

# Department for International Development (DFID) Letter to Management

## Executive Summary

A team comprising Kate McKee of USAID, Leila Webster of the World Bank Group, and Brigit Helms and Alexia Latortue of CGAP conducted a Donor Peer Review of DFID in London from 13-17 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 DFID to identify the success factors and constraints that influence the effectiveness of the agency's microfinance operations. EDD provided the team with an orientation to DFID and organized meetings with over 50 staff members, including extensive consultation with field-level staff and a field visit to Uganda. The team briefed Director General Richard Manning, several department heads and staff on its initial findings on May 17.

The Peer Review team found its visit to be timely given the reorganization and new priorities at DFID that present some potential trade-offs for effective pro-poor finance. The team hopes that this management letter will enrich the internal discussions and provide specific ideas of how DFID can maintain its successful pro-poor finance practice within the move towards large programs, PRSPs, upstream work, and the increasing program budget.

This letter outlines DFID's strengths and challenges, and presents a number of specific recommendations for change. A matrix at the end of the letter provides a summary of the key findings and recommendations organized around six strategic areas.

The recommendations address the risk that pro-poor finance will become increasingly marginalized within DFID. The Peer Review team's suggested actions for change fall into four main categories:

- ***Achieve Strategic Clarity.*** DFID should clarify internally the contribution of pro-poor finance to the Millennium Development Goals and how best to support it.
- ***Adopt a Pluralistic Approach to Support Modalities—PRSP Plus.*** DFID should adopt a pluralistic approach and work both within the PRS process (budget support, SWAPs) and outside, including investments in the sector globally, as well as at wholesale and retail levels, to deepen the financial sector.
- ***Maintain Technical Skill in Pro-poor Finance.*** DFID should maintain its key comparative advantage *vis-à-vis* other donors in pro-poor finance—the quality of its technical staff.
- ***Clarify Role of London-based Technical Advisors.*** DFID should house EDD with private sector and/or financial sector development departments. DFID should also clarify the role of London-based staff as a service center for other advisory, regional and policy departments, with responsibilities for internal mainstreaming and engaging internationally.

## **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 also apply to other areas of development assistance pursued by each agency.

A Peer Review team including Kate McKee, Director, Office of Microenterprise Development, USAID and Leila Webster, Program Manager, SME Department, World Bank Group visited DFID headquarters from 13–17 May, 2002. This team was accompanied by Brigit Helms and Alexia Latortue of the CGAP Secretariat. The review team interviewed more than 50 DFID staff members from a wide range of departments. Given the decentralized nature of DFID operations, the team made a significant effort to obtain views from the country offices, both through telephone interviews and a field visit to Uganda conducted from 29 April–3 May, 2002.

The Peer Review team's findings for DFID, 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 DFID's strengths and challenges with respect to applying good practices in microfinance. 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.

## **DFID Strengths**

DFID is clearly recognized within the donor community to have a deep and clear commitment to the Millennium Development Goals (MDGs). Internally, DFID staff display a remarkable level of consistency and coherence in referring to the MDGs and related DFID policies.

DFID plays a leadership role in pro-poor finance within the donor community. DFID has made a strong contribution to sustainable impact in the global microfinance industry, and this contribution has been disproportionate to its microfinance grant budget. DFID's comparative advantage in pro-poor finance rests on the following factors:

- Superior technical staff, both as reported by other donors in the field and colleagues in the country offices and headquarters.
- Positive influence in the sector globally through its technical and funding partnership with CGAP, including active participation on its Executive Committee.
- Deep and effective relationships with local stakeholders and knowledge of field-level context, based on decentralized structure and the presence of Enterprise Advisors in the country offices.
- Credibility with policy makers, private sector stakeholders and other donors derived from its grounded technical capacity. DFID leverages this credibility to enhance its effectiveness in upstream work.
- High quality, sustainable investments in building institutions for the permanent availability of financial services – not just isolated projects.
- Innovation in pushing the frontier on product development, new funding instruments, and alternative delivery mechanisms (examples include MicroSave Africa, AfriCap, SIDBI).

