



## SMARTAID FOR MICROFINANCE INDEX 2011

### KFW ENTWICKLUNGSBANK (KFW)



## Background

The SmartAid for Microfinance Index measures and rates the way microfinance funders work. Heads of 29 major development institutions endorsed CGAP's development of the Index.<sup>1</sup>

The premise of SmartAid is simple: funders with strong management systems are better equipped to support microfinance effectively. Its indicators assess five areas agreed by all funders as critical for effective microfinance: strategic clarity, staff capacity, accountability for results, knowledge management, and appropriate instruments.

SmartAid enables funders to understand how their systems, policies, procedures, and incentives affect their work in microfinance. An independent, external assessment, the Index highlights strengths and areas for improvement. It can also provide an impetus for funders to take action, prioritize changes, and hold themselves to account for their own performance.

Funders support microfinance with the goal of reducing poor people's vulnerabilities and increasing their incomes. Having the right systems is a necessary, not sufficient, condition for achieving this goal. SmartAid does not, however, evaluate the quality of programs on-the-ground.

Six funders— AusAID, EIB, GIZ, KfW, MIF and UNCDF —participated in SmartAid 2011, increasing the total number of funders participating in the SmartAid Index to 18. Prior rounds have included the participation of AECID, AFD, AfDB, AsDB, CIDA, EC, FMO, IFAD, IFC, ILO, SDC, and Sida. Four agencies from the 2011 round had participated in prior SmartAid rounds (GIZ, KfW, MIF, and UNCDF). This diverse group of funders includes development finance institutions focusing mainly on mature retail institutions, large multilateral development institutions that make sovereign loans to governments, and bilateral and multilateral agencies that primarily provide grants.

The Index presents a standard appropriate for all types of donors and investors. However, good performance against the indicators can take different forms for different agencies. Systems that work can look radically different across funders, based on numerous factors including size, level of centralization, and strategy.

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<sup>1</sup>See the Better Aid for Access to Finance meeting, 2006: [www.cgap.org/betteraid\\_meeting/compact](http://www.cgap.org/betteraid_meeting/compact).

