

## **CIDA Letter to Management**

### **Executive Summary**

A team comprising Katharine McKee of USAID, C. Ross Croulet of AfDB, and Jennifer Isern and Eric Duflos of CGAP conducted a Donor Peer Review of CIDA in Gatineau from 8 to 13 June, 2003. The review is part of a 17-agency initiative launched by Development Ministers, heads of agencies, and CGAP to concretely tackle aid effectiveness by using microfinance as a test case.

The peer review team focused on the internal procedures, practices and processes of CIDA to identify the success factors and constraints that influence the effectiveness of the agency's microfinance operations. The Policy branch provided the team with an orientation to CIDA and organized interviews with 58 people throughout the agency, including consultation with field-level staff and partners. The peer review team also read a comprehensive set of documents prepared by the Policy branch. The team briefed the Minister of International Cooperation Susan Whelan, the President of CIDA Paul Thibault, and several department heads and staff on its initial findings on June 12<sup>th</sup> and June 13<sup>th</sup>.

The peer review team found its visit to be timely given the growing demand by CIDA stakeholders to increase development aid effectiveness. The team hopes that this management letter will enrich the internal discussions and provide specific ideas of how CIDA can increase its effectiveness in microfinance. This letter outlines CIDA's strengths and challenges, and presents specific recommendations. A matrix at the end of the letter provides a summary.

The peer review team makes five concrete recommendations to management to enable CIDA to improve its microfinance operations. The team hopes these recommendations will also prove helpful for enhancing CIDA's overall aid effectiveness.

1. ***Focus its involvement.*** CIDA should focus on fewer countries and fewer types of higher quality operations, employing equal or fewer resources.
2. ***Build a strategy for microfinance.*** CIDA should develop and implement a microfinance strategy, based on its existing documents, and on other donors' work. This strategy should increase competitive selection of its partners and be as practical and operational as possible. It should be promoted actively by top leadership.
3. ***Review and clean up the portfolio.*** CIDA needs to develop an inventory of its current portfolio, review the work done by Canadian Executing Agencies (CEAs), and phase out problem projects and credit components.
4. ***Strengthen technical skills and analysis.*** To ensure quality and effectiveness in microfinance, CIDA should create a full time microfinance focal person in the policy branch, place specialists strategically, provide orientation to non specialists, and enhance knowledge management.
5. ***Improve performance management.*** CIDA should require technical specialist analysis of all new projects and extensions, utilize common performance indicators, develop minimum standards checklists, and design and enforce performance contracts for CEAs and consultants.

## **Background**

Early in 2002, Development Ministers, Heads of Agencies, and CGAP launched an initiative to improve aid effectiveness, using microfinance as a test case. As a first step in this initiative, 17 bilateral and multilateral development assistance agencies have volunteered to participate in a series of Donor Peer Reviews. These peer reviews are not evaluations or detailed portfolio reviews, but rather focus on each agency's internal procedures, processes, practices and systems to identify success factors and constraints to good practices in microfinance.

The short but intensive reviews result in concrete recommendations for each agency and should lead to senior management commitment to specific changes that improve the effectiveness of microfinance operations. It is also expected that the analysis and recommendations may also apply to other areas of development assistance pursued by each agency.

A peer review team including Katharine McKee, Microenterprise Director of the US Agency for International Development (USAID), C. Ross Croulet, Coordinator and Head of the Central Microfinance Unit of the African Development Bank (AfDB), and Jennifer Isern, Lead Microfinance Specialist and Eric Duflos, Microfinance Specialist of the Consultative Group to Assist the Poor (CGAP) visited CIDA headquarters from 9 to 13 June, 2003. The peer review team interviewed 58 people from most branches of CIDA (Africa and Middle East, Americas, Asia, Central and Eastern Europe, Canadian Partnership, Multilateral Programs, Policy, Human Resources and Corporate Services, Information Management and Technology, and Performance Review). The peer review team also obtained views from staff from eight Canadian embassies (Bangladesh, Cameroon, Jamaica, Mozambique, Nicaragua, the Philippines, Senegal and Vietnam), and from consultants and executing agencies working with CIDA in microfinance, mostly through telephone interviews. The reviewers also read a comprehensive set of documents on CIDA. The team presented its initial findings and recommendations to the Minister of International Cooperation, the president of CIDA, and to several department heads and staff on 12 and 13 June, 2003.

