSave-Africa. N.d. Website, www.microsave-africa.com. The website of *MicroSave-Africa*, a DFID/UNDG/CGAP initiative, lists a number of interesting field studies, essays and synthesis papers, as well as links to other selected publications, under the “study programme” section.

Simanowitz, Anton. 2001. Review of Impact Assessment Tools. Imp-Act. Brighton, UK, <http://www.ids.ac.uk/impact/publications/guidelines/GL2ToolsReview.doc>

USAID (U.S. Agency for International Development). N.d. Assessing the Impact of Microenterprise (AIMS) project, www.usaidmicro.org/pubs/aims. This project produced a plethora of research and writing on the impact of microfinance projects, including in-depth academic impact assessments and cost-effective, practical tools to track and assess the impact of programs.

Micro Level: Promoting Strong Retail-level Institutions

CGAP. 1999. Format for Appraisal of Microfinance Institutions. *CGAP Technical Tools Series*, no. 4 (July). Washington, D.C.: CGAP.

Charkham, Jonathan, CBE. 2004. *Guidance for the Directors of Banks*. Global Corporate Governance Forum. Focus 2, , D.C.: The European Bank for Reconstruction and Development/The World Bank. Washington

Duval, Ann. 2003. Donor Collaboration and Transparency: Standardized Donor Reporting in Uganda. *CGAP DIRECT Donor Good Practice Case Study*, no.7 (July), www.cgap.org/direct/docs/case_studies/cs_07.php.

Rosenberg, Richard. 1999. Measuring Microcredit Delinquency: Ratios can be Harmful to your Health. *CGAP Occasional Paper*, no. 3 (June).

Rosenberg, Richard, Patricia Mwangi, Robert Peck Christen, and Mohamed Nasr. 2003. *Financial Statement Disclosure Guidelines*. 2nd edition. Microfinance Consensus Guidelines. Washington, DC: CGAP.

National MFI performance monitoring tools

Richardson, D.C. 2002. *PEARLS Monitoring System*. Wisconsin, USA: The World Council of Credit Unions.

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

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

Examples of social performance work:

CERISE. N.d. Web site, www.cerise-microfinance.org.

CERISE (Comité d'échanges, de réflexion et d'information sur les systèmes d'épargne-crédit), is a platform of leading microfinance support organizations based in France: IRAM (Institut de recherches et d'applications des méthodes de développement, Paris), CIDR (Centre international de développement et de recherche), CIRAD (Centre de coopération internationale en recherche agronomique pour le développement), GRET (Groupe de recherches et d'échanges technologiques).

Imp-Act. N.d. Web site, www.imp-act.org.

Imp-Act is a three-year action-research program designed to improve the quality of microfinance services and their impact on poverty through the development of impact assessment systems. Building on the priorities and agendas of microfinance organizations and their clients, the Imp-Act program is designed to develop credible, useful impact assessments. The program seeks to empower organizations to be proactive in developing their own learning systems, both to inform internal decision making and to satisfy the requirements of external stakeholders.

SEEP. Working Group on Client Assessment. Washington, DC.

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). These indicators will be part of a more general framework that outlines the purpose and benefits of social performance management and defines sound practices in this area, with a focus on process as well as outcomes (e.g., how to conduct a client assessment from an operational perspective).

USAID and Center for Institutional Reform and the Informal Sector (IRIS), Department of Economics, University of Maryland, College Park. N.d. Poverty assessment web site, www.povertytools.org. In 2003, the U.S. Congress passed an amendment to the Microenterprise for Self-Reliance Act that required the U.S. Agency for International Development (USAID) to develop, field test and certify at least two tools for assessing the poverty level of its microenterprise clients. USAID has been working with the IRIS Center of the University of Maryland to field test tools, both to gauge their accuracy and the practical implications of their implementation. Tools will be finalized in fall 2005.

Meso Level: Supporting Industry Infrastructure

CGAP. 2003 (August). *Definition of Selected Financial Terms, Ratios, and Adjustments for Microfinance*. Consensus Microfinance Guidelines. Washington, DC: CGAP.

Committee of Donor Agencies for Small Enterprise Development. 2001. Guiding Principles for Donor Intervention (also known as the “Blue Book”). Business Development Services for Small Enterprises, World Bank, Washington, DC.