### **DFID Challenges**

Notwithstanding its strong comparative advantage, DFID faces a number of current constraints to making pro-poor finance even more effective:

- There is a need for greater clarity on how pro-poor finance links to DFID's major priorities related to growth and poverty eradication. For instance, DFID staff have not made the connection between ensuring access to financial services among the poor and achieving the MDGs. It is unclear where the responsibility for policy-setting lies, and what channels are in place for ensuring staff internalization of policies that exist.
- Microfinance appears to be marginalized in parts of DFID. Many staff perceive microfinance as a disjointed set of small projects that do not seem significant. Despite a number of large and highly strategic investments in microfinance market development, for example in India, Eastern and Southern Africa, staff question whether there has been sufficient impact, scale, and systemic change from microfinance projects.
- Efforts to mainstream good practices for microfinance throughout DFID could be improved, especially in departments that use credit components in their projects.
- As in other agencies and across the microfinance industry, DFID struggles with the challenge of how to apply or bend microfinance best practices to more difficult settings, like rural finance, post-conflict, humanitarian situations, etc.
- The increasing programme budget without a concomitant increase in the budget for running costs has placed enormous pressure within DFID to achieve higher and higher degrees of leverage from already overstretched staff.
- The support role of the London-based technical advisors in knowledge management and evidence-based learning could be strengthened. With only 2 full time advisory staff without any specific geographical responsibilities, EDD finds it difficult to balance the various roles

for the center: developing global public goods; conducting policy work and influencing the multilaterals; and serving as a service unit to both specialists and non-specialists across the agency.

- A pre-condition to improving practices in pro-poor finance is having a better knowledge of the portfolio. Currently DFID does not have a clear grip on the extent of financial services offered throughout the agency, especially credit components in larger multi-sector projects.

In addition to the challenges listed above that relate to DFID's current constraints, DFID's new priorities present some clear trade-offs with respect to aid effectiveness in pro-poor finance.

- **PRSP and budget support.** Working through PRSPs and budget support raises important questions about the role of the private sector, including the financial sector, in development. Pro-poor finance is an inherently private sector activity, inappropriate for direct government intervention. DFID will have to address with partner governments and private organizations how the financial sector fits into the PRS process, and choose where to focus in the range of financial sector reform activities, with pro-poor finance as one possible area.
- **Large Programs.** Microfinance does not always lend itself to "big spend" projects, especially the upstream work currently preferred by DFID. It is difficult and often inappropriate to move large amounts of money into microfinance. As with many other areas of the private sector, some of the activities that add the most value have small budgets, and are often labor-intensive.
- **Upstreaming.** Within DFID there is a perceived illegitimacy of downstream work, but it is precisely DFID's downstream groundedness and concrete technical arguments drawn from direct knowledge of current retail practice that have afforded DFID the credibility with which to influence the upstream players. The upstreaming agenda will also affect the type of staff DFID hires, as it will increasingly look for Private Sector Development generalists rather than staff with specialist expertise.
- **Outsourcing.** Whilst being clearly defensible on efficiency grounds, outsourcing removes technical staff from the action and makes it more difficult to ensure that lessons are learned.
- **Multilateralism.** Working with or through multilateral institutions could pose a risk of losing direct contact with operations, possibly presenting new challenges for ensuring consistency with DFID's standards and international best practices.
- **Reorganization.** The impending reorganization of the Policy Division prioritizes greater inter-disciplinary integration, which could erode the value accorded to specialized expertise.

The overall picture of the "new" DFID could mean that the agency does less pro-poor finance, and risks the deskilling and loss of ground-truthing of its staff – the very basis of its comparative advantage

## Recommendations

Given the current challenges facing DFID and the potential trade-offs with the new priorities, the Peer Review team has specific recommendations for DFID to build on its strengths and comparative advantages and improve its effectiveness in pro-poor finance.