Follow-up to the peer reviews is envisioned both at the agency-specific level and across all agencies participating in the exercise. The review team and CGAP are available to discuss the recommendations contained in this letter in more detail and to support their implementation. The team's findings for CIDA will also be combined with those from other agencies reviewed in a synthesis report. Synthesis reports already exist for agencies reviewed in 2002. Overall results and issues for agencies to tackle jointly will be discussed in various fora involving technical staff and senior management. A final meeting of Ministers and heads of agencies participating in the peer reviews will be organized upon completion of all the reviews in February 2004 in Paris to share experiences and reforms made as a result of the exercise.

This management letter outlines CIDA's strengths and challenges with respect to applying good practices in microfinance. It then presents a number of specific recommendations for change. Finally, a matrix summarizes the key findings and recommendations according to six analytical areas. The team hopes these recommendations will also prove helpful for enhancing CIDA's overall aid effectiveness.

## CIDA's Strengths

The best estimate is that between two and five percent of the total value of Canadian ODA is in microfinance. While this amount of funding seems relatively small, it has significant impact in the field. The peer review team identified the following strengths at CIDA that are directly relevant to microfinance operations:

- **Long experience with recognized partners.** CIDA has gained substantial experience in supporting retail microfinance institutions through its 35 years of involvement in the sector. During this time, CIDA has built solid partnerships with internationally recognized Canadian partners, such as Développement International Desjardins, Société de Cooperation pour le Développement International, Mennonite Economic Development Association, Aga Khan Foundation, CCA, Centre Canadien d'Etude et de Cooperation Internationale, and the Coady Institute. By funding them, CIDA has contributed to the development of key actors in pro-poor finance. With activities in 120 countries, it has accumulated a wealth of different experiences.
- **Contribution to the development of credit union models.** Credit and savings cooperatives are a long-standing part of Canadian tradition and culture. CIDA has contributed to the global development of the cooperative/credit union model. At a time when the demand for financial services significantly surpasses supply, investing in different types of financial institutions with high outreach potential contributes to reducing the gap.
- **Significant role in Africa.** CIDA has funded some of the largest MFIs in West Africa (Burkina Faso, Cameroon, Guinea, Mali, and Senegal). These institutions, even though fragile in some cases, serve a large number of people in rural areas, at a time when the industry is trying to increase access to finance for the rural poor.
- **Increasing focus on sustainability.** CIDA documentation on microfinance and many staff interviewed acknowledge the need to focus support on potentially sustainable institutions. While not always implemented consistently, this attitude shows a positive evolution of the microfinance culture at CIDA. Building sustainable institutions responds to the demand of the poor who need permanent access to a wide array of financial services, rather than a temporary project that serves their needs for a limited period of time.
- **Active role in donor agency coordination.** Coordination of donor agency activities in microfinance enhances economies of scale, promotes a global learning agenda, and avoids duplication of funding or conflicting interventions in the sector. Over the past few years, CIDA has shown the willingness and capacity to engage in donor coordination in some countries. Some notable examples lie with the creation of CGAP in 1995, the launch of multi-donor discussions on supervision and regulation with the BCEAO (Banque Centrale des Etats Africains de l'Ouest), engagement in the design of a national microfinance strategy in Senegal, and participation in the Microcredit Summit. CIDA has also increased its cooperation with other donors by working with them on Sector Wide Approach Programs.
- **Critical self assessments.** Staff interviewed are open to constructive criticism. On several occasions, CIDA has commissioned external analyses of its activities in the microfinance sector and beyond, such as the 1999-2000 Synthesis Report for Microfinance Development and Micro-enterprise Development, the DAC (Development Assistance Committee) report on overall aid effectiveness, and the CGAP peer review. Even though their recommendations are not yet fully implemented, most of these reports have shown that CIDA has gained awareness of its own strengths and weaknesses.

