

African Development Bank (ADB) Letter to Management

Executive Summary

A team comprised of Camilla Bengtsson of Sida, Stephan Boven of EBRD, and Elizabeth Littlefield and Alexia Latortue of CGAP conducted a Donor Peer Review of the African Development Bank (ADB) in Abidjan from 6-10 May, 2002. The review is part of a 21-agency initiative launched by UK Secretary of State Clare Short 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 ADB to identify the success factors and constraints that influence the effectiveness of the Bank's microfinance operations. AMINA and the Task Force provided the team with an orientation to ADB and organized meetings with about 30 staff members. The team briefed President Omar Kabbaj, the AMINA Oversight Committee, and the Task Force on its initial findings on May 10.

The Peer Review team found its visit to be timely given the debate and decisions underway at ADB regarding AMINA and the future role of microfinance in the Bank. The team hopes that this management letter will enrich the internal discussions and provide specific ideas of how the Bank can move toward good practice microfinance.

The analysis of strengths and challenges, and the recommendations included in this letter take into account all of the Bank's microcredit activities, including the portfolio of country and sector departments and the work of AMINA. The matrix at the end of the letter provides a summary of the key findings and recommendations organized around six strategic areas.

The recommendations depend on whether ADB decides to make a strategic shift toward a new vision of microfinance: the creation of permanent financial systems for the poor. A key element of this shift entails the urgent need to improve the performance of credit components in multi-sector projects in the country and sector departments. The team suggests that ADB consider its recommendations as a set of actions to take during a short, intensive reform period (1-2 years) to clean up the portfolio and create a positive environment for future work in microfinance.

The Peer Review team's specific suggested actions for change fall into three main categories:

- ***Articulate Clear Strategy and Vision.*** ADB should clarify internally what microfinance is, how it differs from targeted microcredit components and when and how it can contribute to the Bank's overarching goal of poverty reduction.
- ***Improve Accountability and Enhance Current Operations.*** ADB should make it a priority to gather and analyze basic information on the Bank's portfolio of microcredit components and to introduce performance-based criteria.
- ***Strengthen the Central Microfinance Unit.*** ADB should house the microfinance unit in the Private Sector Department and ensure that it is sufficiently staffed to operate as a dedicated internal service unit to task managers in the country and sector departments.

Background

Early in 2002, CGAP and DFID's Secretary of State Clare Short launched an initiative to improve aid effectiveness, using microfinance as a test case. As a first step in this initiative, more than 20 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 will 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 apply to other areas of development assistance pursued by each agency.

A Peer Review team including Camilla Bengtsson, Senior Microfinance Advisor of Sida, Stephan Boven, Principal Banker of EBRD, Elizabeth Littlefield, Executive Director of CGAP and Alexia Latortue, Microfinance Specialist of CGAP visited the African Development Bank (ADB) in Abidjan from 6-10 May, 2002. The review team interviewed about 30 ADB staff members from a wide range of departments, including social development, agriculture, policy and the country departments.

The Peer Review team's findings for ADB, contained in this management letter, will be combined with those from other agencies in a synthesis report. The overall results and specific follow-up actions will be discussed in a meeting hosted by Clare Short in Rabat, Morocco on September 9, 2002. A final meeting of all the Ministers and heads of agencies participating in the peer reviews will be organized upon completion of all the reviews in 2003 to share experiences and changes made as a result of the exercise.

This management letter outlines ADB's strengths and challenges with respect to applying good practices in microfinance, taking into account all the Bank's microcredit activities including the portfolio of country departments and the work of AMINA. It then presents a number of specific recommendations for change. Finally, a summary matrix presents the key findings and recommendations according to six analytical areas.

ADB Strengths

ADB is well poised to play a leadership role in alleviating poverty and promoting development in Africa. Through its presence on the continent and cadre of professional staff from diverse African nations, ADB enjoys close relationships with its member countries and possesses a good understanding of local realities. Through the African Development Fund (ADF), the ADB is dedicated to working with the poorest of African member countries.

Though microfinance represents a small portion of its overall activities in loan volume terms, ADB enjoys several strengths that could translate into comparative advantage in microfinance.

