

European Commission (EC) Letter to Management Executive Summary

A team comprising Henri Dommel of IFAD, Gisela Strand of Sida, and Brigit Helms and Eric Duflos of CGAP conducted a Donor Peer Review of the European Commission (EC) in Brussels from 24-28 March, 2003. The review is part of a 17-agency initiative launched by Development Ministers, Head 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 the EC to identify success factors and constraints that influence the effectiveness of the agency's microfinance operations. The Economic and Commercial Cooperation Unit of the "C" Directorate of the Europe Aid – Cooperation Office (AIDCO), in conjunction with DGDEV and the thematic sub-group for microfinance, provided the team with an orientation to the EC and organized meetings with 80 people throughout the RELEX family, including extensive consultation with field-level staff and partners. The team briefed AIDCO Deputy Director Marc Franco, Cabinet Member Kristian Schmidt and several department heads and staff on its initial findings on March 28th.

The Peer Review team found its visit to be timely given the current reforms at the EC aimed at improving development cooperation overall. The team hopes that this management letter will enrich the internal discussions and provide specific ideas of how the EC can improve its effectiveness in microfinance. Although the letter encompasses the entire RELEX family, much of the analysis and recommendations pertain to operations, and thus the focus is on AIDCO. This letter outlines the EC's opportunities and challenges, and presents specific recommendations. A matrix at the end of the letter provides a summary of the key findings and recommendations.

The Peer Review Team makes five concrete recommendations to management to enable the European Commission to improve its microfinance interventions:

1. ***Make a choice on EC level of involvement in microfinance.*** Management should decide whether the EC should continue to work in microfinance. In the event that it wishes to remain engaged, the remaining peer review recommendations seek to help align the EC's microfinance work more fully with good practice standards.
2. ***Build a common EC vision and commit to it.*** This implies (i) sending a clear message from top management to work according to good practices, (ii) continuing a consultative process of reviewing in-house and outside experiences, and (iii) building a common understanding of good practices.
3. ***Work through strategic partners.*** The EC should identify partners with specialized microfinance expertise, complementary instruments and shared objectives to manage its microfinance operations.
4. ***Improve quality control and accountability.*** Microfinance guidelines should include rules of the game (dos and don'ts) that match existing instruments, financial regulations, and systems. The EC should develop specific tools to operationalize these dos and don'ts.
5. ***Enhance staff capacity.*** More effective EC intervention in the sector will require investments in human resources, such as (i) creating one or two full time microfinance focal points in AIDCO, (ii) recruiting specialized expertise for selected regional offices, and (iii) strengthening the existing sub-thematic group.

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 Henri Dommel, Rural Finance Technical Advisor at IFAD, Gisela Strand, Specialist in Financial Sector Development, Swedish International Development Cooperation Agency, Brigit Helms, Lead Microfinance Specialist and Eric Duflos, Microfinance Specialist of the Consultative Group to Assist the Poor (CGAP) visited EC headquarters from 24–28 March, 2003. The review team interviewed 80 people from a wide range of EC directorates (AIDCO, DG Dev, DG RELEX, DG Enterprise). The team also obtained views from the Delegations, mostly through telephone interviews. The table below provides more details about the different parts of AIDCO, DGDEV and the various delegations with whom the team met.

Directorate	Direction
AIDCO	A2, A3, A6, B2, B4, C1, C3, C5, C6, C8, D3, D4, E2, E4, E5, E6, F2, F5, F6, G2, H4, H6
DGDEV	A1, B, B2, B3, B4, B5, C1, C2
Delegations	Bolivia, Egypt, Ecuador, Honduras, Jordan, Kenya, Mozambique, Malawi, Nicaragua, Palestine, Tadjikistan

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 the EC will also be combined with those from other agencies reviewed in a synthesis report. A synthesis report already exists 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 late 2003 / early 2004 to share experiences and reforms made as a result of the exercise.