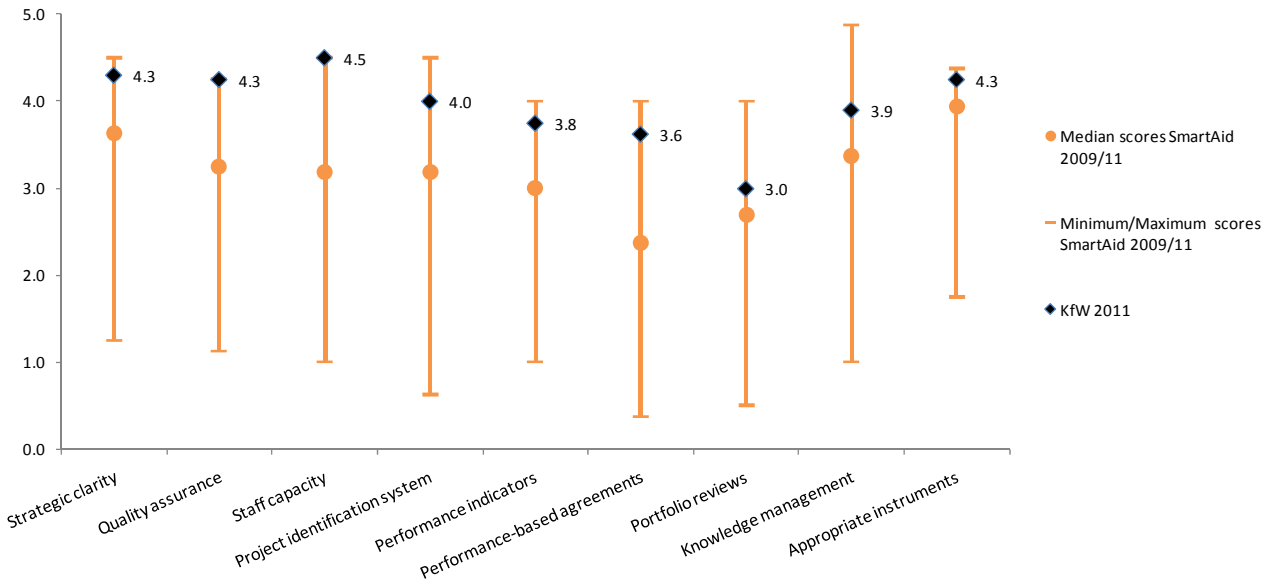
# Key Findings

KfW received 80 out of 100 points, meaning that overall it has “very good” systems in place to support microfinance. As the graph below shows, KfW received scores of 4 and higher on 5 out of 9 indicators (on a scale from 0 to 5). It received the strongest score of any agency in the past two rounds on staff capacity (indicator 3) and had very strong scores on strategic clarity, quality assurance and appropriate instruments (indicators 1, 2, and 9). The scores on project identification system and knowledge management are only slightly lower (indicators 4 and 8). Scores are comparatively less strong, but still much higher than the median scores, on indicators related to accountability, namely performance indicators, performance-based agreements, and portfolio reviews (indicators 5, 6, 7).

KfW is by far the funder with the largest commitments to microfinance. With \$2.6 billion committed, KfW represents 12% of total cross-border funding to microfinance and its portfolio has been growing significantly in the last few years. With size comes responsibility, and KfW has undertaken several steps to be a responsible funder. The move of the Competency Centre for Sustainable Economic Development to the Africa & Middle East directorate can be interpreted as a clear sign as to where KfW will, and can, add most value in the future.

At a Glance	
Type of funder:	Development finance institution
Microfinance portfolio (committed as of 12/2009):	\$2.6 billion
Microfinance as % of total portfolio:	9%
Number of projects:	153
Primary level(s) of intervention:	<input checked="" type="checkbox"/> Retail <input type="checkbox"/> Infrastructure <input type="checkbox"/> Policy
Primary instrument(s):	Commercially-priced debt, equity
Primary source of funding:	Public funds, Private commercially oriented funds

KfW Scores



KfW was an early pioneer and still plays a leading role in advancing responsible finance principles within the industry, and has integrated them in internal systems. As reflected in the scores, staff capacity is one of KfW's major assets. This is a prerequisite to successively broaden the range of financial products and approaches used to support access to finance. With a growing portfolio and an increasingly complex market environment, systems for institutional learning become more and more important.

## Key Strengths and Weaknesses

- **Strategic Clarity (4.3/5.0).** KfW's microfinance strategy builds on the BMZ policy on financial systems development (FSD), a comprehensive framework that is binding for all German development cooperation agencies. The BMZ policy aims at developing sustainable local financial systems and requires that projects are based on the principles of subsidiarity, comparative advantage, integration with country policies and sustainability. Although dated 2004, this strategic framework is still relevant and takes into account current challenges in broadening and deepening access to finance.

KfW's 2011 Microfinance Strategy, formally endorsed in April 2011, sets a clear strategic focus and is responsive to recent developments in the industry such as over-indebtedness and overheating in certain market segments. Several internal guidelines and the Financial Sector Toolkit help operationalize the strategy. The Toolkit is user-friendly, accessible on the intranet and also used for staff training. More could be done to integrate the different strategy documents, position papers and internal guidelines into a coherent "strategy package" that is easily available to staff. The weight of the policy papers issued by the Competency Centre could be strengthened, for example by ensuring that they are regularly integrated into the Toolkit.

As the funder with the largest commitments to microfinance, KfW has a major impact on microfinance markets. KfW takes this responsibility seriously by championing the responsible finance agenda in the industry and by taking steps to ensure its investments, and those of its partners, are responsible. KfW has clear responsible finance guidelines that are approved by management. They include a checklist for promoting responsible finance and suggest integrating a responsible finance clause in agreements with partners.

KfW is often an anchor investor, leveraging capital of other investors. In its project documents, KfW articulates how the projects it designs add value. While additionality is discussed during project appraisals, there are no explicit operational guidelines that explain what additionality means for KfW and how to check whether investments fulfill additionality criteria. It is increasingly important for DFIs to explicitly clarify in their strategies and due diligence guidelines what additionality means for their investments. This not only helps to ensure that all staff are aligned in their approach, but also to ensure that it is not just taken for granted with every project.