## CIDA Challenges

- **No clear vision or strategy for microfinance.** CIDA has not yet developed a clear vision on the nature and role of microfinance, nor has the agency provided adequate strategic guidance to staff on design and implementation of microfinance activities. The existing Reference Guide for the Microfinance Sector was prepared as a technical tool for project managers. While comprehensive, it does not provide a user-friendly tool for staff to understand what microfinance is, its role in poverty reduction, and how it can play this role more effectively and efficiently. Generalist staff involved with microfinance projects do not regularly consult the Reference Guide. Without a clear vision and strategy, CIDA's programs will continue to be of uneven effectiveness. The highly centralized structure of CIDA makes it even more important for the head office to communicate a clear vision and provide a strategic framework to the rest of the agency.
- **Limited technical expertise and lack of a focal point.** There is currently no full time focal point (person responsible) for microfinance at CIDA, unlike most agencies reviewed. CIDA's staff includes around five microfinance specialists familiar with particular models and regions, but they do not always function as a coherent team. While some specialists have strong technical capacity, they are spread throughout the branches in a sub-optimal pattern, they are not consulted consistently, they do not have adequate authority, and several are due to retire soon. Most decisions on programs are left to project managers who have close to full authority on projects and who are generalists, often without substantial knowledge on microfinance. International experience shows that the quality of a donor agency's microfinance portfolio is highly correlated with the level and cohesion of its technical expertise.
- **Widespread credit components.** CIDA funds many project components where credit is used as an input into a broader objective. These credit components are widely present in projects financed through the counterpart funds and managed by country offices. This trend is common in agriculture and rural development projects, for example, and creates a number of problems. Experience has shown that in most cases these components do not receive the required technical support to be successful. The component can induce clients to invest in inappropriate activities, contribute to the indebtedness of those with insufficient cash flow, distort financial markets, and encourage corruption. Credit activities often disappear after the end of the project.
- **Heavy reliance on "responsive mechanisms".** As noted in the 1999-2000 Synthesis Report, CIDA's partners have a significant influence on the development and execution of all projects. For example, all microfinance operations initiated with Canadian organizations by the Partnership Branch (i.e. approximately half of CIDA's total funding to this sector) are responsive and are not subject to competitive bidding to requests for proposals by CIDA. A representative sample provided to the peer review team showed that two thirds of all CIDA microfinance projects were not subject to competitive bidding. Such a *modus operandus* prevents CIDA from developing a framework of intervention in the sector, accumulating competence internally, engaging with new executing agencies that might have new methods and ideas, or creating a climate of competition and efficiency. By effectively giving *carte blanche* to a few organizations, CIDA's microfinance programs seem less responsive to partner countries than to Canadian organizations, and are less likely to link up with developing country priorities.

- **Uneven quality of the portfolio.** Like many other donors, CIDA has a limited knowledge of its own microfinance portfolio. One key contributing factor is that many projects have microfinance components embedded in them. This makes it virtually impossible to determine an accurate figure on how much CIDA spends on microfinance. There is evidence of both good and poor design and implementation. The peer review team noticed a few examples of low quality operations funded by CIDA (e.g., support for conflicting approaches within the same geographical area of a country, funding for a new model without adequate upfront research, replication of a law in a new country without consideration for the local context, and work to gain a position of “pioneer” without consultation with other donors). Unfortunately, even small microfinance operations can be harmful to the clients and to the financial sector of a country or region if not designed and implemented well.
- **Disbursement pressure.** As budget allocations are annual and cannot be carried over to the next year, staff have pressure to spend allocated funds within a given year. The current trend to include funding targets for specific sectors increases disbursement pressure at the expense of quality and development effectiveness. This pressure, combined with possible reductions of administrative budgets, could lead staff to push funding out quickly, encouraging microfinance institutions to disburse either too rapidly to the wrong clients, or in unviable regions.
- **Lack of performance-based management.** The lack of specific agency-wide performance indicators for microfinance prevents CIDA from measuring the success of its operations in the sector. There are no incentives for project managers and CEAs to suspend or cancel under-performing projects or reward successful ones. Results-Based Management (RBM) is used for aggregation of reporting but has not yet translated into guidance for project approvals or extensions. The team noted several examples where projects were extended to new phases almost automatically with limited quality review (for 21 years in one case).
- **High dependence on external consultants.** An unusually high reliance on external consultants, especially for project monitoring, prevents CIDA from internalizing lessons learned in its operations, developing an institutional memory, and managing proactively the quality of its portfolio. Constraints on travel funds for CIDA staff reinforce the tendency to contract out project monitoring.
- **Barriers to learning and applying lessons.** Each branch of CIDA has its own vision of development and there are inadequate incentives promoting cross-fertilization with other branches. This trend is amplified by the unusually fast rotation of generalist staff (1 to 3 years on average). The lack of user-friendly operational tools also prevents CIDA from disseminating lessons learned internally and externally. For example, the Reference Guide is thorough but intimidating and the website does not yet include the best available research and tools on the topic.

Successful donor agencies in the area of microfinance combine a clear vision of the role of microfinance, high levels of cohesive technical capacity, solid performance-based management, and efficient knowledge management systems. Given the above challenges, the peer review team found that CIDA has a limited comparative advantage in microfinance.

## Recommendations

Even though it represents a small percentage of its total funding, the yearly contribution of CIDA to the development of microfinance could make a difference for a large number of poor people if it was spent more effectively. Based on its analysis, the peer review team makes the following five recommendations to management:

**1. Focus its involvement in microfinance:** CIDA should focus on fewer countries and fewer types of higher quality operations, employing equal or fewer resources.