This management letter outlines the EC's opportunities 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. Although the letter encompasses the entire RELEX family, much of the analysis and recommendations pertain to operations, and thus the focus is on AIDCO.

EC opportunities:

Microfinance is a dynamic field which encompasses a diversity of financial services for the poor. Poor people use and need financial services to increase their income, provide education to their children, improve their social status in a community, cope with health problems, and prepare themselves for difficult times. To be effective in using microfinance as a poverty reduction tool, donor agencies have developed and agreed on good practice standards.

The peer review team found that the EC's current reforms and process of stocktaking on microfinance could significantly contribute improving its microfinance operations.

- The 1998 **Microfinance communication** and guidelines reflect internationally accepted good practices. These documents could provide a solid basis for improving current and future operations.
- The EC's extensive field presence and current **deconcentration** process could improve understanding of microfinance needs at the local level, as most project management responsibilities will be transferred to the Delegations. Deconcentration will increase exchange between the EC and other donors. This process would also free up some time for head office staff to provide additional thematic and technical support to the delegations.
- The **creation of thematic groups** indicates a commitment from EC management and staff to increase technical rigor of their programs, address cross-cutting issues, and support specialization. The sub-thematic group for microfinance confirms the active engagement from AIDCO management, and the growing level of exchange among directions to improve EC interventions in microfinance.
- EC management and staff are committed to **staff training**. While training might currently focus on procedures in the context of deconcentration, it could incorporate specialized technical areas like microfinance to ensure basic understanding of microfinance good practices. The large number of people attending the team's debriefing confirmed a wide interest in learning more about microfinance.
- The EC has **grant resources**, which are particularly useful in microfinance for financing much-needed technical assistance and institutional capacity-building projects. These resources can complement the instruments available from other donors such as soft loans, equity participation, and guarantees. As an example of potential good practice, the Cotonou Agreement allows the EC to channel technical assistance grants through non-state actors. An expert facility (Framework Contract) also enables Delegations to mobilize TA within short notice.
- The EC has built a few **successful partnerships** with donor agencies with comparative advantage in supporting the development of microfinance institutions such as EBRD, AFD, KfW and EIB. These partnerships could provide a model for future EC operations.
- The EC is developing **quality control** procedures by setting up Quality Support Groups and a **monitoring** system available in the Common Relex Information System (CRIS) database. Both these initiatives could ensure higher quality operations in microfinance. For example, the team found that the questions raised in the CRIS on efficiency and sustainability are relevant for microfinance.

EC Challenges

General Challenges

A review of the EC's microfinance operations requires an understanding of the general context of the EC RELEX family, which has undergone a series of reforms over the last two years.

- EC Development Policy
- AIDCO creation
- Deconcentration
- Thematic Groups
- New Country Strategy Papers
- New Quality Support Groups
- New Financial Regulations

Microfinance specific challenges:

The EC faces a number of challenges that prevent it from applying good practices to its microfinance operations, and could potentially lead to the misallocation of resources.

Strategic challenges:

- **Lack of political commitment to agreed good practices in microfinance:** While the European Parliament seems to exert pressure on the Commission to do microfinance, there is no clear message at the political level to follow good practices. This lack of a clear message on quality could send inappropriate signals as microfinance operations can be detrimental to the market, and therefore to poverty reduction, if they do not follow good practices.
- **Lack of coherent vision:** Staff understand microfinance in many different ways. Interpretations encompass such wide-ranging areas as social, rural, enterprise, gender, private sector and financial sector development. This variety of viewpoints creates unclarity on (i) the role of microfinance in development, (ii) the role of the EC in microfinance, and (iii) whether the EC should be involved in this sector at all. This lack of coherence results in uneven application of good practices.
- **Invisibility in strategy and systems:** Microfinance does not appear in the six priority areas of the EC's development policy, the Country Strategy Papers (CSPs), nor the various budget lines and project monitoring systems. Nevertheless, many projects include a credit component. This invisibility makes it difficult to track operations and provide appropriate technical inputs and quality control.