- 1) DFID needs to gain **strategic clarity** on what pro-poor finance is about and how to support it. This strategic clarity could be achieved by pursuing four inter-related activities:
  - *Craft Case Statement.* DFID should craft its own *Case Statement* for pro-poor finance that would inform leadership and staff (specialist and non-specialist alike), other donors, multilaterals, the British public, etc. on why DFID engages in this field and how making financial markets work for the poor contributes to the MDGs.
  - *Develop operational guidance.* DFID should develop concrete operational “how to” guidance to incorporate good practices in all programmes with finance components. The guidance should target key individuals in DFID and outline the most effective ways to support pro-poor financial development in specific circumstances, e.g. the relationship between pro-poor finance and rural livelihoods, a very challenging global issue.
  - *Promote evidence-based learning.* DFID specialist advisors should commission non-academic, practical action research in the field that is used to support evidence-based learning internally on strategic issues related to pro-poor finance. The technical advisors (Enterprise Advisors or future equivalent) should engage both DFID colleagues in departments such as rural livelihoods, and other donors to address challenges such as rural, post-conflict, and humanitarian situations.
  - *Reaffirm commitment to pro-poor finance at high level.* Given the Secretary of State’s strong influence on DFID policy and staff priorities, the *Case Statement* should be accompanied by a reaffirmation by the Secretary of State of DFID’s commitment to pro-poor finance.
- 2) DFID needs to take a pluralistic approach to its support modalities that moves beyond PRSP and budget support – **PRSP Plus**. This strategy entails working both within and outside of the PRS process to improve effectiveness.
  - *Include pro-poor finance in PRSPs.* Within the PRS process, DFID can draw on its technical comparative advantage to facilitate input by the private sector; ensure that the content of the PRSPs is technically sound (i.e. keeping government out of direct delivery of financial services); and provide concrete inputs to advance pro-poor financial sector development (i.e. supporting government to enhance the enabling environment, legal/regulatory framework, etc.).
  - *Continue work outside PRSPs.* Beyond the PRS process (that is, the “plus” part), DFID should retain the flexibility to make complementary investments at the sectoral, wholesale, and retail levels – even, when necessary, through funding very small projects. This flexibility is crucial to maintain the strong link between the upstream credibility and downstream experience, and also remains important for countries outside the PRSP framework. For instance, DFID’s East and Southern African umbrella financial services programs constitute cutting-edge, high value projects that keep DFID active at all levels of the industry. Additionally, specialist advisors should explore the possibility of applying new non-grant financial instruments afforded by the new Development Act to microfinance operations.

- 3) Given the prominence of DFID’s technical skills in defining its comparative advantage *vis-à-vis* other donors, and the risk of deskilling under the agency’s new priorities, DFID should do all it can to **maintain its technical skills in pro-poor finance**.
- *Retain specialist staff.* DFID should pursue a balanced recruitment strategy, hiring versatile technical staff that can work both upstream and downstream and optimize linkages between the different levels. However, to avoid having too many generalists that lose the deep knowledge and experience, DFID should ensure that it retains 2 – 3 world-class specialists located in the field, as is currently the case.
  - *Integrate knowledge management in work processes.* DFID should ensure that technical advisor job descriptions and work plans include sufficient time and space for knowledge management and feedback loops to enhance learning within the organization. At least 20 percent of all advisors’ time should be dedicated to this function. In the case of outsourcing approaches like the challenge funds and umbrella projects, DFID should explicitly build in a role for technical advisors to learn and share experiences.
  - *Develop appropriate incentives.* DFID should make sure that the values of grounded work, knowledge management, and learning (as opposed to disbursement of large sums) are integrated firmly into incentive systems and the annual review process.
- 4) To enhance and improve its effectiveness in pro-poor finance, DFID could further **optimize its organizational structure**, and in particular **clarify the role** of the London-based technical advisors.

Internal Functions. The London-based advisors should play two crucial internal roles: “mainstreaming” good practices throughout the organization, and acting as a service center to specialist advisors.

*Mainstream good practices.* Mainstreaming good practices within DFID, especially among non-microfinance specialist staff, constitutes a core function of the center that could be improved. Concrete ideas for how to improve this function include:

- More orientation and training – demand-driven tools, seminars, and sensitization
- More knowledge management – “just in time” rather than “just in case” information, feedback loops, etc.
- More proactive internal engagement with non-specialist staff, both face-to-face and electronically
- More knowledge of the portfolio through cataloguing all existing projects with microfinance and establishing a simple tracking mechanism to monitor existing and future projects, especially important to capture the proportion of the portfolio initiated by non-specialists
- Continue to outsource grant contracts like the challenge funds, to free up advisory time for mainstreaming.