- **Quality Assurance (4.3/5.0).** KfW is a fairly centralized organization with microfinance specialists at headquarters designing, implementing and monitoring microfinance investments. Quality assurance relies in the first place on the capacity of project managers. They have good operational tools at their disposal, e.g. a solid due diligence checklist, and are trained on processes and technical skills. Microfinance specialists in thematic teams (Schwerpunktteams) within the regional directorates can draw on technical advice of the Competency Centre for Sustainable Economic Development. Housed

within the Africa & Middle East regional directorate, the Competency Centre is close to operations and has a clear mandate to develop and review compliance with technical quality standards. A Quality Assurance Committee (QSG) reviews a sample of projects and checks policy compliance. Its recommendations enjoy very high attention within KfW and are binding. Thematic teams and the Competency Centre are responsible for implementation, and there are strong incentives for project managers to follow the QSG recommendations. Thematic teams have to report on the progress of implementation at one subsequent QSG meeting. However, it is unclear whether there are any other follow-up mechanisms that ensure recommendations are implemented.

- **Staff Capacity (4.5/5.0).** KfW's Competency Centre for Sustainable Economic Development counts seven staff with microfinance expertise and experience working at KfW. Job descriptions for project managers in the regional teams require a strong academic background and solid knowledge of microfinance and international best practices. As KfW is a fairly centralized organization, there are only six staff that work on microfinance in country offices. KfW can hire consultants through project budgets according to clear guidelines or through a special BMZ fund (Studien- und Beratungsfonds). KfW invests heavily in training and skills-building of its staff. The Competency Centre has a mandate to organize regular internal microfinance trainings, an annual Financial Sector Seminar, and the Financial Sector Symposium, an industry-wide learning event. Staff can also participate in external trainings such as the Boulder Microfinance Programme and the Frankfurt School of Finance & Management's Summer Academies. The practice of including technical staff in ex-post evaluations is an excellent way of developing staff skills, sharing knowledge across teams and building microfinance knowledge within the evaluation department.
- **Project Identification System (4.0/5.0).** KfW has a solid project identification system that captures all microfinance projects. Staff is required to code all projects using the official DAC CRS codes for financial sector development. Recently, a subsector code for microfinance was introduced which allows the Competency Centre to easily identify KfW's microfinance portfolio. There are no coding guidelines, but the accuracy of the codes is checked annually by the Competency Centre and discrepancies are resolved with the relevant teams. All staff within KfW has access to the project database and can export the list of microfinance projects to Excel. Data on disbursements and outstanding amounts is accessible and updated monthly, but it is tracked in a separate system which makes it more cumbersome for staff to get an overview on disbursement schedules. Given the size of KfW's microfinance portfolio, having an integrated system with all project data and fiduciary information in one place would facilitate tracking the portfolio.
- **Performance Indicators (3.8/5.0).** Reporting on the performance of projects is required, whether for direct investments in microfinance institutions or for investments via holdings or other types of investment vehicles. BMZ requires annual monitoring reports for projects financed with BMZ funds. Regular reporting to the board of managing directors is required for any investments in microfinance. The templates for project proposals and monitoring reports require financial performance indicators, and the bank monitoring template incorporates a list of performance indicators based on industry standards. Agreements aimed at strengthening the market infrastructure are beginning to include performance targets. KfW is testing a framework for social performance reporting for MIVs which could be used as a standard in the future, within KfW and beyond. In general, KfW is strong at monitoring the

performance of intermediaries (MIVs, holdings, etc.) in which it invests, as well as the performance of their underlying investment portfolio. However, it is unclear how this information is analyzed and whether KfW checks if its portfolio is aligned with its development objectives. For example, the portfolio overviews prepared by the Competency Center provide a good snapshot of KfW's activities in microfinance, but they do not include any information about the performance of investments.