Organizational challenges

- **Pervasiveness of microfinance throughout AIDCO:** Microfinance is widely present in the EC portfolio with over 270 microfinance operations currently accounted for. The team was aware of at least seventeen departments within AIDCO that currently fund microfinance activities (A2, A3, A4, B2 B3, B4, B5, C3, C5, C6, D2, D3, D4, E3, E4, F2, F5). This pervasiveness poses a challenge for the EC to ensure appropriate technical inputs and quality control, since many dispersed actors can generate microfinance operations.

- **Insufficient expertise:** The absence of a full-time microfinance focal point and technical specialists in Brussels has implications for the EC's effectiveness in microfinance. Experience shows a high correlation between technical expertise and good microfinance programming, even when most activities are contracted out. Many AIDCO staff do not have the technical background to engage with specialists, nor can they rely on an established network of specialized resources either through the framework contracts or elsewhere. In addition, even though it seems small from the perspective of the overall EC development cooperation budget, the microfinance portfolio is disproportionately large compared to the low overall technical expertise in the RELEX family and especially AIDCO. The EC funds sizeable initiatives in the sector compared to other donors with more microfinance expertise.

Operational challenges:

- **Limited knowledge of the portfolio:** While the sub-thematic group has begun tracking microfinance operations, the EC has a limited knowledge of its overall portfolio, and performance tracking remains uneven and ad hoc. This is particularly true with budget line programs such as NGO co-financing and food security that have many small projects but no system to track them. The lack of microfinance performance indicators prevents the EC from measuring its real impact in the sector, learning lessons, and making more informed decisions on project extension, suspension, or replication.
- **Uneven quality of operations :** Not all staff engaged in microfinance operations are familiar with the existing microfinance guidelines. Even when they are known, they are not always accepted and rarely applied. The uneven application of guidelines translates directly into uneven quality of operations. Further EC staff may not realize the magnitude of the impact of their microfinance projects on the ground. The EC's projects can be very large in a given country context, with the potential to create long-term distortions in financial markets.
- **Inadequate Instruments :** The Cotonou Agreement for ACP countries and the new financial regulations for all countries require full ownership of instruments by governments. While such arrangements might be adequate for programmes such as budget support, Sector Wide Approach Programmes (SWAPs), and infrastructure projects, they can hamper microfinance initiatives, which generally require working with private financial institutions using a business-like approach.
- **Lack of clarity of financial regulations:** Staff, including finance and contract staff, have different interpretations of the ownership of accrued interest and credit lines at project end. This lack of clarity leads to confusion and prevents staff from designing appropriate project exit strategies.

Recommendations

The following features characterize good donor practices in microfinance: 1) small projects in terms of money; 2) high level of labor-intensive technical inputs; 3) private sector approach; 4) specialized partners; 5) long-term commitment; 6) flexible instruments; and 7) performance-based contracts. Unfortunately, the EC's profile is nearly the opposite in every dimension. The EC provides large grants with low levels of technical expertise, often through government implementing agencies, and in many cases without specialized partners, flexibility and performance indicators.

The peer review team questions whether the EC has a comparative advantage to directly fund microfinance (including microcredit) initiatives. Notwithstanding this analysis, the EC remains heavily involved in the sector. The peer review team offers the following set of recommendations to EC management as they consider the appropriate future for microfinance in the agency.