- The creation of a pilot microfinance technical unit—AMINA—in 1997 represents the start of a fundamental shift in how microcredit is viewed within ADB. Microfinance, or rather microcredit, was originally seen primarily as a tool to mitigate the negative social impact of structural adjustment programs. The very decision to create AMINA signaled an appreciation within the Bank of the potential of microfinance as not simply a means of transferring resources to beneficiaries but a means to proactively build permanent financial services for the poor. ADB has further solidified its commitment to microfinance by hiring four dedicated specialists. Moreover, management has given the green light to convert the pilot project AMINA into a permanent Central Microfinance Unit pending Board approval of a business plan in July 2002.
- ADB staff, managers and Board are highly competent and experienced, and express remarkable consistency in their commitment to reducing poverty and contributing to sustainable growth in Africa.
- ADB staff widely recognize and frankly discuss the poor performance of microcredit components in multi-sector projects. At the same time, they express an increased awareness, analytical interest and excitement about the potential of microfinance and want to learn about successful experiences and models to emulate. These positive and open attitudes are highly conducive to improving the microfinance portfolio.
- The high levels of trust of country governments enjoyed by ADB staff ensures access to senior government officials and enables a comparative advantage for helping to improve the policy framework for microfinance and influencing important policy processes such as PRSPs. ADB has a rare advantage among donor agencies and multilaterals in its potential to effectively convince governments of the steps needed to create an enabling environment for financial services for the poor.
- ADB's active Board of Directors is interested in the institutional viability of intermediaries providing financial services, sending a strong signal that projects should use specialized implementing partners and ensure that a conducive enabling environment exists. The Board thus provides an important level of quality control before projects are approved and disbursements made.

ADB Challenges

Notwithstanding its strengths and potential in microfinance, the ADB faces several serious constraints to improving its effectiveness:

- ADB staff exhibit lack of clarity about what microfinance is. Specifically, staff grapple with the difference between the *microcredit* historically included in many rural, agricultural and other projects, and the notion of *sustainable microfinance* that is broader than credit and places a priority on the permanent access to financial services for poor people. Microfinance as a specialized field requiring specialized expertise is a fairly new concept at the Bank.

Many ADB staff perceive microfinance as a small, insignificant activity with limited potential to contribute to the Bank's overarching goal of poverty reduction. Also, many express doubts that sustainable financial services can help the poor and poorest.

- Microcredit is generally seen as an input or catalyst to multi-sector projects to achieve objectives of country and sector departments. Project designers often assume that credit is a key constraining factor to the success of social and rural development projects. However, ADB staff indicate that disbursement rates on credit components could be as low as 17 percent. The low disbursement rates of many projects call into question whether credit truly is a binding constraint. These low disbursement rates also suggest that even when credit is a key constraint, poor component design or the use of inappropriate instruments inhibits effective disbursement.
- It appears that credit components are not working as well as they should. ADB staff express that client (end-user) repayment rates are very low. Only now is a sense of urgency beginning to develop despite an organizational culture of resource transfers to the poor that tends to breed complacency about repayment performance. Staff should be encouraged not to be satisfied only as long as the target group receives the funds, rather than considering how much more effective the funds could become if they were repaid and lent to others.
- There is a near total absence of information on the credit portfolio. Project objectives and monitoring seldom specifically address the credit component. End-user repayment rates and other performance indicators are rarely tracked leading to the rapid depletion of funds that do not “revolve.”
- Along with other multilateral development banks (MDBs), ADB must determine how its main financing instrument—credit lines to government—can effectively support sound microfinance. As much as governments are the essential client for policy work mounted by MDBs, international experience suggests that microfinance is fundamentally a private sector activity and that government ministries are not the appropriate implementing entities for financial services delivery. Moreover, the ADB should ensure that government involvement in project origination and technical issues does not introduce a political dimension to projects that works against good practice.
- ADB, like most MDBs, suffers from disbursement pressures since task managers are at least partly assessed by the number of projects presented to the Board. This disbursement pressure is antithetical to improving the quality of the microfinance portfolio, which tends to be less intensive in funding and more intensive in technical inputs.
- By virtue of its very design and high-level position within the agency, AMINA has been separated from the rest of the Bank. Reporting directly to the vice-president for operations and charged with its own projects in 10 pilot countries, AMINA is perceived as being “apart” or isolated from the rest of the Bank. In addition, AMINA's leadership at the outset seems to have caused some tensions between AMINA and the rest of the Bank. AMINA has only recently become involved in mainstreaming activities, and has only recently begun to see this internal focus as a high priority.

- In the context of creating the new Central Microfinance Unit, ADB lacks consensus on the appropriate institutional home for the unit and on whether specialized staff should be concentrated or dispersed. There is a risk that microfinance would be erroneously perceived as cross-cutting rather than a specialized field if the unit is placed in the policy department, thus losing the commercial focus that is so important for sustainable microfinance. Another major risk would be to diffuse expertise too thinly by spreading staff out among too many departments.
- ADB has insufficient staff to carry out the human resource-intensive work of improving the portfolio of the country and sector departments and supporting the creation of financial systems for the poor across Africa. Outside of AMINA, ADB lacks capacity in microfinance skills, and task managers have little time to acquire new skills. Additionally, with the exception of the director, AMINA staff are consultants without full benefits which compromises motivation. Recruiting consultants to augment thin staff capacity is cumbersome and time consuming.