- In consultation with the technical specialists, CIDA should **concentrate its funding on fewer countries** where it can bring added value, and where host countries show interest in private sector and financial sector development. The choice of countries could be based on such criteria as: CIDA's history and size of portfolio in each country, the nine CIDA countries of emphasis, and potential regional or global partnership with other donors.
- CIDA could **focus on building retail institutions (such as cooperatives/credit unions) and federations**, based on its long history and experience in these areas. CIDA's grant instruments and experienced partners would be most relevant for launching retail institutions, which could subsequently transition to other donors and funders that offer loans and equity investments in the medium term. CIDA should continue to fund innovative approaches in rural finance as it has gained some experience in this field with a few of its partners. There is also a high global demand for innovation in this area.
- **Entrust policy work to international financial institutions (IFIs).** Policy work consists of creating conducive policies for financial sector development, and regulatory and supervisory frameworks for microfinance institutions, including cooperatives. While demand for policy level work is expanding, CIDA should rely more on IFIs that are better positioned to lead in this work, based on their experience and expertise in financial sector development and access to policy-makers. CIDA could still contribute to this area through in-country coordination.
- Considering its current commitment, human resources, overall funding trends, and pressures to reduce administrative costs, the peer review team would recommend that **CIDA invest the same amount or fewer funds in the sector in the future.** By increasing its focus, CIDA will become more effective and efficient in its microfinance operations, thus gaining additional results for the same amount of funding.

**2. Build a strategy for microfinance.** CIDA should draft a microfinance strategy, based on its existing documents and the work done by other donors. This strategy should be concise and as operational as possible. It should address the need for geographical and operational focus, and increase competitive selection of its partners and consultants. Finally, to achieve the intended results, the strategy must be promoted by top management.

- The process used in drafting the strategy will be as important as the actual document. For example, to create proper institutional ownership, the design of the strategy should **involve a large number and array of staff** from different branches (including Policy, Geographical branches, Partnership, Multilateral, Performance Review), Canadian embassies and key executing agencies.

- The content of the strategy would be adapted to and revised on the **basis of existing documents** such as the 1999-2000 Synthesis Report, the Private Sector Development Policy, the Reference Guide for the Microfinance Sector, as well as other donor agency strategies in the sector. For example, CIDA could take inspiration from the strategies of Agence Française de Développement, DANIDA and CGAP III.
- The strategy should spell out how CIDA can **increase competitive bidding** and untie the contracting process for its external consultants and partners. This shift would enable the agency to get more value for money by accessing a wider range of qualified partners (including from outside Canada), and attract more innovative approaches. Hiring high quality external support is particularly relevant for CIDA given the extent to which project monitoring is outsourced. CIDA should select partners that are willing to work within their new strategy.
- The new CIDA strategy should **clarify linkages between microfinance and its larger strategic priorities** such as the six key priority areas of development (basic human needs, gender, environment, private sector development, infrastructure services, human rights), the social agenda (basic education, health and nutrition, HIV/AIDs), and the recent trends toward increased support for agriculture. While permanent access to financial services to the poor constitutes an output of its own, it also contributes significantly to several areas of development and to the achievement of the Millennium Development Goals (MDGs) on which CIDA focuses. It is important to show how microfinance can best be used to contribute to other development objectives. Such clarity will also help CIDA decide when and how microfinance can be funded through SWAps (Sector Wide Approaches).
- The strategy should guide staff on how to **phase out problem areas and projects**. For example, it should provide clear indications on how to avoid counterproductive credit components. It should also offer performance criteria and guidance on renewing projects or winding down and ending poorly performing projects. The strategy needs to question whether the use of counterpart funds for microfinance is relevant and if so, how it could be done to ensure coherence with the CIDA's programming objectives.
- Based on the centralized nature of CIDA, **leadership will need to support and disseminate the strategy**. Top management could visit successful CIDA microfinance operations, participate in key microfinance fora, help the Policy Branch to disseminate the strategy widely, and promote good practices and success stories through official statements and public media.

**3. Review and clean up the portfolio.** CIDA needs to make an inventory of its current portfolio, review the work done by CEAs, and phase out problem projects and credit components.

- CIDA should launch an **agency-wide review of its current operations in microfinance**. The first step toward improving the quality of programming is to have a better grip on the current successes and challenges on the ground. The review should include a comprehensive analysis of the CEAs on the basis of previous reviews done in this area. The corporate review should cover projects with embedded credit components, and counterpart funds. CIDA could base the corporate review on the ongoing "Summary of Lessons Learnt

in Evaluating Microfinance Development Support Programs/Projects” initiated by the Performance Review Branch, although the scope and scale of this ongoing study may need to be revised to incorporate the findings of the microfinance peer review.

