

## **DANIDA Letter to Management**

### **Executive Summary**

A team comprising Doris Wong of CIDA, Kathi von Daeniken of SDC, and Xavier Reille and Eric Duflos of CGAP conducted a Donor Peer Review of DANIDA in Copenhagen from 28 April to 1 May, 2003. The review is part of a 17-agency initiative launched by Development Ministers, Head of Agencies, and CGAP to concretely tackle aid effectiveness by using microfinance as a test case.

The Peer Review team focused on the internal procedures, practices and processes of DANIDA to identify the success factors and constraints that influence the effectiveness of the agency's microfinance operations. The Technical Assistance Services (TSA) department, provided the team with an orientation to DANIDA and organized meetings with 32 people throughout the agency, including consultation with field-level staff and partners. The team briefed the Secretary of State for the South Group Carsten Staur, the Under Secretary of State Peter Lysholt Hansen, and several department heads and staff on its initial findings on 1 May.

The Peer Review team found its visit to be timely given the current reforms at DANIDA aimed at improving development cooperation overall. The team hopes that this letter to management will enrich the internal discussions and provide specific ideas of how DANIDA can increase its effectiveness in microfinance. This letter outlines DANIDA's strengths and weaknesses, and presents specific recommendations. A matrix at the end of the letter provides a summary.

The Peer Review Team makes six concrete recommendations to management to enable DANIDA to improve its microfinance operations. The team hopes these recommendations will also prove helpful for enhancing DANIDA's overall aid effectiveness.

1. ***Decide on the future level of involvement in microfinance.*** In light of DANIDA's limited comparative advantage in microfinance, management should decide, together with its partners, whether it wishes to expand, maintain or reduce its microfinance portfolio.
2. ***Build a common vision on the role of microfinance.*** DANIDA needs to articulate a clear and consensus-based vision of the role of microfinance, embed its microfinance operations in private sector development, and ensure that staff internalize the new vision.
3. ***Implement microfinance good practices.*** DANIDA needs to develop simple tools (e.g. a list of "dos and don'ts", a two-page note on what works, and a tick sheet to be used by the involved parties during program preparation and approval and integrate these tools into the aid management guidelines and other key documents.
4. ***Develop a performance measurement framework.*** DANIDA should include a set of 4-5 microfinance indicators in the design, monitoring and evaluation of its microfinance operations; analyze performance; compare it with international benchmarks; and adapt funding accordingly.
5. ***Improve technical capacity and knowledge management.*** To ensure quality and effectiveness in microfinance, DANIDA should create a full-time microfinance focal point and further train its staff in basic knowledge of microfinance good practices.
6. ***Work through strategic partnerships.*** DANIDA should identify global, regional, and country microfinance leaders (donors and practitioners), study their respective strengths, and establish strategic partnership agreements with them.

## **Background**

Early in 2002, Development Ministers, Heads of Agencies, and CGAP launched an initiative to improve aid effectiveness, using microfinance as a test case. As a first step in this initiative, 17 bilateral and multilateral development assistance agencies have volunteered to participate in a series of Donor Peer Reviews. These Peer Reviews are not evaluations or detailed portfolio reviews, but rather focus on each agency's internal procedures, processes, practices and systems to identify success factors and constraints to good practices in microfinance.

The short but intensive reviews result in concrete recommendations for each agency and should lead to senior management commitment to specific changes that improve the effectiveness of microfinance operations. It is also expected that the analysis and recommendations may apply to other areas of development assistance pursued by each agency.

A Peer Review team including Doris Wong, Enterprise Specialist of Canadian International Development Agency (CIDA), Kathi von Daeniken, Program Officer of Swiss Agency for Development and Cooperation (SDC), and Xavier Reille, Senior Microfinance Specialist and Eric Duflos, Microfinance Specialist of the Consultative Group to Assist the Poor (CGAP) visited DANIDA headquarters from 28 April to 1 May, 2003. The peer review team interviewed 32 people from a wide range of departments and units (all the regional departments, Technical Advisory Services, Policy and Planning, Financial Institutions, Evaluation, Quality Assurance, Competence Development). The peer review team also obtained views from staff from four Danish embassies, and from consultants working with DANIDA in microfinance, mostly through telephone interviews. The team presented its initial findings and recommendations to the Secretary of State for the South Group Carsten Staur, the Under Secretary of State Peter Lysholt Hansen, and to several department heads and staff on 1 May.

