



# AID EFFECTIVENESS INITIATIVE

## MICROFINANCE DONOR PEER REVIEWS

APRIL 2004

### Elements of Donor Effectiveness in Microfinance: Policy Implications

Seventeen development agencies participated in the Microfinance Donor Peer Reviews as part of an aid effectiveness initiative to improve donor practice.

What makes a donor agency effective in supporting financial systems that work for poor people? The Microfinance Donor Peer Reviews, conducted from May 2002 to November 2003, offered some concrete answers to this question.

The Peer Reviews 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. While not exhaustive, these elements shape an individual agency's ability to apply good practice to its microfinance operations – thus achieving greater impact in 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.



This paper explains the five core elements of effectiveness and gives examples of good practice for each. It also illustrates how the elements help determine an agency's comparative advantage and appropriate niche in microfinance vis-à-vis others. Finally, the note suggests ways that donors can forge partnerships with those that have complementary strengths, thus making the donor community as a whole more effective.

## FIVE CORE ELEMENTS OF DONOR EFFECTIVENESS

### Strategic Clarity

The coherence of an agency's vision of microfinance, especially the relationship between microfinance operations and broader development goals, affects quality at every level. Agencies with strategic clarity know where they want to go and align their behavior and operations to that vision. A coherent approach (rather than a splintered one) does not stifle diversity and creativity, but rather defines the boundaries of a common commitment to principles of good practice. A high-quality microfinance policy is important, but not sufficient; policies must be internalized by staff to translate into results on the ground.

Donor agencies and microfinance leaders increasingly embrace a common vision of microfinance. This vision embeds financial systems for the poor within private or financial sector development – while appreciating the cross-cutting impact of microfinance on other areas like social sectors and rural development. This approach to microfinance will ensure permanent access to a broad range of financial services for the world's poor on a massive scale, through viable local institutions that endure beyond the life of a given donor project. Agencies with strategic clarity tend to view microfinance along these lines. This vision differs from the more traditional and narrow perception of financial services, mainly credit, as an input or resource transfer to specific target populations.

Examples of agencies with strong strategic clarity include DFID, GTZ, KfW, and SDC. All have a coherent vision of microfinance as part of financial sector development. This coherence is evidenced by one or more of the following: strong policies that adhere to international standards; principles of good practice clearly understood and internalized by headquarter and field staff; and the appropriate placement of microfinance specialists within financial sector development units or departments. Other agencies moving quickly toward reaching greater clarity on their vision for microfinance include USAID, AFD, and NORAD.

### Strong Staff Capacity

The Peer Reviews confirmed a direct link between staff with solid microfinance technical expertise and the quality of an agency's microfinance operations. Within donor agencies, most microfinance programs are managed by non-microfinance specialist staff, functionally splitting those with technical expertise on the one hand, and those with control over money on the other.

The four most effective agencies overall among those that were reviewed – DFID, GTZ, KfW and USAID – have strong technical focal points (individuals or teams of technical specialists, usually concentrated in a single unit). Beyond the focal point, staff have a solid basic knowledge of microfinance principles, even if they work in this area only a small proportion of their time.

Several other agencies, notably some of the multilateral organizations with large microfinance portfolios, also have strong focal points. These include AsDB, IFAD, ILO, and UNDP. However, even a high-quality focal point cannot assure quality in agencies with a large volume of programs. This challenge is particularly acute in agencies where microfinance originates from many different departments, and/or from decentralized country offices.



Focal points that prioritize spreading good practices among non-specialist colleagues at headquarters and in the field tend to be more effective than those who spend most of their time managing their own projects. But incentives in two directions are needed to encourage this interaction. The focal point must have an incentive to engage non-microfinance specialists, and program managers must see the benefits of seeking technical advice from microfinance experts. KfW technical specialists are motivated to support colleagues throughout the organization because this function is embedded in their TORs and workplans, and team leaders from other regions comment on their annual performance evaluations.