- CIDA should **take action on problem areas**, such as credit components that do not apply recognized good practices. In some cases it will mean immediate suspension of projects that show no potential of sustainability. While it will be easier to take action once the review is completed, specialists can start working on key problem areas such as counterpart funds and projects with embedded credit components as they are identified.

**4. Strengthen technical capacity.** To ensure quality and effectiveness in microfinance, CIDA should create a full time microfinance focal person in the policy branch, place specialists strategically, provide orientation to non specialists, expand and diversify its sources of external support, and enhance knowledge management. Technical supervision within CIDA is particularly important since a significant share of the agency’s funding supports a relatively high-risk part of the industry (institutions that mobilize the savings of the poor on a large scale).

- CIDA should **create a full time position for a microfinance focal person in the Policy Branch.** This position would need to be filled by someone with technical and field experience in microfinance who can communicate easily with staff. The main tasks of the focal person could be the following:
  - Lead the development of a microfinance strategy
  - Build a professional network of microfinance specialists within CIDA, and liaise with external microfinance networks
  - Represent CIDA at major international fora
  - Develop tools for performance management
  - Develop improved procedures for selecting and monitoring the quality of the external consultants, partners and executing agencies
  - Identify strategic partnerships with donors, networks, and implementers
- **CIDA should place specialists strategically.** Beyond the focal point and based on the microfinance strategy, specialists should be placed where most needs will occur. For instance, given the large volume of microfinance funding managed by the Partnership Branch, a specialist placed there could play an active role in providing guidance and improving project selection and performance. The peer review team recommends that CIDA recruit specialists to replace those who will soon retire or rotate, using this as an opportunity to strengthen and broaden the expertise and experience of the team. Given CIDA’s current microfinance programming, a team of three to five full time specialists at head office, including the focal point, would be sufficient to ensure good practices are implemented across the portfolio.
- **Familiarize non-specialists on basic good practices.** Most people interviewed noted the need for improving basic knowledge in microfinance. Non-microfinance specialist staff could take advantage of current tools available worldwide such as the UNCDF/CGAP donor staff training or the CGAP DIRECT. The microfinance network could also organize brown bag lunch meetings and sessions on success stories and good practices to motivate staff and promote discussion among the Regional and Partnership Branches.

- **Enhance knowledge management.** Building on the investments made by CIDA in overall knowledge management, the focal point, in cooperation with the network of CIDA microfinance specialists, should develop tools to share information on microfinance among staff and partners. Exchanging lessons learned, good practices, donor information, documents and contacts can significantly increase the quality of operations. CIDA could use its website, informal channels, consultant database as well as microfinance electronic lessons to increase the flow of information across branches and with other partners.

**5. Improve performance management.** CIDA should ensure specialist review of all microfinance activities, utilize common performance indicators, develop minimum standard checklists, and design and enforce performance-based contracts for CEAs and consultants.

- To solve current problem areas, avoid new ones, and optimize the potential results of CIDA's operations, every project with microfinance should systematically **require inputs from a suitably qualified CIDA technical specialist.** Experience shows that expert inputs, especially at the design phase, greatly improve the quality of operations. With an emphasis at the early design stage, specialists would write recommendations on concept papers for all projects, including any new phase for the Partnership Branch, bilateral branches and counterpart funds. Specialists could also take part in selected project monitoring and evaluation activities.
- CIDA should develop and use Results Based Management (RBM) tools such as **common key performance indicators** for microfinance operations. Indicators that focus on outreach, efficiency and profitability can be found on the Microfinance Information eXchange (MIX) website. CIDA could incorporate these indicators in the existing RBM handbooks and other key project/program management documents (e.g. performance contracts, and terms of reference for CEAs) and require its partner institutions to report through the MIX. Management should regularly review the indicators and make appropriate management decisions, based on this analysis. Microfinance could be used as a test case for strengthening RBM.
- CIDA needs to create user-friendly **minimum standards checklists of dos and don'ts** that staff and program support units can use to improve practices. These lists could include well-recognized practices such as focusing on institutional and financial sustainability, tailoring financial services to the demand, and applying market based interest rates. CIDA should ensure that staff as well as external consultants and executing agencies use these lists for project design, monitoring and evaluation.
- To make its partners more accountable for the results of their microfinance operations, CIDA also needs to **negotiate and enforce performance contracts** for CEAs and consultants. Such contracts would include minimum performance thresholds phased on a semester or annual basis throughout the life of the project that must be reached to process remaining funding tranches.