*Support specialists in the field.* DFID’s specialist advisors should continue to reside in the country offices (both in-country and at headquarters) to maximize field-level practical experience. The role of the London-based advisors *vis-à-vis* this network of advisors should encompass acting as a resource to technical staff, pointing them in the direction of specific technical support or resources on a demand-driven basis. At the same time, the London-based advisors should find ways to extract learning from the field experience and systematically share that knowledge in a cost-effective and relevant way. DFID could leverage CGAP and other resources and tools to support the mainstreaming and service center roles.

*Place pro-poor finance where PSD and FSD resides.* There exists some uncertainty about where the Enterprise Advisors (or PSD advisors) would “sit” in the context of the proposed DFID reorganization. Whilst it is difficult to say exactly how the reorganization will finally pan out, it is crucial to place the enterprise advisors where private sector development and financial sector development will reside. Pro-poor finance is about “making markets work for the poor” and requires a commercial, private sector approach. This means that specialist skills and advisors should be readily identifiable with the strong market-oriented approach, even as they work to mainstream pro-poor finance with other colleagues on important “social” issues in DFID’s development agenda.

External Functions. DFID’s central office also has an important external role to play, both through supporting its International Financial Institutions Department (possibly through brigaded staff) and directly. DFID’s culture of collaboration and donor coordination is particularly conducive to this strategy, and would also allow it to take a leadership and/or collaborative role in producing and disseminating international public goods that help build the pro-poor finance industry. An example of this type of contribution is action research and tools on new product development through jointly-funded projects like *MicroSave-Africa*. It is important to note that DFID’s internal strengths reinforce the effectiveness and robustness of its external work. Also, selective engagement with multilateral structures will help maximize DFID’s impact on pro-poor financial systems.

Staff Up. To fully play the important mainstreaming, service center, knowledge management, and international leadership roles, the center would require more technical resources than currently available. The current complement of 2 people will not be sufficient, especially considering that pro-poor finance is only one part of EDD’s work, and of DFID’s overall private sector agenda of making markets work for the poor. The Review Team recommends that the current global resources based in London be extended to 3 full time people, with at least one specialized in pro-poor finance. In addition, 1-2 highly-skilled advisors should be placed in the field, with a certain amount of flexibility to support country offices regionally or globally.

## AID EFFECTIVENESS AND MICROFINANCE MATRIX – Department for International Development (DFID)

		<b>Analysis</b>	<b>Recommendations</b>
1.	<b>Strategic Clarity and Organizational Culture</b>	<ul style="list-style-type: none"> <li>• Very consistent “big picture” vision of development and DFID’s approach (MDGs)</li> <li>• Less clarity on the role of microfinance within the larger picture</li> <li>• Lack of coherence in how financial services might fit into difficult settings (rural finance, post-conflict, humanitarian situations, etc.)</li> <li>• “Microfinance” as a concept not widely understood and often marginalized</li> <li>• Corporate culture values quality technical inputs</li> </ul>	<ul style="list-style-type: none"> <li>• Develop <i>Case Statement</i> that links pro-poor finance to MDGs and DFID priorities</li> <li>• Reaffirm commitment to pro-poor finance at highest level</li> <li>• Develop operational guidance: “how to” notes, especially for difficult settings</li> <li>• Commission practical action research to highlight DFID and others’ experience</li> </ul>
2.	<b>Technical Expertise &amp; Resources</b>	<ul style="list-style-type: none"> <li>• Superior technical capacity in microfinance, especially in the field</li> <li>• Technical capacity gives DFID credibility with upstream players</li> <li>• Trend toward recruiting/maintaining generalists rather than specialists</li> <li>• Trend toward increased outsourcing of technical work risks deskilling of advisors</li> <li>• Expertise in focal unit is not sufficient to cover all mainstreaming and technical support needs (only 2 people without specific geographical responsibilities)</li> </ul>	<ul style="list-style-type: none"> <li>• Maintain technical skills in microfinance</li> <li>• Retain 3 staff (with PSD skills, including pro-poor finance) at the center to play a full time support role, and 2-3 world-class specialists (as currently the case) in the field to play a regional advisory role</li> <li>• Make sure outsourced contracts include explicit opportunities for technical advisors to learn and share experiences</li> </ul>
3.	<b>Organizational Structure and Flows</b>	<ul style="list-style-type: none"> <li>• Focal unit exists and has strong technical capacity</li> <li>• Very strong knowledge of local conditions through decentralized structure</li> <li>• Role of the focal unit is unclear with respect to both internal and external functions, and its institutional home under the reorganization of Policy Division</li> <li>• Efforts to mainstream good microfinance</li> </ul>	<ul style="list-style-type: none"> <li>• Clarify role of the London-based advisors, both internal functions and external</li> <li>• Mainstream good practices to non-specialists: more orientation and training, knowledge management, proactive internal engagement with non-specialist staff, knowledge of the portfolio</li> <li>• Act as service center to specialist advisors</li> <li>• Continue to outsource grant contracts like the</li> </ul>