1. ***Make a choice on level of involvement in microfinance.*** Management needs to make some clear decisions about microfinance. On the one hand, the agency has no clear comparative advantage in the sector. On the other hand, microfinance is a powerful tool for poverty reduction, a very important political-level objective for European governments. If the EC decides it is important to continue supporting microfinance, it should consider the following recommendations, and bring its portfolio more into line with internationally agreed good practices. Such a choice would require a clear commitment to good practices and investments in organizational capacity as outlined below.
2. ***Build a common vision and commit to it.*** This recommendation implies (i) sending a clear message from top management to work according to agreed good practices in microfinance; (ii) continuing a consultative process of reviewing in-house and outside experiences in microfinance; and (iii) building a common understanding of good practices (such as financial and institutional sustainability and integration in the financial sector) based on the existing microfinance communication.
 - Top management at the EC and the European Parliament should send a clear message to staff that if and when microfinance is promoted, it should be done according to clearly defined sound practices. References on such practices are readily available from existing multi-donor sources, such as the "pink book" guidelines or the normative work undertaken by CGAP.
 - The EC should extend the work of the sub-thematic group on microfinance to obtain a better picture of the present portfolio and identify success stories where EC has funded institutions showing good prospects for financial, and institutional sustainability combined with a mission to reduce poverty. Based on this initial research, the group could select two success stories in each region and share them with other staff involved in microfinance. The group could also sample other donors' projects to learn from their successes and compare them to the showcased EC projects.
 - The EC could build on and update the existing microfinance communication and guidelines. These documents are now five years old, and the microfinance field has evolved significantly during this time. This exercise should be organized by the sub-thematic group

and involve the Delegations and DGDEV which currently plays a leading role in the area of policy. The guidelines would be based on the work done on the new private sector development guidelines and stock taking of concrete success stories. By jointly updating the guidelines, the sub-thematic group would build staff ownership of the documents while incorporating most recent developments in the sector. The sub-thematic group could also take this opportunity to simplify these guidelines and make them more operational.

3. ***The EC should work through strategic partners.*** Based on the analysis of opportunities and challenges, this option is preferred by the peer review team. Some of the EC's partners such as EBRD, IDB, EIB, AFD, KfW, and IFC have significant technical expertise, and similar development objectives. These agencies also have funding instruments complementary to those of the EC, such as loans, guarantees, and equity participation; they can use these instruments to work directly with the private sector. The EC could delegate the management of their microfinance initiatives to these partners. There is solid experience and basis for such partnership in the Cotonou Agreement article 11.4 and annexe 2, and the EC could look for other mechanisms for non-ACP countries. Special arrangements might need to be developed to enable EC funding to go through bilateral agencies either directly or through multi-donor sector programs.

The main benefits of the partnership approach would be an increased impact on poverty reduction, more coordination with other donors, especially with European bilateral agencies, project funding spent more safely and more effectively, and reduced burden of monitoring multiple projects.

4. ***Improve quality control and accountability.*** While the preferred option is to work through strategic partners, the peer review team recognizes that the EC has many on-going projects and budget lines that will likely continue to attract credit components. The EC cannot afford to have an invisible microfinance portfolio if it wants to promote good practices. Therefore, the EC needs to build a framework to increase the visibility and improve the quality of all its operations, whether conducted through strategic partnerships or other mechanisms.

- With external technical support, the sub-thematic group could identify simple rules of the game (i.e. dos and don'ts) that draw from the updated communication and guidelines. Examples of such rules include working through specialized institutions, developing clear exit strategies from the start, using performance-based contracts, supporting the development of sustainable financial institutions rather than un-sustainable credit components, and making sure that interest rates of supported programs are not subsidized.
- The group could identify which instruments and partners can be used and how financial regulations need to be interpreted. Specific standards and checklists can be integrated into existing systems (QSG, CRIS, etc.). Ultimately, the group could draft a practical handbook on how to design and implement specific types of microfinance operations relevant for specific circumstances.
- Since microfinance is not part of the EC's six development priority sectors, it may often be "attached" to existing priorities within the CSPs. When microfinance (or credit) is included in a CSP, the EC should include a checklist for quality control (QSGs), standard-reporting requirements, and clear performance indicators related to microfinance in the CRIS.