## AID EFFECTIVENESS AND MICROFINANCE MATRIX – CIDA

		<b>Analysis</b>	<b>Recommendations</b>
1.	<b>Strategic Clarity and Organizational Culture</b>	<ul style="list-style-type: none"> <li>• CIDA contributed to the development of credit union models</li> <li>• CIDA plays a significant role in Africa with support to some of the largest MFIs in West Africa</li> <li>• Staff are open to constructive criticism, and CIDA has launched at least three self assessments on its strengths and weaknesses</li> <li>• Staff put more and more emphasis on the needs to focus on sustainability of microfinance operations</li> <li>• CIDA doesn't have a clear vision or strategy for microfinance</li> </ul>	<ul style="list-style-type: none"> <li>• Build a strategy for microfinance, involving a large number and array of staff</li> <li>• Base strategy on existing documents and other donors' work</li> <li>• Increase competitive bidding and untie contracting process as part of the strategy</li> <li>• Clarify linkages between microfinance and CIDA's larger strategic priorities</li> <li>• Leadership needs to support and disseminate the strategy</li> </ul>
2.	<b>Technical Expertise &amp; Resources</b>	<ul style="list-style-type: none"> <li>• CIDA has developed a long experience with recognized executing agencies such as DID, MEDA, SOCODEVI, AKF, CCA, CECI, Coady Institute</li> <li>• Limited in-house technical expertise and lack of a full time focal point</li> </ul>	<ul style="list-style-type: none"> <li>• Create a full time position for a microfinance focal person in the Policy Branch</li> <li>• Place specialists strategically</li> <li>• Familiarize non specialists, especially project managers, on basic good practices</li> </ul>
3.	<b>Organizational Structure and Flows</b>	<ul style="list-style-type: none"> <li>• CIDA plays an active role in donor agency coordination</li> <li>• CIDA depends highly on external consultants, including for project monitoring</li> <li>• Project managers have most decision making power in project cycle</li> <li>• Fast rotation of project officers, limited cross fertilization among branches, and lack of tools create barriers to learning and applying lessons</li> </ul>	<ul style="list-style-type: none"> <li>• Enhance knowledge management by building on existing tools to share lessons learnt, contacts and good practice information</li> </ul>
4.	<b>Instruments and Incentives</b>	<ul style="list-style-type: none"> <li>• Widespread embedded credit components especially through counterpart funds create quality problems</li> <li>• Over-reliance on "responsive mechanism" limits competition, internal accumulation of competence and innovation</li> <li>• Disbursement pressure leads staff to push funding out quickly at the expense of quality</li> </ul>	<ul style="list-style-type: none"> <li>• Take action on problem areas such credit components and low performing projects</li> <li>• Launch agency-wide review of current operations in microfinance</li> <li>• Use grant instruments to focus on building retail institutions</li> <li>• Entrust policy work to international financial institutions</li> </ul>

		<b>Analysis</b>	<b>Recommendations</b>
5.	<b>Program Cycle</b>	<ul style="list-style-type: none"> <li>• Lack of performance-based management prevents CIDA from measuring the success of its operations in the sector</li> <li>• CIDA has limited knowledge of its portfolio, but there is evidence of uneven quality of the portfolio, with several low quality operations</li> </ul>	<ul style="list-style-type: none"> <li>• Require inputs from a suitably qualified CIDA technical specialist on every project with microfinance</li> <li>• Develop common key performance indicators for microfinance operations</li> <li>• Create user-friendly minimum standards check-lists of dos and don'ts</li> <li>• Negotiate and enforce performance contracts with Canadian Executing Agencies and consultants</li> </ul>
6.	<b>Future Microfinance Operations</b>	<ul style="list-style-type: none"> <li>• Limited comparative advantage in microfinance</li> </ul>	<ul style="list-style-type: none"> <li>• Focus involvement with fewer countries, fewer types of higher quality operations employing equal or fewer resources</li> </ul>

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DEC 02 2003

Ms. Jennifer Isern  
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Dear Ms. Isern:

I would like to thank the Consultative Group to Assist the Poor's (CGAP) Peer Review team for their excellent review of the Canadian International Development Agency's (CIDA) microfinance operations.

Staff familiar with the review process were impressed with the professionalism and dedication of the team, as well as with the honest and fair assessment the team delivered in their debriefing of staff at the end of the review week. Indeed, CIDA is pleased to have participated in this process.

At CIDA, we believe in the importance of microfinance, recognizing it as a powerful tool for assisting the poor. As you have noted, our experience with the development of the microfinance sector in West Africa has demonstrated what can be accomplished when the best practices are followed. Realizing that our microfinance operations can be strengthened, we are committed to doing so and welcome CGAP's advice. We genuinely believe that the Tackling Aid Effectiveness from the Top: Microfinance as a Test Case initiative will, as the name of the review implies, help to improve our aid effectiveness using microfinance as a test case.