Follow-up to the Peer Reviews is envisioned both at the agency-specific level and across all agencies participating in the exercise. The review team and CGAP are available to discuss the recommendations contained in this letter in more detail and to support their implementation. The team's findings for DANIDA will also be combined with those from other agencies reviewed in a synthesis report. A synthesis report already exists for agencies reviewed in 2002. Overall results and issues for agencies to tackle jointly will be discussed in various fora involving technical staff and senior management. A meeting of Ministers and heads of agencies participating in the Peer Reviews will be organized upon completion of all the reviews in late 2003 / early 2004 to share experiences and reforms made as a result of the exercise.

This letter to management outlines DANIDA's strengths and weaknesses with respect to applying good practices in microfinance. It then presents a number of specific recommendations for change. Finally, a matrix summarizes the key findings and recommendations according to six analytical areas. The team hopes these recommendations will also prove helpful for enhancing DANIDA's overall aid effectiveness.

## DANIDA's Strengths

### *General strengths*

The peer review team identified the following strengths which are not specific to DANIDA's microfinance operations but affect its overall engagement in development work. These strengths include the following:

- *Commitment*: Denmark is the largest donor in terms of public development aid per capita. This commitment is reflected in the sense of dedication to development shown by DANIDA staff.
- *Pragmatism*: Staff do not spend a lot of time in ideological discussions or dogmatic approaches to development, but prefer learning-by-doing, and changing programs that do not work. Staff can also take the decision to close a program if appropriate.
- *Receptiveness and openness*: Staff are open-minded and willing to receive technical advice.
- *Consensus*: DANIDA's flat organization and small size enable people to exchange information and make rapid decisions.
- *Demand focus*: By focusing on a limited number of countries, DANIDA can gain a good knowledge of the local context, and better adapt its programs to country needs.
- *Multilateralism*: Staff are more concerned about contributing to development than promoting Danish interests. As proof, Denmark commits 44 percent of its development assistance to multilateral organizations.

### *Microfinance specific strengths*

The peer review team identified the following strengths at DANIDA that are directly relevant to microfinance operations:

- The **1999 Guidelines for support to financial services reflect good practices**. These guidelines introduce a separation of financial services from other types of services, the need for a diversity of financial services, and the importance of a supportive environment. They also explain the rationale for charging market-based interest rates, and for focusing on financial and institutional sustainability through a private sector approach.
- DANIDA incorporated some of its recent **microfinance initiatives within the financial sector**, such as in Tanzania, Nicaragua and Burkina Faso. A financial sector approach coincides with good practices as microfinance institutions (MFIs) need to be integrated in the financial systems to become independent from subsidies, borrow commercially, offer savings services, gain the capacity to reach more people, and have a larger impact on poverty reduction.
- The agency has a proven record of **cooperation with other donors** such as DFID, GTZ, AFD, IFAD, and ADB. This collaboration provides opportunities for DANIDA to exchange experiences and, in some cases, channel its funding through leaders in the sector.
- DANIDA has acquired a **good knowledge of the rural context** in the countries where it works. DANIDA has invested for years in cooperative movements and participatory development methodologies and follows a demand-driven approach. This experience can be capitalized to better promote financial services in rural areas, which is a key issue on the global microfinance agenda.

- DANIDA has some **flexibility in its funding**. By retaining unallocated funds in its program budgets (5-20%), DANIDA offers a funding flexibility that can be vital for microfinance. Microfinance programs usually require small and flexible funding over a relatively long period of time. Unlike many donors, DANIDA does not seem to have significant disbursement pressures.
- DANIDA is willing to **invest in the long term** with its partners (10-15 years). Most microfinance initiatives, especially in challenging environments, take several years before they can become fully sustainable. MFIs often require different types of subsidies over time until they become fully profitable.
- DANIDA's current **decentralization** process implies a reallocation of roles and staff to the embassies. Decentralization will bring DANIDA's staff closer to the clients and other donors, thus increasing chances to better match its programs to demand and identify other donors to partner with that complement DANIDA's strengths.
- Danish development assistance focuses more and more on the **private sector** as an engine of development. DANIDA is adopting this approach in its most recent programs. Microfinance requires a private sector perspective, as most institutions successful in providing financial services to the poor are private.