Recommendations

The Peer Review team has specific recommendations for ADB to build on its strengths and comparative advantages and improve its effectiveness in microfinance. These recommendations focus on the urgent need over the short-term (1 to 2 years) to support the country and sector departments in improving the performance of credit components in multi-sector projects. The “Future Microfinance Operations” part of the matrix in the next section highlights areas where ADB may wish to explore developing comparative advantage in the future.

If ADB is interested in supporting a new vision for microfinance that seeks to build permanent financial systems for the poor, the following strategic shift should be adopted.

| Microcredit as an Input | Financial Services for the Poor |
|--|--|
| Targeting, supply driven → | Market research, demand-driven |
| One-off, time bound to length of project → | Permanent access to financial services |
| Subsidized interest rates, depleting capital → | Cost-recovery/commercial interest rates, revolving capital |
| Delivery managed through project implementation units (public) → | Delivery managed by specialized financial intermediaries (private) |
| Generalists, technical know-how not incorporated in design → | Specialist, technical input early in design stages |
| Accountability for outreach: size of target group → | Accountability for performance: clear indicators on efficiency, financial viability and outreach |

The following recommendations rest on the premise that ADB is committed to making the strategic shift and supporting the development of sustainable financial services for the poor.

1) ADB needs **strategic clarity** internally on what microfinance is, how it differs from microcredit and how it contributes to the Bank's overarching goal of poverty reduction. ADB also needs to gain clarity on how it can best support microfinance. This strategic clarity could be achieved by taking four specific actions:

- *Write a Case Statement.* ADB top management should commission the Central Microfinance Unit and the Task Force for microfinance to craft a Case Statement on the contribution of microfinance to poverty reduction and sustainable growth, and the role of microfinance within the Bank. The Case Statement should clearly define the strategic shift that started in 1997 by demonstrating how microfinance aims to establish a permanent financial system for the poor, rather than being a mere input to social and rural projects.
- *Expose ADB staff to broad vision of microfinance.* ADB should organize a series of informal meetings and workshops to make staff aware of the new vision of microfinance as a broad discipline that encompasses not only credit, but also savings, insurance, payment systems, etc. This information campaign should help task managers understand the potential of microfinance as a field in its own right.
- *Embed microfinance organizationally and conceptually in the private sector.* ADB should make microfinance part of the Private Sector Development (PSD) department, both organizationally and conceptually. Notwithstanding microfinance's contribution to the social and agricultural sectors (e.g. health, education, women's empowerment, rural households), a market-oriented approach and business-like emphasis is critical to building permanent, sustainable services for the poor. The sustainability of the financial services will in turn ensure the on-going social contributions. This suggested move into the PSD department is subject to PSD having an interest in taking on microfinance and having a strategy that would accommodate financial services for the poor.
- *Develop operational "what works" notes.* ADB should develop short, concrete operational notes ("what works") to help task managers make decisions about microfinance in the challenging environments of ADF countries, in rural settings with agriculture-dependant households and for the very poor. The notes should draw from existing experiences and tools of other donors and practitioners, and highlight ADB success stories whenever possible.

2) ADB should enhance its microfinance operations by **improving accountability for results**.

- *Collect basic information on portfolio.* ADB urgently needs basic information on the size, distribution, disbursement rates and performance of its microfinance portfolio. At a minimum, data on performance should include financial, outreach and efficiency indicators. Strategies for improving results will fail unless they are grounded in good information.
- *Introduce performance criteria for credit lines.* ADB should introduce performance criteria for disbursement of funds to apexes and microfinance institutions under ADB-funded credit components. Funding to implementing partners should be based on performance-based contracts whereby funds are disbursed in tranches against the achievement of well-defined minimum performance thresholds. Such contracts require unambiguous, measurable performance targets and close monitoring.
- *Combat disbursement pressure.* ADB should encourage task managers to re-allocate unutilized funds in credit components without penalty in order to relieve disbursement pressure on microfinance and ensure the best use of development assistance. While more

difficult to implement, ADB managers and executive directors—like all managers of donor agencies—need to align incentives to reduce disbursement pressure and reward good performance.