We agree with your analysis of CIDA's strengths — and with some of the analysis of the challenges CIDA faces — in the microfinance sector. However, I would respectfully disagree with a number of the review team's criticisms of CIDA's programming in microfinance.

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The reviewers noted that CIDA funds many projects which make use of credit components as one aspect of an overall intervention, but concluded that the use of such credit components has been frequently found to cause problems. While certain difficulties have undoubtedly been encountered, in our view this does not, by itself, support the argument for outright elimination of such components, but rather for greater caution in their use. We believe that credit remains an important and useful adjunct to other interventions as long as it is managed in line with established best practices. For this reason, we do not propose to end this practice; although, as you will see later in the enclosure accompanying this letter, it is our intention to carefully review existing projects which include embedded credit components.

With respect to the criticism of the heavy reliance on the use of responsive mechanisms — as is the case in our Partnership programming — the reviewers would appear to be assuming that if projects have not been selected on a competitive basis, CIDA is giving *carte blanche* to our implementing partners. However, in responding to a project proposed by an implementing partner, CIDA still ensures that the implementing partner has the competencies necessary to undertake the project, and that the project is fundamentally sound. If the project is not deemed fundamentally sound, CIDA either negotiates project design changes that will satisfy concerns, or rejects the proposal.

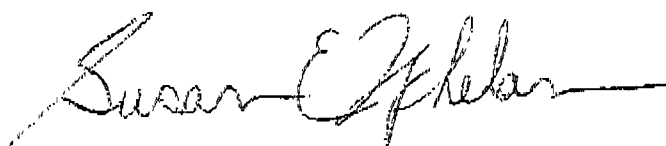
The review also states that project quality and effectiveness suffer in the face of disbursement pressures. As there are no funding targets assigned to the microfinance sector, there are few pressures, if indeed any, to disburse funds in ways which will prejudice project outcomes.

Given the strengths acknowledged by the peer review team, we are surprised to see that it found CIDA to have only a "limited comparative advantage" in microfinance. Our conclusion is different: given CIDA's successful track record, its support continues to be sought for the development of the microfinance industry in the developing world. For this reason, we strongly believe that CIDA continues to offer unique opportunities for partnering in this sector. If this were not the case, we would be seriously questioning our future involvement in the sector.

Given these points, I am pleased to enclose a document that addresses each of the major recommendations identified in the report, that offers our own assessment in each area and that outlines the actions CIDA is committed to taking in response to the recommendations.

We welcome the opportunity to collaborate with the CGAP Secretariat and other CGAP members in moving forward on our plan of action.

Yours sincerely,

A handwritten signature in cursive script that reads "Susan E. Whelan". The signature is written in black ink and includes a long horizontal flourish at the end.

The Honourable Susan E. Whelan, P.C., M.P.

Enclosure

**CGAP Peer Review Findings**  
**Tackling Aid Effectiveness from the Top: Microfinance as a Test Case**

**1. Building a strategy and focussing CIDA's involvement in microfinance**

For some time now, CIDA has recognized the need for a microfinance strategy to give greater focus to its operations. Our Performance Review Branch's review of CIDA's microfinance and microenterprise development operations in 2000 identified areas which could best be addressed through the formulation and implementation of an Agency-wide strategy for its microfinance operations. However, the Agency decided to await the completion of its private sector development policy and of the CGAP peer review, since the outcomes of both exercises were deemed important foundations for the development of the strategy. As the private sector development policy has been launched and CIDA has received the findings of the CGAP peer review, an Agency-wide working group has now been struck and has started work on the formulation of the microfinance strategy. Following further preparatory work inside CIDA, we intend to consult with our Canadian implementing partners for the microfinance sector before finalizing this strategy.

The strategy will address a number of the issues raised within the review report. It will make the linkages between microfinance and CIDA's overall strategic priorities more explicit. It will tackle the crucial question of how to provide greater focus to CIDA's involvement in the microfinance sector. The objective will be to establish the parameters for CIDA's future directed and responsive interventions in microfinance. In this regard, the suggestions offered by the report are useful. For example, we will be looking to concentrate our funding in fewer countries, an approach to which I have already committed CIDA to more generally, and to limit the scope of our interventions within the microfinance sector. The strategy will also identify the minimum requirements that all microfinance project proposals must contain if they are to be considered for CIDA support, and it will identify common indicators that must be used to monitor the performance of the microfinance institutions being supported with CIDA funds.