		<p>practices throughout DFID could be improved</p> <ul style="list-style-type: none"> <li>• Focal unit is not aware of all DFID projects with finance components, especially in countries/regions without enterprise advisors</li> <li>• Information flows not sufficient to ensure knowledge generation and sharing within and outside of DFID</li> <li>• Strong collaboration with other donors and stakeholders</li> </ul>	<p>challenge funds to free up advisory time</p> <ul style="list-style-type: none"> <li>• Build knowledge management and feedback loops into technical advisors' workplans (20% of their time)</li> <li>• Place enterprise advisors under market-oriented teams in the reorganization</li> <li>• Engage selectively with multilateral organizations involved in microfinance, possibly through brigaded staff to IFID</li> </ul>
4.	<b>Instruments and Incentives</b>	<ul style="list-style-type: none"> <li>• Very appropriate and flexible grant instruments used to promote sustainable microfinance institutions with a performance-based approach</li> <li>• Willingness to take a certain amount of risk and promote innovation</li> <li>• New Development Act offers possibility of using non-grant financial instruments for microfinance</li> <li>• Trend toward budget support and sector-wide approaches via the PRSP process may not be conducive to good microfinance programming</li> <li>• Incentives trend toward large-scale programs and upstream policy work</li> </ul>	<ul style="list-style-type: none"> <li>• Adopt a two-pronged "PRSP Plus" approach to development assistance</li> <li>• Within PRS process, ensure private sector input, sound technical content, and pro-poor finance contribution</li> <li>• Retain flexibility to make complementary investments, even if they might be small</li> <li>• Explore potential of using non-grant financial instruments for microfinance</li> <li>• Build in mechanisms to ensure grounded, field-based experiences to underpin credibility for upstream work</li> </ul>
5.	<b>Project Cycle</b>	<ul style="list-style-type: none"> <li>• Where enterprise advisors exist on the ground, qualified technical staff influence the design of projects at the right time and right place</li> <li>• Insufficient monitoring of project results and learning from experiences</li> </ul>	<ul style="list-style-type: none"> <li>• Ensure systematic third party evaluations of microfinance projects</li> <li>• Compile, synthesize, and analyze monitoring information already collected in the field through a simple portfolio tracking mechanism</li> </ul>
6.	<b>Future Microfinance Operations</b>	<ul style="list-style-type: none"> <li>• Organizational trends (PRSP/budget support, large programs, upstreaming, outsourcing, etc.) present trade-offs with microfinance programming</li> <li>• Unclear vision of microfinance (as well as other areas of private sector development) going forward</li> </ul>	<ul style="list-style-type: none"> <li>• Retain microfinance as an important part of the overall strategy to achieve MDGs</li> <li>• Avoid pressure to de-emphasize microfinance when DFID has a strong leadership role</li> </ul>