- The NGO co-funding budget line contains the largest number of small credit components in the EC (estimated to be 174 out of 273 recorded projects). The EC should develop specific calls for proposals for NGO-supported microfinance projects, where the guidelines and “dos and don’ts” would be attached. The sub-thematic group and staff from the delegations could draft specific checklists for the selection of NGOs (for example ensuring their technical expertise in the area of microfinance), and be involved in selecting the NGOs.
 - The EC should encourage transparent reporting by the microfinance institutions that it supports. For example, institutions receiving microfinance support could report through existing international mechanisms like the MIX (Microfinance Information eXchange).
5. ***Enhance staff capacity:*** Improved EC interventions in microfinance will require investments in human resources, such as (i) creating one or two full time microfinance focal points at AIDCO, (ii) recruiting specialized expertise for regional offices, and (iii) strengthening the existing sub-thematic group by including delegation and contract/finance division staff, and organizing exposure trips and training for key members.
- Given the size and pervasiveness of the microfinance portfolio, the peer review team sees the need for at least one full time focal point with microfinance expertise in AIDCO, and possibly a second focal point within the F directorate (NGOs and food security). In addition, the EC should continue to allocate a part time focal point in DGDEV. Some of the possible responsibilities of the focal points would include: leading the stock taking exercise, animating the thematic group, contacting strategic partners, maintaining an overview of the microfinance portfolio, providing advice on TORs, supporting the delegations, managing training and knowledge dissemination, managing a consultant database, and serving as an anchor at headquarters for EC microfinance expertise.
 - Regional delegations should recruit expertise to strengthen capacity in the field to apply good practices and select appropriate partners. This expertise, which could be part time, would provide technical support to national and regional delegations on a demand-driven basis.
 - The peer review team recommends enlarging the sub-thematic group to include regional and national delegations as well as staff from contracts and finance. Key tasks of such a group would be to develop the “dos and don’ts”, continue its portfolio review, identify strategic partners that can manage microfinance initiatives, develop relevant checklists for quality control (QSGs), and take part in international fora on microfinance and in specialized training such as the Microfinance Training Program in Boulder, Colorado (USA). Individual staff members’ TORs should explicitly include this work, and promotion points should be awarded to create incentives and accountability.

AID EFFECTIVENESS AND MICROFINANCE (MF) MATRIX – EUROPEAN COMMISSION (EC)

		Analysis	Recommendations
1.	Strategic Clarity and Organizational Culture	<ul style="list-style-type: none"> • The EC lacks the political commitment to apply MF good practices • The 1998 microfinance communication and guidelines reflect good practices but are not applied • MF is invisible in the strategy and systems, even though the EC portfolio includes over 300 MF operations • The EC lacks a coherent vision with different understanding of MF among staff 	<ul style="list-style-type: none"> • Make a decision on whether EC should continue its involvement in microfinance • Management and parliament should send a clear message to staff to follow MF sound practices • Build a common vision of good practices through the microfinance sub-thematic group, by capitalizing lessons learnt internally and globally, continuing the MF inventory work, building on the MF communication and guidelines in consensus with delegations and partners • Identify success stories and share them with staff involved in MF
2.	Technical Expertise & Resources	<ul style="list-style-type: none"> • Staff has a limited level of knowledge of MF, but is committed to training • There is no technical staff or full time focal point for microfinance • The creation of the sub-thematic group in microfinance could be instrumental in building the EC's technical knowledge • Deconcentration provides opportunities to contract MF-expertise locally, and free up HQ time to increase technical support 	<ul style="list-style-type: none"> • Appoint at least one full time focal point with MF expertise within AIDCO, and possibly a second one in the F directorate • Recruit expertise in regional delegations to help delegations apply good practices and select appropriate partners • Enlarge the sub-thematic group to include staff from delegations and contract/finance, and train the group in MF good practices
3.	Organizational Structure and Flows	<ul style="list-style-type: none"> • MF is omnipresent in AIDCO with at least 270 MF projects within 17 departments • The EC has limited knowledge of its MF portfolio, despite the recent efforts of the sub-thematic group to track existing operations • Deconcentration could improve understanding of MF needs at the local level and increase exchanges with other donors 	<ul style="list-style-type: none"> • With external support, the sub-thematic group could identify simple rules of the game that draw from the communication and guidelines • Identify which partners and instruments can be used and how financial regulations have to be interpreted • Integrate checklists for standards into existing systems and draft a practical handbook on how to design and implement specific types of MF projects