When employing full-time specialist staff is not financially or politically feasible, agencies can adopt creative ways to access technical expertise, through outsourcing or strategic alliances. However, there is no substitute for in-house staff capacity. At a minimum, non-microfinance specialist staff who handle microfinance projects should have a baseline of knowledge. They need to know what questions to ask and when, how to select technical partners and consultants, and how to interpret reports from microfinance projects. Tailored training for non-microfinance specialist staff such as that offered by USAID and UNDP can help improve overall staff capacity.



### **Accountability for Results**

Transparency about performance of microfinance programs is critical for aid effectiveness. Only with accurate information can agencies make sound decisions on whether to continue, extend, terminate or replicate a program. Yet, the Peer Reviews found that most of the agencies that were reviewed do not know how much money they have invested in microfinance, nor do they have sufficient knowledge of the performance of their microfinance operations. In many agencies, especially the multilaterals, pressure to approve and disburse projects exacerbates the problem; the imperative to get projects approved often takes precedence over setting up systems to ensure accountability.

USAID most systematically collects basic information on its portfolio via the Microenterprise Results Reporting (MRR) system. A number of other agencies conduct periodic inventories of projects, such as AFD, AsDB, CIDA, EC, IFAD, and Sida. UNDP is completing a major portfolio review to determine the quality of its projects and design a course of action to improve performance.

Some agencies have chosen to leverage existing international tools to improve their accountability for results. IFAD and the Dutch Microfinance Platform have recently decided to use the Microfinance Information eXchange (MIX Market), an internet-based reporting tool for microfinance institutions and funders, for project reporting. In Uganda, 15 donor agencies (including AfDB, DFID, EC, NORAD and USAID) have developed a single Performance Monitoring Tool (PMT) that their Ugandan partners can use for all donor reporting.



### **Relevant Knowledge Management**

Knowledge management – the creation, dissemination and utilization of knowledge – is about transforming information into usable knowledge and ensuring that it reaches the right people at the right time. When knowledge management enables agencies to learn from their own and others' experience, it greatly contributes to effectiveness. By emphasizing knowledge management as a personal and joint staff objective, GTZ succeeded in creating a culture of intellectual exchange and shared responsibility.

Several agencies have very strong research programs and provide valuable public goods to the global microfinance community. These agencies include USAID, AsDB, and DFID. Though an important component of knowledge management, research does not always translate into improved practices on the ground, real exchange among staff, or institutional learning. Also, most agencies are either highly decentralized or moving rapidly in that direction. Knowledge management is particularly challenging in these environments, where country-level officials often have a fair amount of autonomy in setting strategy and making funding decisions.

Internal knowledge networks (such as the Financial Services Team and the Savings and Credit Forum at SDC, the Rural Finance Thematic Group at IFAD, the Rural and Microfinance Committee at AsDB, regional sector networks at GTZ, and the Sub-thematic Group on Microfinance at the EC) enable staff to exchange, disseminate and retain knowledge within their organization.

### Appropriate Instruments

A wide range of funding instruments is required to support microfinance well. These instruments include grants, loans, loan guarantees and equity participation, and are used to build institutional capacity, provide technical assistance, fund lines of credit, facilitate the access of financial institutions to local capital, bolster equity, launch policy initiatives and build financial infrastructure (such as credit rating agencies and auditors). All instruments should be used flexibly, with disbursements linked to the attainment of clear performance goals.

Overall trends in donor agencies emphasize new aid modalities, a “program” approach (as opposed to a “project” approach), direct government budget support and Sector-wide Approaches linked to Poverty Reduction Strategies, and policy dialogue. These trends pose certain trade-offs for expanding financial services for the poor. Good microfinance operations are usually incompatible with large budgets and direct government intervention. Effective instruments accommodate small projects focused primarily on strengthening private sector institutions.