## DANIDA Weaknesses

- **Unclear vision of microfinance**: Staff interviewed do not share a common vision on the meaning and objectives of microfinance. Microfinance is often perceived as an input into a larger objective, such as credit to develop a certain type of agricultural production, rather than a segment of the financial sector. Such confusion about the role of microfinance prevents DANIDA from having a clear strategy for supporting diverse and sustainable microfinance institutions. Without a clear and common understanding and vision of the role of microfinance, DANIDA will not be able to engage effectively and efficiently in this sector.
- DANIDA does not have the **organizational structure to promote and supervise microfinance operations**. In the leading donor agencies in microfinance, the technical supervision of microfinance is usually placed within a private sector or a financial sector development unit. While DANIDA is developing more and more business development programs, there is no unit in charge of this sector yet within TAS or other departments.
- **Staff rarely know about or implement the 1999 financial sector guidelines**. This lack of awareness might be due to the fact that the guidelines have not been designed in a consensus-based way, nor are they presented in a user friendly format for those involved in operations.
- **Technical expertise at DANIDA is particularly thin**, with only one focal persons who dedicates 20% of his time to microfinance. Such limited management time prevents DANIDA from ensuring the technical supervision of its portfolio, selecting appropriate partners and consultants, writing TORs, capitalizing and disseminating experiences

internally, and participating effectively in global debates. This lack of technical supervision will gain particular significance in the context of decentralization. International experience shows that the quality of a donor's microfinance portfolio is highly correlated with its level of technical expertise. Even though DANIDA's microfinance operations are relatively small compared with other donors, they still require technical supervision, as small projects can sometimes have significant negative repercussions on the market without proper guidance.

- **Reliance on uneven external expertise.** DANIDA uses several external experts to provide technical advice to its microfinance operations. Staff interviewed perceive that the expertise of these consultants is uneven. While the size of DANIDA's microfinance portfolio justifies using external consultants, staff do not have sufficient expertise to engage with them technically. DANIDA's reliance on consultants without appropriate guidance also prevents staff from building institutional knowledge.
- There is **no consistent performance monitoring system.** While the current trend at DANIDA supports the development, of performance measurement tools through the creation of the quality assurance department the system is not yet fully in place. Lack of adequate performance measurement in microfinance prevents DANIDA from (i) being accountable for the results of its operations; (ii) learning lessons through the results of these operations; and (iii) making appropriate decisions on the allocation of resources for new phases or new microfinance operations.
- While the focal point has recently gathered information on the microfinance portfolio, DANIDA has **no formal structure to capitalize and exchange knowledge and lessons learned.** The learning process in microfinance has been mostly informal, by involving a limited number of people. DANIDA does not have instruments to collect, analyze and disseminate information on its microfinance operations. Efficient knowledge management is key for learning lessons and ensuring quality programs.
- **Budget cuts** have created a sense of insecurity among the staff. Further cuts could have a negative impact on the effectiveness of DANIDA in microfinance. These cuts could reduce the quality of programs by reducing the level of staff supervision of microfinance programs, and affecting knowledge management tools such as the web site, training or attendance at international fora.

## Recommendations

The peer review team's recommendations have to be put in the context of the current constraints and opportunities for Danish development aid. Based on its analysis, the peer review team makes the following six recommendations to management:

1. ***Decide on the level of future involvement in microfinance.*** Microfinance constitutes a low strategic priority in the development policy (Partnership 2000), in terms of budget and staff time. The peer review team believes that DANIDA has a relatively limited comparative advantage in microfinance compared with other donors that might have more technical resources and experience in financial sector development. Management, in cooperation with its partners, needs to make a decision on its level of involvement in microfinance in the future. There are three potential scenarios:
  - **Expansion:** this option would require DANIDA to transform microfinance into a strategic priority, and would require significant investments in staffing, training and programming.
  - **Consolidation:** DANIDA would retain the same volume of microfinance spending, and improve its quality following internationally accepted good practices.
  - **Phasing out:** DANIDA would stop developing new microfinance operations, and complete existing ones in light of good practices.

The following recommendations to DANIDA are to help to ensure better effectiveness in the agency's current and future operations. They are particularly relevant for the expansion and consolidation scenarios.

2. ***Build a common vision on the role of microfinance.*** The peer review team has identified the following three concrete actions that DANIDA could take to attain a clear and common understanding of microfinance:
  - **Articulate the vision.** DANIDA should develop a one-page concept note to explain what microfinance means, i.e. a diversity of financial services for a variety of clients with different needs. The poor need permanent access to financial services, among other services, to improve their social and economic situation. The concept note should make clear that microfinance today is considered to be an integral part of the overall development of the financial sector, rather than a component of agriculture development. The note should stress the need to invest in institutions that show a potential to supply financial services to the poor on a permanent basis. In the consolidation or expansion scenario, DANIDA's vision could focus on building institutions involved in microfinance such as credit unions, savings and loans institutions, financial companies, venture capital and equity investment schemes, and formal banks.
  - DANIDA should ensure that all the **staff and partners understand and internalize the vision.** This could be done by involving a critical mass of staff in the actual design of the one-page concept note mentioned above, and widely distributing this Microfinance Donor Peer Review Letter to Management. These documents could be discussed using a participatory process, during the annual meetings with embassy staff, for instance. In

addition, DANIDA should disseminate the vision to all its development partners (governments, NGOs and external consultants) once it is completed.