		Analysis	Recommendations
4.	Instruments and Incentives	<ul style="list-style-type: none"> • Most EC instruments are inadequate for funding microfinance as they emphasize government ownership; MF is traditionally best implemented by private organizations • Grant resources can complement other donors instruments (such as loans and equity) especially to finance technical assistance and capacity building • EC has built some successful strategic partnerships with other donors (e.g. EBRD, AFD, KfW and EIB) 	<ul style="list-style-type: none"> • Work through strategic partnerships • Leverage grant instruments of the EC with other donors instruments (loans equity) in the context of strategic partnerships • Include work done in the sub-thematic group in staff TORs and promotion system
5.	Project Cycle	<ul style="list-style-type: none"> • The financial regulations are unclear to the staff with regard to ownership of accrued interest and credit lines at project end • EC is developing quality controls (QSG) and monitoring systems (CRIS) which could ensure higher quality in the future • MF operations lack specific quality standards and performance indicators 	<ul style="list-style-type: none"> • When credit is attached to priorities in the CSP, include a checklist for QSG, standard reporting requirements, and clear performance indicators • Encourage transparent reporting by institutions supported by the EC, through existing international systems (such as the MIX) • Develop special calls for proposals for NGO supported microfinance projects, with simple guidelines and do's and don'ts checklists • Set up MF quality control and evaluation standards within existing systems
6.	Future Microfinance Operations	<ul style="list-style-type: none"> • MF requires small projects, high level of labor-intensive technical inputs, a private sector approach, flexible instruments and long term commitments • It is questionable whether EC has presently any comparative advantage in working in the microfinance sector 	<ul style="list-style-type: none"> • Make a decision on level of involvement of EC • Work through strategic partners with similar resources and significant technical expertise such as EBRD, IDB, EIB, KfW, IFC to increase effectiveness, improve results, and reduce burden on staff • For NGO budget lines, work through specialized MF-NGO identified during special calls for proposals.

Brussels, 22-07-2003
AD (03) 676

Dear Ms. Helms,

Following our letter of 30 June 2003 we would like to give you the full response to the Microfinance Donor Peer Review conducted by CGAP. I am also replying on behalf of Commissioner Patten.

1. General appreciation

The peer review team has produced a very concise and well-structured analysis of our microfinance operations. It has helped us to see more clearly our strengths and weaknesses in this field. I am aware that our current microfinance projects face a number of challenges. In this respect, I would like to point out that the RELEX family has been in a fundamental reform process for the last three years. We acknowledge that this internal reorganisation has absorbed much of our time and energy. Soon we will have the time and resources to focus more on some specialised fields, like microfinance, which did not represent a priority in the past.

The recommendations in the peer review will certainly help us to improve our work in this field. Therefore, I would like to congratulate you again for the work that you and your team have done.

2. Detailed comments

a) EC opportunities

We agree with your analysis that our current reforms and characteristics in the field of development policy are a good basis to have improved microfinance operations. This relates to the fact that we have a strong field presence following our process of deconcentration. Another opportunity is the fact that we have grant resources, which is very important for capacity building of microfinance institutions.

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b) Microfinance – strategic challenges

As mentioned in your letter, we have defined six priority areas on which our development policy will focus on. Microfinance is not mentioned as one of the six priority areas because we consider it to be rather a means than an objective: the priority areas are broad categories of goals that encompass various development instruments. The first priority area (“link between trade and development”) includes private sector development as an important area of EC support. Microfinance is one of our instruments in the field of private sector development. Therefore, the broader priority areas cover microfinance as a field of EC development assistance. Moreover, poverty reduction is the central objective of our development policy. We consider microfinance as a very effective means of direct poverty alleviation and clearly an area we have to remain engaged in.