- **Performance-based agreements (3.6/5.0).** KfW includes performance-based elements in loan contracts and technical assistance agreements. The agreements define performance targets and measures for non-compliance. Partners are required to report on indicators defined in the agreements and performance is monitored by the project managers. Loan contracts specify a waiver procedure which has proven useful during the financial crisis. While granting waivers was appropriate under these market circumstances, the risk that waivers are used extensively needs to be managed. While KfW's role as an anchor investor makes it difficult to terminate loan agreements or reject waivers, clear criteria and conditions for waivers could help enforce agreements. KfW plays an active role on the boards of institutions it supports as an equity investor, which is another way to influence performance and ensure that agreements are respected.
- **Portfolio Reviews (3.0/5.0).** KfW conducts ex-post evaluations for a sample of its projects and has undertaken several cross-cutting reviews. KfW uses cross-cutting portfolio reviews to look at the performance of underlying investments and at the quality of its inputs; however such reviews are not done on a regular basis. The cross-sector analysis of ex-post evaluations from 1990 to 2009 provided a good analysis of project performance across the financial sector. The review looked at project success rates and analyzed performance patterns across time, regions and types of projects. As it was based on existing ex-post evaluations only, it did not look at detailed financial and social performance indicators of the institutions currently supported by KfW in order to come to an overall judgment of the performance of the portfolio as a whole. Another report that compares evaluations of financial sector projects dates back to 2002; but a new evaluation is planned for 2011. The evaluation of KfW's investments in ProCredit is another example of a portfolio review covering a substantial segment of KfW's investments, albeit focused on one client. Ex-post evaluations do include some cross-cutting conclusions, but they are not consolidated or systematically analyzed, which limits their impact on future project design. Ensuring that the results of cross-cutting evaluations feed into decision-making and that there is a management response would further strengthen the learning utility of these evaluations. As the largest and one of the leading funders in microfinance KfW should

### Good Practice Highlight

#### Responsible Finance - From commitment to practice

KfW has undertaken several steps to integrate responsible finance into its internal systems. It has clearly articulated what responsible finance means for KfW and how it feeds into operations. The definition of "red lines" (Rote Linien) helps staff identify and critically assess responsible finance issues during due diligence. KfW has integrated responsible finance clauses into agreements with MFIs, holdings, investment vehicles and apexes. The new microfinance strategy includes a strategic focus on strengthening conditions for responsible finance, and KfW considers potential support of the financial market infrastructure to help improve responsible finance practices (credit bureaus, bank supervision, payment systems, and financial literacy).

integrate regular portfolio reviews as part of its accountability systems in order to continually stay ahead of the curve and continue to improve future project design.

- **Knowledge Management (3.9/5.0).** KfW uses a broad variety of knowledge management tools to make sure staff has access to information and is up to date on key issues in microfinance. The Competency Centre for Sustainable Economic Development has a clear mandate for internal and external knowledge management and organizes several learning events per year, for example the annual Financial Sector Symposium, a renowned industry event. All staff come together at an annual retreat and there are regular meetings of financial sector teams, between the team leaders and the Competency Centre for Sustainable Economic Development and between the different Competency Centres. Cross-regional working groups have been formed around specific topics, such as responsible finance, and include country office staff. The intranet is a one-stop-shop for guidelines, operational tools, such as the Financial Sector Toolkit, and publications and provides information on who to contact on specific issues. These tools are useful to ensure an efficient one-way communication flow and access to information. However, knowledge management should also entail two-way communication and feedback mechanisms so that knowledge is distilled and feeds back into the project cycle (e.g. through case studies, lessons learned briefs). A recent analysis of KfW's information and knowledge management systems identified strengths and weaknesses and provides a good roadmap with concrete recommendations to strengthen the system. Implementing these recommendations and consolidating the various tools into a coherent approach will help KfW adapt to the increasing knowledge management challenges that go hand in hand with a growing portfolio and staff.
- **Appropriate Instruments (4.3/5.0).** KfW can use a wide range of products to act on its microfinance strategy. It is clearly defined which products can be used with BMZ funds and which can be used with KfW's own funds. KfW has the ability to develop, deploy and manage innovative financial products and to provide local currency funding. Internal risk management procedures for microfinance investments have been clarified recently and there are mechanisms in place to resolve differences of opinions between the risk department and the technical departments. While there is a clear division of labor among the German development agencies with GIZ as the main technical assistance provider, KfW can provide TA as an accompanying measure to investments and for the creation of greenfield microfinance institutions. As a DFI, KfW has to balance financial and developmental returns. A developmental rating system has been introduced to rate investments done with KfW's own funds. There are guidelines for the pricing of loans and a due diligence checklist for investments in funds that include responsible finance and social performance aspects. While the checklist addresses the exit strategy of funds, there is no clear policy on KfW's own exit strategies. As building local capital markets is a strategic objective, there should be more thinking about concrete exit strategies in the medium to long term.