- *Publicize simple Board criteria.* Given the Board’s detailed scrutiny of credit components and increasing requests for additional information, ADB should formalize and publicize criteria used by the Board to evaluate the components. These have largely related to including increased information on microfinance institutions in appraisal reports, and demonstrating the need for microfinance as the most suitable instrument in a given situation. Disseminating the criteria widely would enable task managers to address them early in the design stage. The criteria should be as simple as possible to ensure they are known to all task managers and executive directors without needing to refer to a policy document (one or two criteria enforced is preferable to many not enforced). At a minimum, the criteria could include whether the intermediary charges commercial interest rates. Others could be ensuring the intermediary is a specialized institution and that the government is not involved in the direct delivery of financial services.
- 3) ADB should **strengthen the technical capacity of the Central Microfinance Unit** to re-direct its focus internally to serve the country and sector departments and improve the portfolio. This internal focus is essential for the short and intensive reform period of one to two years.

Role

- *Focus on task managers as sole clients.* The central unit’s customer for the immediate term should be task managers in the country and sector departments. Departments with sufficient levels of microfinance activity should be assigned a specific dedicated staff member from the unit. Though unit staff should report to the head of the central unit, operations departments to whom they are assigned should provide input in their annual performance appraisal. Unit staff should offer the following services to task managers:
 - offer technical input early in project origination and design phases
 - assist in project preparation including accompanying project identification missions, designing TORs, designing projects, identifying consultants and conferring with other donors on task managers’ projects
 - perform continual backstopping of task managers throughout the project cycle
 - participate in country policy and enabling environment work (CSPs, PRSPs)
 - support project-specific capacity building through specialized service providers
- *Adopt a proactive approach to mainstreaming.* In addition to responding as a first priority to operations departments, unit staff should be proactive, helpful and provide hands-on operational advice in its mainstreaming activities. Unit staff should engage in the following mainstreaming tasks:
 - manage internal data gathering, analysis and dissemination; build microfinance indicators in LAF
 - offer regular in-house training on basics of microfinance
 - disseminate internal and external models and sound practice cases
 - draft short briefs and operational guidelines
 - develop tools for task managers such as sample performance-based contracts

- *Phase out AMINA projects.* The unit should not take on new projects and should phase out existing commitments. The unit should do policy work upon the request of country departments. Staff should leverage the contacts they already enjoy with other donors and multi-donor consortia such as CGAP.

Organizational Structure

- *Concentrate staff in central unit.* A critical mass of microfinance specialists should be housed together in the unit to build cohesion and credibility. This concentration of staff will facilitate the cross-fertilization of knowledge in the rapidly evolving microfinance field and will help the team promote a coherent vision of microfinance across the Bank.
- *House the unit in the PSD department.* The Central Microfinance Unit should be housed in the Private Sector Development department, providing the department is interested in incorporating the unit and in supporting the development of financial services for the poor. Microfinance is about financial intermediation and is best done by financial experts as a private sector activity. The portfolio, however, will remain with the operations departments (all but about USD 1 million of ADB's microfinance portfolio is in components managed by country and sector departments).
- *Keep funds with the unit.* The remaining unspent AMINA TAF funds should continue to be earmarked for microfinance and should be managed by the central unit for: a) salaries and operational costs of the unit for internal mainstreaming; b) policy work as demanded by country departments; and c) capacity building fund that country and sector departments can tap for their projects.

Staffing

- *Enhance full-time technical staff.* ADB should staff the new Central Microfinance Unit with between 5 to 7 persons to concentrate on improving the credit portfolio during a short, intensive period of reform (1 to 2 years). Having sufficient microfinance specialists in the unit is critical to provide country and sector departments with dedicated staff, obtain results and quickly create a more positive environment for future microfinance work. Specialists should be recruited for their proven competence in microfinance, knowledge of MDBs, strong interpersonal skills and high energy. New recruits should be given one to two year contracts. Once the existing portfolio is improved and greater clarity achieved for the future role of microfinance, ADB should offer regular Bank contracts to staff whose profiles reflect the new vision of ADB's comparative advantage in microfinance.
- *Assign specific staff from the unit to support each department.* Assigning each requesting department a specific person from within the unit will help ensure ownership, accessibility and a relationship of trust. The directors of the departments could provide input on their assigned microfinance specialist's annual performance appraisal.
- *Improve ease of access to expert consultants.* ADB should have access to consultants with diverse expertise in the broad field of microfinance to augment the capacity of the central unit and allow for detailed, specialized follow-up with the country and sector departments. ADB should negotiate a pre-approved roster of microfinance consultants with Human Resources to maximize flexibility and ensure timely response to country and sector departments' requests for assistance. This roster could be housed as a sub-database in HR's larger database.