Levy, F. 2001. Apex Institutions in Microfinance. *CGAP Occasional Paper*, no. 6 (November). Washington, DC: CGAP.

SEEP. 2004. *Recommendations on Donor Guidelines to Support Microfinance Associations*. Prepared for the German Agency for Technical Cooperation (GTZ). Washington, DC: SEEP.

SEEP. 2004. *Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis and Monitoring (Draft)*. Washington, DC: SEEP, www.seepnetwork.org.

Rating Companies and Resources

MicroRate: www.microrate.com

Microfinance Rating and Assessment Fund: www.ratingfund.org

PlanetFinance: www.planetfinance.org

ACCION: www.accion.org

Class & Asociados, SA: www.classrating.com

Standard and Poors Microfinance Ratings:

www.standardandpoors.com/LatinAmerica/Spanish/opinion/micro.html

Other

MIX (Microfinance Information exchange). N.d. Web site, www.mixmbb.org.

The MIX is a non-profit 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 website.

The Business Development Services (BDS). N.d. Web site, 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 wirjubg in small enterprises.

Macro Level: Fostering a Conducive Policy Environment and Ensuring the Appropriate Role of Government

Christen, Robert Peck, and Richard Rosenberg. 2000. The Rush to Regulate: Legal Frameworks for Microfinance. *CGAP Occasional Paper*, no. 4 (April). Washington, DC: CGAP.

Christen, Robert Peck, Timothy R. Lyman, and Richard Rosenberg. 2003. *Guiding Principles on Regulation and Supervision in Microfinance*. Microfinance Consensus Guidelines. Washington, DC: CGAP.

Helms, Brigit, and Xavier Reille, 2004. Interest Rate Ceilings and Microfinance: The Story so Far. *CGAP Occasional Paper*, no. 9 (September). Washington, DC: CGAP.

ANNEX 2. MINIMUM PERFORMANCE INDICATORS FOR RETAIL-LEVEL FINANCIAL INSTITUTIONS²⁶

At a bare minimum, donor staff who design or monitor microfinance projects should measure the performance of microfinance institutions that they fund in five core areas:

<p>1. <u>Outreach.</u> <i>Indicator:</i></p>	<p><i>How many clients are being served?</i> number of active clients or accounts</p>
<p>2. <u>Depth of outreach.</u> <i>Indicator:</i>²⁷ <i>or</i></p>	<p><i>How poor are the clients?</i> average outstanding balance per client account as a proportion of Gross National Income (GNI) per capita</p>
<p>3. <u>Portfolio quality.</u> <i>Indicator:</i> <i>or</i></p>	<p><i>How well is the financial institution collecting its loans?</i> portfolio at risk > 30 days (PAR) <i>and</i> write-off ratio Annual Loan-loss Rate</p>
<p>4. <u>Financial sustainability.</u> <i>Indicator:</i> <i>or</i> <i>or</i></p>	<p><i>Is the financial institution profitable enough to maintain and expand its services without continued injections of subsidized donor funds?</i> <i>- for unsubsidized institutions:</i> return on assets (ROA) return on equity (ROE) <i>- for subsidized institutions:</i> adjusted return on assets (AROA) financial self-sufficiency (FSS)</p>
<p>5. <u>Efficiency.</u> <i>Indicator:</i></p>	<p><i>Is the financial institution providing services at the lowest possible cost to clients?</i> cost per client <i>or</i> operating expense ratio</p>

Indicators in these five areas do not capture all relevant aspects of MFI performance. Most funders and certainly, all MFI managers, will want to monitor a longer list of indicators. There are also important dimensions of institutional operations, such as quality of governance, that simply cannot be quantified. The five performance areas listed above thus represent a minimum that should be

- addressed in all project designs (reporting past performance of all participating institutions and insuring that systems are put in place to measure these indicators during ongoing projects)
- included in all appraisals or evaluations of existing institutions
- reported and monitored during implementation

²⁶ To calculate the various indicators indicated in this annex, please refer to CGAP, 2003, *Definitions of Selected Financial Terms*; SEEP, 2004, *Measuring Performance of Microfinance Institutions*; and, for collection ratios, Rosenberg, 1999, *Measuring Microcredit Delinquency*.

²⁷ 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.