- DANIDA needs to **embed microfinance in its new private sector development approach**. DANIDA staff at TSA, in the embassies, and consultants should take a business like approach to develop sustainable MFIs. Most governments do not have the financial means nor expertise to subsidize financial services for the poor, and donor funding is more and more scarce. Therefore, microfinance operations are usually best managed by private sector or financial sector specialists. This business-like approach would have to complement the PRSP approach, which emphasizes government ownership. The PRSP approach could prove challenging if DANIDA is requested to fund microfinance operations that do not coincide with a private sector approach. Considering the current reflexion on the future of TSA's structure, the peer review team recommends that the microfinance operations are supervised by private sector development specialists.
3. **Implement microfinance good practices.** Over the past few years, DANIDA has made some efforts to improve its microfinance operations. It could, however, further integrate internationally accepted good practices in its operations. The peer review team provides a list of indicative tools to reach the above objective:
- Develop a **list of “dos and don'ts”**. This document could be a two-page list that spells out the very basic requirements for formulating a successful operation. The “do” list could include such items as (i) keep financial and non-financial services separate in a program; (ii) ensure that partners have a realistic plan to reach financial and institutional sustainability; (iii) require that services are clearly adapted to client demand; and (iv) establish performance targets. The list of don'ts could include (a) don't target credit to specific activities (b) don't subsidize interest rates; and (c) don't overburden MFIs with numerous objectives.
  - DANIDA needs to **draft a two-page “what works” operational note**, starting from the existing guidelines, and providing some concrete examples. For example, if DANIDA and its partners decide to launch a guarantee fund, or provide technical support to an emerging MFI, the note would explain the different steps to follow. These guidelines can be most useful for embassy personnel and partners directly involved in designing microfinance operations.
  - To ensure that the program cycle includes a basic acknowledgement of microfinance good practices, DANIDA should **draft a “tick sheet”** with key requirements from identification to appraisal. The staff responsible for the preparation and approval of new microfinance programs/components would be required to complete the sheet..
  - In the context of the current decentralization, DANIDA should include the above documents in the **aid management guidelines**. The peer review team sees no need to draft new guidelines but rather craft short key messages based on the existing guidelines and the ones produced internationally (by CGAP for example). These messages should also be included on the DANIDA website on a microfinance page, and in the Competence Center staff training, to facilitate their dissemination.

4. **Develop a performance measurement framework.** By developing a performance framework, DANIDA will gain the capacity to evaluate and report on the effectiveness of its operations. While creating more accountability *vis à vis* tax payers, it will also enable the agency to adjust its future interventions according to its results.

- DANIDA should **draft a simple set of microfinance specific indicators**, based on indicators that already exist in the microfinance industry. These four or five indicators could focus on outreach, efficiency and profitability, and be used by the embassies to monitor microfinance operations. Microfinance indicators can be found in the Microfinance Information eXchange (MIX) and in the glossary of financial terms ratios and adjustment for microfinance developed by CGAP. Please see [www.microfinancegateway.org/download/finaldefinitions.doc](http://www.microfinancegateway.org/download/finaldefinitions.doc).

- DANIDA should make its implementing partners accountable for the results of its microfinance operations by **introducing performance contracts** that include targets that need to be reached to process payments.

- DANIDA should **incorporate indicators in key documents** such as program documents, performance contracts with partners, and terms of reference for program design and evaluations. DANIDA staff should also ensure that staff regularly track and monitor performance against these indicators along the program cycle.

- DANIDA should systematically **analyze the indicators** so that staff can use the results to re-orient or maintain operations, during annual sector reviews for example. DANIDA would also approve payments and grants based on attainment of results.

- DANIDA should **compare the results of its operations with the global microfinance industry**. The industry has developed clear benchmarks to measure the performance of microfinance institutions. For example, the *Microbanking Bulletin* collects information from MFIs (NGOs, financial companies, banks, credit unions) throughout the world and posts this information on the MIX web site ([www.mixmarket.org](http://www.mixmarket.org)).

5. **Improve technical capacity and knowledge management.** While DANIDA's microfinance portfolio is relatively small, the peer review team believes that improving the current portfolio as well as addressing the new challenges arising from the decentralization process require that DANIDA increase its microfinance technical capacity and knowledge.