AID EFFECTIVENESS AND MICROFINANCE MATRIX – African Development Bank (ADB)

| | | Analysis | Recommendations |
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| 1. | Strategic Clarity and Organizational Culture | <ul style="list-style-type: none"> • Very consistent commitment to poverty reduction • Less clarity on the vision of microfinance and its potential to contribute to overarching goal • Organizational culture of resource transfer to target populations fuels complacency about repayment performance of microfinance partners • Inadequate expertise on how financial services might be appropriate for rural areas and the very poor | <ul style="list-style-type: none"> • Develop <i>Case Statement</i> that demonstrates the impact of microfinance as a powerful tool for poverty reduction and suggests a strategic shift for ADB in microfinance • Run informal clinics and workshops on how a permanent financial system for the poor meets with ADB’s goals • Research innovative solutions for rural finance and serving the poor; leverage relationships with other donors on this topic |
| 2. | Technical Expertise & Resources | <ul style="list-style-type: none"> • Focal unit understaffed and cannot do “hands-on” work with operations departments • Recruitment process for consultants is cumbersome and slow | <ul style="list-style-type: none"> • Staff up unit (5-7 specialists) to assist in project identification & design, draft TORs & contracts, develop tools, identify consultants, and facilitate capacity building • Recruit staff with proven microfinance technical expertise and familiarity with MDBs • Create pre-approved roster of MF consultants |
| 3. | Organizational Structure and Flows | <ul style="list-style-type: none"> • Lack of consensus on appropriate institutional home for focal unit • Lack of consensus on whether specialized staff should be concentrated or dispersed among operations departments • Uncertainty on whether and how the unspent TAF funds will remain earmarked for microfinance and who will control them • Weak links and low trust between focal unit and operations department • Focal unit does not view internal functions as priority • Focal unit has little knowledge of projects with credit components (disbursement, repayment rates) • Little to no microfinance—or finance—capacity in | <ul style="list-style-type: none"> • Place focal unit in PSD, subject to PSD’s interest, and harmonize the title of head of unit with the rest of ADB nomenclature • Retain TAF allocated to AMINA in central unit • Assign staff from focal unit as dedicated resource to support operations departments • Include input from operations departments on annual focal unit staff performance appraisal • Establish a profile for central unit staff; stress qualities such as energetic, good communications and interpersonal skills, results-oriented • Phase out projects managed by focal unit; keep portfolio with operations • Offer regular in-house trainings on basic |

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|----|---------------------------------------|---|---|
| | | <p>operations departments</p> <ul style="list-style-type: none"> • Heavy travel schedules and work loads inhibit ability to acquire knowledge of new areas and skills | <p>principles of microfinance</p> <ul style="list-style-type: none"> • Develop operational “what works” notes • Disseminate internal and external models and sound practice case studies to emulate |
| 4. | Instruments and Incentives | <ul style="list-style-type: none"> • Credit lines to governments and implementation managed by Project Implementation Units not effective • Disbursement pressure since task managers are informally assessed on the number of projects presented to Board • ADB staff risk adverse due to Board-level pressure to improve overall portfolio of Bank • AMINA staff (except director) are consultants without full benefits leading to lack of motivation | <ul style="list-style-type: none"> • Structure instruments to ensure selection of existing, specialized implementing partners for credit components • Introduce performance criteria that hold partners accountable for results and disburse against attainment of performance targets • Allow reallocation of unused credit components • Provide 1 to 2 year contracts with full benefits during transition, then offer regular Bank positions |
| 5. | Project Cycle | <ul style="list-style-type: none"> • ADB working towards minimizing potential negative effect of governments’ involvement in project origination for influencing project design • Majority of design done by economists without finance skills • Monitoring is very weak due to an absence of information on the credit portfolio • Board is introducing quality control by posing detailed questions on credit components, but it is too late in the project cycle | <ul style="list-style-type: none"> • Ensure technical input in early stages of project inception and design • Participate in policy and enabling environment work (CSPs, PRSPs) • Formalize and publicize criteria used by Board so quality control occurs prior to Board meetings, e.g. one criterion could be whether the intermediary charges commercial interest rates • Create internal database for microfinance and help build indicators into LAFs • Backstop task managers during project cycle |
| 6. | Future Microfinance Operations | <ul style="list-style-type: none"> • Trust of member country governments • Staff has strong knowledge of local realities • Africa’s <i>investment</i> bank | <ul style="list-style-type: none"> • Explore comparative advantage in enabling policy environment work • Explore comparative advantage in innovation building on indigenous informal finance • Explore comparative advantage in loans/equity investments in commercially viable MF institutions |