A number of agencies have appropriate instruments to support microfinance, notably bilateral agencies like AFD, KfW, USAID, and the Netherlands through the Dutch Microfinance Platform. They can work directly with the private sector using a relatively wide range of flexible instruments. Other agencies with strong instruments include DANIDA, DFID, SDC, and Sida. This group of agencies can also work easily with the private sector, but either do not have as wide a range of instruments and/or do not yet fully exploit the range instruments that they do have.

While many agencies work through governments, multilateral development banks face specific challenges. Their main instrument is loans to governments. They are also more likely to implement credit components within larger multi-sector projects. Experience has shown that governments should not be directly involved in the delivery of financial services or the management of microfinance initiatives. Government ministries and project management units usually lack the technical skills and political independence needed to manage microfinance projects. Also, governments are often understandably reluctant to take loans for small technical assistance projects, even though such assistance is vital to support permanent access to financial services for the poor.

Many agencies have recognized that credit components (also known as credit lines, revolving funds, and community development funds) do not produce the intended results. Following the EC Peer Review, the agency’s top management decided to cease funding



new credit lines that distort markets and have limited impact on poor people. Other agencies are approving fewer credit components as well.

## **IMPLICATIONS: IDENTIFYING AND ACTING ON COMPARATIVE ADVANTAGE**

Building financial systems that work for the poor – the majority of the world’s population – is a daunting task. Today, demand far exceeds supply for financial services, and market failures continue to block poor people’s access. Continued donor support of the sector remains vital. The range of required donor engagements encompass working with diverse types of financial intermediaries (e.g., banks, cooperatives, postal systems), entering into policy dialogue with governments and other stakeholders, and helping to build industry infrastructure. At the same time, not every agency can or should work on all these different levels.

Donors can use the five core elements of effectiveness as one input to identify their comparative advantage in promoting financial services for the poor. Combined with other agency-specific considerations, these elements can help guide donor actions in a given country context and/or type of intervention. For example, decentralized decision-making and technical expertise are important success factors 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 for credibility and give an agency a local comparative advantage.

The Peer Reviews highlighted potential opportunities for several agencies to align their operations with their comparative advantage, for example:

- GTZ’s strengths include a cadre of in-house technical specialists, a sophisticated knowledge management strategy, efficient regional microfinance staff networks, and a long history of involvement in microfinance. These strengths make it an ideal organization to pursue highly specialized technical work to support financial intermediaries in areas like rural finance and savings mobilization. GTZ can also effectively provide hands-on support to those who implement key government policies, e.g., bank supervisors.
- NORAD is a small bilateral donor with grant funds and limited technical staff, especially at the embassy level. Its Microfinance Position Paper outlines a strategy that leverages its grants by focusing on relatively high risk innovations and industry infrastructure programs and working through Norwegian NGOs. The agency plans to only fund individual MFIs in close cooperation with other donors.
- Both KfW and AFD have diverse banking instruments that allow them to work with a range of financial institutions – primarily loans, loan guarantees, and equity participation. However, they have limited grant funding available for technical assistance, and financial disincentives to launch small capacity-building projects. These agencies could fruitfully partner with others that have flexible grant funding to broaden the range of support they can offer to partners.
- The ILO’s tripartite governance structure (which includes governments, workers, and industry) could offer the organization a comparative advantage in constituency-based work, such as supporting workers’ banks, providing social protection through microinsurance, and generating employment through small enterprise development.

Analysis of comparative advantage can guide agencies to determine their optimal level of involvement in microfinance. Some possible action scenarios include:

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

As donor agencies identify and act on their comparative advantage, they can also build on one another's strengths to form operational alliances. Collaboration makes possible the consistent application of good practice standards, a greater range of funding instruments and partners, and reduced transactions costs – enabling donors to attain far more impact together than any single donor could achieve alone.

Options for this kind of collaboration range along a wide 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. Regardless of the model chosen, preliminary experience suggests that the key to success of true collaboration is a clearly articulated vision that is shared by all donors involved.