## Recommendations

KfW is a leading funder of microfinance, not only based on the size of its portfolio, but also thanks to its strong staff capacity and thought leadership on topical issues within the industry. Through its participation in a donor peer review in 2002, the SmartAid pilot round in 2007 and SmartAid 2011, KfW has continuously shown its strong commitment to effectiveness. Already a top performer in 2007, KfW has further strengthened its internal systems since then. The strong commitment of KfW's management to financial

systems development and microfinance in particular has helped bring about these internal changes. The Competency Centre for Sustainable Economic Development was further strengthened with additional staff, and its move to the Africa & Middle East directorate helps align its operations with KfW's strategic focus. The new Microfinance Strategy takes into account current challenges within the industry and sets clear lines of action going forward. While there have been improvements on accountability systems, notably on the use of performance-based agreements, this area still needs more attention.

The following suggestions emerge from the SmartAid review:

- **Learn from what works and what doesn't and make sure findings feed into future project design.** There is an enormous wealth of experience at the level of project managers. Extracting this learning from individuals so that it feeds the overall institutional learning process requires a few additional steps. Recommendations from each ex-post evaluation should be consolidated and the Competency Centre for Sustainable Economic Development should follow through to ensure recommendations are implemented. In addition to ex-post evaluations, KfW should explore the use of mid-term evaluations which would help learning during project implementation. KfW should also do regular portfolio reviews that analyze the performance of projects throughout the portfolio and also look at the quality of KfW's inputs and its additionality. Portfolio reviews can cover the full portfolio, a specific region or delivery model, e.g. greenfields or downscaling, but they should follow a similar methodology so that results can be compared. Lessons learned from portfolio reviews should be discussed with management and feed into strategy discussions. The Competency Centre should develop an implementation plan for recommendations from portfolio reviews and ex-post evaluations. More opportunities for staff to exchange could also help strengthen KfW as a learning institution.
- **Strengthen performance-based agreements.** For performance-based agreements to be effective, clear and realistic measures for non-compliance have to be defined. While KfW has the legal power to enforce compliance with performance targets in agreements there seems to be more reflection needed on what measures can actually be taken. Enforcing the agreement without putting the borrowing institution, or even the broader market, at risk is a balancing act. A clear policy on the waiver procedure with defined application criteria and conditions in case a waiver is granted would help this balancing act. It would also be helpful for coordination with other investors as a means for clarifying performance expectations and approaches to non-compliance upfront.
- **Facilitate overview on disbursements and outstanding amounts.** So far, transaction management is handled separately from project implementation. As a consequence, information on disbursements and outstanding amounts is not tracked in the same system as project documents, monitoring reports and performance information. Staff has to consult separate systems to get an overview on the disbursements made by KfW to a partner institution and the performance of this institution. KfW should consider creating an integrated system where both project-level information and transaction management data can be accessed easily by staff.
- **Take social performance reporting to the next level.** KfW is a pioneer in terms of integrating responsible finance principles into operations and regularly includes social indicators in its reporting requirements. More recently, there have been commendable efforts made to strengthen further social

performance measurement within KfW. The social performance questionnaire currently being tested in one region is a strong tool and could become a standard once lessons learned are integrated.

## Methodology

SmartAid distills learning from over nine years of aid effectiveness work undertaken by CGAP with its members. The indicators draw on the consensus *Good Practice Guidelines for Funders of Microfinance* and a body of knowledge developed through peer reviews, country reviews, and portfolio reviews. Aid effectiveness experts from the Center for Global Development and OECD’s Development Assistance Committee contributed crucial advice.

The nine indicators used in the SmartAid Index were selected and refined over the course of a pilot round in 2007, an external evaluation, consultation with experts and the first round of the Index in 2009. For the 2011 round two of the indicators were further refined to remove redundancy, however the indicators remain consistent in nature and scores are comparable across the 2009 and 2011 rounds. The scores of the 2007 pilot round are not comparable.