We acknowledge that microfinance has in the past not been very visible in strategy and systems. One first step to remedy this is the new communication on “the Commission’s approach to future support for the development of the business sector”. This communication mentions support for microenterprises, including microfinance, as one of five instruments of private sector development. The communication is currently being discussed in the Council.

However, further steps are clearly needed. We are committed to insisting more strongly on following good practices in microfinance. Contrary to your assessment, though, I don’t think that a lack of political commitment is at the root of this problem. Rather, it is a question of quality support systems taking into account microfinance. Furthermore, the differences in the contexts and sectors in which we work imply some flexibility in our approaches. For specific development objectives and target groups, e.g. rural areas and the poorest, “good practice” needs to be developed responding to specific problems, objectives and contexts.

Another necessary step is to start an internal policy dialogue with the aim to create a common understanding for microfinance. This dialogue will involve delegations and headquarters and discuss questions like what our role in this sector should be and how the tasks between delegations and headquarters should be divided.

c) Microfinance – organisational challenges

It is true that our microfinance operations are spread over various units in AIDCO and that some staff do not have the necessary technical background to engage with specialists. This is part of the reason why there could be an uneven quality of operation. We are aware of the fact that microfinance is in most cases only a part of a bigger project. This makes it hard to quantify and track our portfolio. It will be one of our priorities to improve this situation.

d) Microfinance – operational challenges

I do not share your view that full ownership by government as foreseen in the Cotonou agreement is in contradiction with a business-like approach required for microfinance. Many of our programmes in the field of private sector support work directly with companies or intermediary organisations, responding to demands of the private sector (“demand driven”). These programmes have a global approval by ACP governments but have autonomy on an operational level. Furthermore, some interventions, such as the improvement of the legal framework for microfinance, require active involvement and ownership by the partner governments.

e) Recommendations

I do not share your doubts whether the EC has a comparative advantage in doing microfinance. These doubts are even partly refuted by your own analysis of EC opportunities:

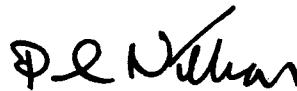
- The EC has grant resources, which are particularly important for capacity building, technical assistance and other complementary measures for microfinance institutions.
- Due to the ongoing process of deconcentration we are getting closer to the field and the final recipients of our aid.
- The EC’s large resources are not contrary to the need for small amounts since funds can be channelled to small projects through other institutions or specific modalities; technical inputs can be delivered through specialised expertise.
- As mentioned above, many of our instruments have a private sector approach (“demand driven”).
- With the start of the Investment Facility, managed by the European Investment Bank (EIB), we have the possibility to team up with a specialised partner in the ACP region. Similar possibilities exist in the MEDA region.
- Many of our projects are programmed for a period of up to five years, so we can make long-term commitments.
- Since we can decide to prolong or not to prolong contracts we can reward performance of the executing agency.

I have taken note of the detailed list of recommendations and consider many of them highly relevant. My staff is currently analysing if and how we can implement the various recommendations. Therefore, it is too early to make specific comments on the implementation of your recommendations. I expect a first internal discussion of this follow-up in September.

To conclude, I would like to point out that it is not a question for us to do or not to do microfinance. Due to its relevance for poverty reduction, which is the overall objective of EC development policy, and due to the fact that it is at least indirectly part of one of our priority areas, we clearly consider microfinance as a field we must be engaged in. Therefore, the crucial question is how we can improve our operations. In this context, I would highly welcome the opportunity to discuss first ideas with Elizabeth Littlefield in Brussels in September.

Let me thank you again for the work you have done. It will help us to improve our activities in the field of microfinance.

Yours sincerely,



Poul Nielson

Annex: Edits to the CGAP letter authorised for publication

CC: C. Patten, K. Richelle, G. Bonacci, M. Franco, B. Petit and all participants of the CGAP peer review in AIDCO, DEV, RELEX and the Delegations