An example of good collaborative practice is the multi-donor Pro-poor Financial Sector Deepening Program (FSD Program) in Tanzania, where four donors pooled funds to support the expansion of financial services to poor people. The FSD program, led by DFID and including CIDA, Sida and the Royal Netherlands Embassy, is built on a common vision, harmonization of procedures, and a professionally-managed trust mechanism to implement capacity-building projects, mainly with financial intermediaries.

The Southeastern European Funds represent another example of this kind of collaboration. In recognition of its comparative advantage in technical expertise, experience with banking instruments, and knowledge of financial intermediaries in the region, KfW manages these funds on behalf of multiple donors, including the EC, BMZ, SDC, the Austrian government, and Netherlands Development Finance Company (FMO).

## LIST OF AGENCIES PARTICIPATING IN THE PEER REVIEW EXERCISE

Donor Agency	Date	Donor Reviewers	CGAP Reviewers
<b>Bilateral Agencies</b>			
Agence Française de Développement (AFD)	10-14 March 2003	Camilla Bengtsson, Sida Roland Siller, KfW	Brigit Helms Eric Duflos
Canadian International Development Agency (CIDA)	9-13 June 2003	Ross Croulet, AfDB Kate McKee, USAID	Jennifer Isern Eric Duflos
DANIDA	28 April- 1 May 2003	Doris Wong, CIDA Kathy von Daeniken, SDC	Xavier Reille Eric Duflos
Department for International Development (DFID)	13-17 May 2002	Kate McKee, USAID Leila Webster, World Bank Group	Brigit Helms Alexia Latortue
Gesellschaft für Technische Zusammenarbeit (GTZ)	14-18 July 2003	Nimal Fernando, AsDB Craig Churchill, ILO	Alexia Latortue Eric Duflos
Kreditanstalt für Wiederaufbau (KfW)	14-18 Oct 2002	Anne Clerc, AFD David Ferrand, DFID	Syed Hashemi Alexia Latortue
Netherlands	19-23 May 2003	Bernd Balkenhol, ILO Mavis Owusu-Gyamfi, DFID Sanjay Sinha, EDA Rural Systems	Syed Hashemi Alexia Latortue
Norwegian Agency for Development Cooperation (NORAD)	4-7 June 2002	Gabriela Braun, GTZ Stav Zotalis, AusAID	Brigit Helms Alexia Latortue
Swedish International Development Agency (Sida)	20-24 May 2002	Richard Roberts, FAO David Stanton, DFID	Brigit Helms Alexia Latortue
Swiss Agency for Development and Cooperation (SDC)	18-22 Aug 2003	Dirk Steinwand, GTZ Johan de Waard, Netherlands	Brigit Helms Eric Duflos
US Agency for International Development (USAID)	10-18 Nov 2003	Richard Boulter, DFID Henri Dommel, IFAD	Brigit Helms Eric Duflos
<b>Multilateral Agencies</b>			
African Development Bank (AfDB)	6-10 May 2002	Camilla Bengtsson, Sida Stephan Boven, EBRD	Elizabeth Littlefield Alexia Latortue
Asian Development Bank (AsDB)	8-12 July 2002	Henri Dommel, IFAD David Stanton, DFID	Syed Hashemi Alexia Latortue
European Commission (EC)	24-28 March 2003	Henri Dommel, IFAD Gisela Strand, Sida	Brigit Helms Eric Duflos
International Fund for Agricultural Development (IFAD)	17-21 June 2002	Heather Clark, UNCDF/UNDP Hege Gulli, NORAD	Douglas Pearce Alexia Latortue
International Labor Organization (ILO)	10-14 Feb 2003	Hege Gulli, NORAD Peter Kooi, UNCDF/UNDP	Brigit Helms Alexia Latortue
UN Development Programme and UN Capital Development Fund (UNDP and UNCDF)	21-25 Oct 2002	Nimal Fernando, AsDB Arlina Tarigan-Sibero, KfW	Brigit Helms Alexia Latortue

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Authors:  
Brigit Helms  
Alexia Latortue