However, the strategy will not specifically spell out how CIDA will increase the use of competitive bidding for the selection of its implementing partners and consultants in the microfinance area, as this is an issue which extends to all of CIDA's operations and deserves a CIDA-wide approach. I would note that, with the Agency's new policy on untying, opportunities will exist for accessing a wider range of suitably qualified partners.

Furthermore, we disagree with the reviewers' suggestion that CIDA should leave policy work, including regulatory and supervisory aspects of the microfinance sector, to international financial institutions. While CIDA will generally rely on the international financial institutions to lead on policy work in this sector, there will be instances where CIDA will give priority to programming in the microfinance sector. In some of these cases, we have an intimate knowledge of the sector, allowing us to make a difference in improving the enabling environment, in collaboration with other donors who may include the international financial institutions.

## **2. Reviewing and cleaning up CIDA's current microfinance portfolio**

As CIDA's Performance Review Branch undertook an extensive review of its microfinance operations in 2000, CIDA is already aware of its successes and of the challenges it still faces in working in the microfinance sector. In many areas, the CGAP Peer Review has re-emphasized the findings of the Performance Review Branch review. We do not see that another review would add significantly to CIDA's knowledge. Rather, CIDA now needs to move from analysis to action. The microfinance strategy will be the first step in identifying areas where CIDA feels it can move fastest to make improvements in its microfinance operations. Our priority will be to finalize this strategy and undertake its implementation.

As noted above, the review has identified that projects with embedded credit components can be particularly problematic. CIDA will carry out a review of all its projects which contain embedded credit components, and will consider terminating those projects which do not apply recognized good practices or show no potential for financial sustainability.

## **3. Strengthening CIDA's technical capacity**

CIDA currently employs six specialists who provide technical advice for its microfinance operations on a part-time basis to some, but not all, of our programs. While we have confidence in the work of our specialists, we recognize that a number of measures could be taken to enhance the technical quality of our microfinance operations.

Key to this endeavour is the creation of a strong focal point within CIDA. In the past, CIDA's Policy Branch has had a full-time position dedicated to providing advice on microfinance and microenterprise development. Currently, the Economic Policies Division in Policy Branch has the responsibility of serving as

focal point for microfinance issues. Field experience and technical advice in this area is provided by the microfinance specialists, who are located within the program branches. Given the limited specialist resources available within the Agency, we see greater value in placing strong specialists within the programming branches, where their expert knowledge will be put to greater use. The focal point in Policy Branch does not provide technical expertise, but rather support to the program branch specialists.

Terms of reference for the focal point will be developed through consultations with CIDA's program branches. At this point, we believe the focal point will be responsible for assisting the program specialists with enhancing CIDA staff's knowledge of microfinance and best practices. This will include organizing formal training for CIDA staff who wish to improve their knowledge of microfinance, identifying existing tools to assist with all phases of microfinance project management, and reactivating the microfinance knowledge network. The focal point will also be responsible for liaising with external microfinance networks and organizations such as CGAP.

The level of knowledge regarding microfinance operations varies between programs; no program can lay claim to being entirely self-sufficient in this regard. In order to draw on experiences from across CIDA, new projects under development or put forward by Canadian partners for CIDA's consideration will be reviewed by experts drawn from across the Agency. The focal point will be responsible for facilitating this process.

Our specialist resources also need to be matched with the demand and need for their services. As the peer review acknowledges, the number of CIDA specialists is sufficient given the current size of CIDA's microfinance portfolio. However, these specialist resources also need to be optimally allocated inside the Agency. To ensure that this is the case, CIDA will examine the possibility of redeploying these resources where there is a mismatch between the demand or the need for their services and the supply.

#### **4. Improve CIDA's performance management**

CIDA's current practice is to seek technical specialists' input at critical stages of the project cycle. However we acknowledge that this method has not always been followed. To ensure the input is obtained and thereby avoid potential problems downstream, programs will be required to obtain a microfinance specialist's sign off before project proposals, as well as terms of reference for monitoring and for the evaluation of microfinance initiatives, can be approved.

Perhaps better than many other development interventions, microfinance projects lend themselves well to the application of common performance indicators. These will be identified within the microfinance strategy as instruments to be used for monitoring the performance of all microfinance institutions being supported with CIDA funds.

CIDA has developed a reference guide for the microfinance sector to assist staff in the management of their microfinance portfolios. The focal point will draw upon expertise as needed to ensure that this guide remains current and, as noted earlier, will identify other existing user-friendly tools that can assist staff with all phases of project management.

Finally, CIDA will explore the possibility of including performance indicators in our contracts with microfinance implementing partners, and of performance contracting with these partners.