The nine indicators are worth between 10 and 15 points each, for a total maximum of 100 points (see table).

Different weights are assigned to indicators, giving more prominence to those that make a greater difference in a funders’ work in microfinance. Accountability for results is a powerful element and accounts for 40 percent of the score. As the wise dictum goes, what cannot be measured, cannot be managed.

The Index is based on self-reported documentation from participating funders, following instructions in the SmartAid Submission Guide. Scores are determined by a review board of four microfinance specialists with broad experience with a range of funders. Each review board member independently scores all funders against all indicators; final scores are agreed upon after discussion among reviewers. For each indicator, funders receive a score on a 0-5 scale (5 being the highest score). These scores are then multiplied by a factor of two or three to arrive at the 100 point scale. Medians as well as minimum and maximum scores shown in the graph in the Key Findings section represent the scores of all participants of the 2009 and 2011 SmartAid rounds. For agencies participating in more than one round, only their latest score is included in the medians.

Naturally, a margin of error is unavoidable in this type of exercise. Funders should not give undue attention to differences of one or two points. The most strong and meaningful messages lie in where a funder performs along the range of scores for each indicator as well as whether its overall performance lies in the “very good,” “good,” “partially adequate,” “weak,” or “inadequate,” range.

	Points	Range
★★★★★ ★★★★★	90–100 80–89	Very Good
★★★★☆ ★★★★☆	70–79 60–69	Good
★★★☆☆ ★★★☆☆	50–59 40–49	Partially Adequate
★★★☆☆ ★★☆☆*	30–39 20–29	Weak
★★☆☆* ★★☆☆*	10–19 0–9	Inadequate

<b>SmartAid for Microfinance Index Indicators</b>			
<b>Strategic Clarity</b>	<b>1</b>	Funder has a policy and strategy that addresses microfinance, is in line with good practice, and is based on its capabilities and constraints.	<b>15 points</b>
<b>Staff Capacity</b>	<b>2</b>	Funder has quality assurance systems in place to support microfinance projects and investments.	<b>10 points</b>
	<b>3</b>	Funder has the staff capacity required to deliver on its microfinance strategy.	<b>15 points</b>
<b>Accountability for Results</b>	<b>4</b>	Funder has a system in place that identifies all microfinance projects and components.	<b>10 points</b>
	<b>5</b>	Funder monitors and analyzes performance indicators for microfinance projects and investments.	<b>10 points</b>
	<b>6</b>	Funder incorporates performance-based elements in standard agreements with partners.	<b>10 points</b>
	<b>7</b>	Funder regularly reviews the performance of its microfinance portfolio.	<b>10 points</b>
<b>Knowledge Management</b>	<b>8</b>	Funder has systems and resources for active knowledge management for microfinance.	<b>10 points</b>
<b>Appropriate Instruments</b>	<b>9</b>	Funder has appropriate instrument(s) to support the development of local financial markets.	<b>10 points</b>
<b>MAXIMUM SCORE</b>			<b>100 points</b>

## About CGAP

CGAP is an independent policy and research center dedicated to advancing financial access for the world's poor. It is supported by over 30 development agencies and private foundations who share a common mission to alleviate poverty. Housed at the World Bank, CGAP provides market intelligence, promotes standards, develops innovative solutions, and offers advisory services to governments, microfinance providers, donors, and investors.

## Funders participating in SmartAid to date

Agencia Española de Cooperación Internacional para el Desarrollo (AECID), Agence Française de Développement (AFD), African Development Bank (AfDB), Asian Development Bank (AsDB), Australian Agency for International Development (AusAID), Canadian International Development Agency (CIDA), European Commission (EC), European Investment Bank (EIB), FMO, Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ), International Fund for Agricultural Development (IFAD), KfW Entwicklungsbank (KfW), International Finance Corporation (IFC), International Labour Organization (ILO), Multilateral Investment Fund (MIF), Swedish International Development Cooperation Agency (Sida), Swiss Agency for Development and Cooperation (SDC), United Nations Capital Development Fund (UNCDF)

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