- DANIDA should create a **full-time microfinance focal point**. This focal point could be part of TSA in its new configuration, preferably involved in business development sector rather than agriculture. It could either be an existing staff member or a new staff with microfinance or financial sector technical expertise. The main tasks of the focal point could be the following:
  - Take leadership on microfinance matters
  - Draft the key operational documents
  - Represent DANIDA at major international fora

- Develop a system to select and monitor the quality of the external consultants
  - Identify strategic partnerships with donors, networks, and implementers
  - Build a professional network, and liaise with other networks (donors, practitioners, Nordic group, CGAP)
  - Build links between DANIDA and existing microfinance web sites (Microfinance Gateway for comprehensive information and knowledge on microfinance and the MIX for MFI and country info)
- DANIDA needs to **further train and support its staff in microfinance**. To minimize costs, DANIDA could conduct training in cooperation with other donors as is being done on PRSP, and utilize existing training material tailored to donor staff (such as the CGAP DIRECT, and other training available for donors). The newly established Competence Center and the focal point could design and manage the training in cooperation with the embassies.
6. *Work through strategic partnerships.* Microfinance networks, operators, and donor agencies have accumulated a considerable wealth of expertise in the area of financial services for the poor. Considering its limited comparative advantage and strategic focus in microfinance, the peer review team recommends that DANIDA explores and forges new strategic partnerships with leading donors and operators.
- DANIDA should **identify microfinance leaders in the field**. DANIDA and its embassies need to determine which organizations are most efficient worldwide, regionally, and in specific countries where it works. For example, some donors or operators will have excellent technical capacity but limited funds, others will have experience in financial sector development, in working in remote areas or in taking equity participation in MFIs. The focal point could help the embassies map microfinance excellence in the countries where DANIDA operates.
  - Based on its market analysis, DANIDA should **develop new partnerships in a few countries** by co-funding programs with market leaders, or even delegating some of its sub-programs to these organizations. This could be done on a global, regional and country scale.

## AID EFFECTIVENESS AND MICROFINANCE MATRIX – DANIDA

		<b>Analysis</b>	<b>Recommendations</b>
1.	<b>Strategic Clarity and Organizational Culture</b>	<ul style="list-style-type: none"> <li>• The 1999 guidelines for supporting financial services reflect good practices</li> <li>• Staff vision of microfinance is unclear, often perceived as an input to agriculture programmes rather than a segment of the financial sector</li> <li>• DANIDA incorporated its recent microfinance initiatives within financial sector development</li> <li>• DANIDA puts emphasis on private sector development</li> </ul>	<ul style="list-style-type: none"> <li>• Articulate the vision in a one page concept note with an emphasis on building sustainable institutions tied to the overall financial sector</li> <li>• Embed microfinance into DANIDA’s new private sector approach</li> <li>• Ensure that staff and partners understand and internalize the vision</li> </ul>
2.	<b>Technical Expertise &amp; Resources</b>	<ul style="list-style-type: none"> <li>• Technical expertise in microfinance is thin with only one focal point spending 20% of his time on microfinance</li> <li>• DANIDA has a good knowledge of the rural context</li> <li>• Staff cannot retain corporate knowledge of the sector because information is held by external consultants</li> <li>• Staff have difficulty in engaging effectively with external consultants</li> <li>• External expertise provides uneven quality</li> </ul>	<ul style="list-style-type: none"> <li>• Create a full time microfinance focal point with microfinance expertise, responsible for taking leadership, drafting key microfinance documents, developing a system to select and monitor consultants, building a professional network, creating links with strategic partners</li> <li>• Further train and support the staff in microfinance through the competence center, the internet and in cooperation with other donors</li> </ul>
3.	<b>Organizational Structure and Flows</b>	<ul style="list-style-type: none"> <li>• Current decentralization process will get DANIDA staff closer to the clients</li> <li>• The current structure does not enable effective promotion and supervision of microfinance operations</li> <li>• DANIDA has no formal structure to capitalize and exchange knowledge and lessons learned</li> </ul>	<ul style="list-style-type: none"> <li>• Local microfinance operations supervision within a private sector or business development team</li> </ul>
4.	<b>Instruments and Incentives</b>	<ul style="list-style-type: none"> <li>• DANIDA has proven record of cooperation with other donors (co-funding)</li> <li>• Funding instruments show flexibility with unallocated funds</li> <li>• DANIDA is willing to invest in the long term</li> </ul>	<ul style="list-style-type: none"> <li>• Work through new strategic partnerships who have complementary funding instruments and high technical capacity</li> </ul>

5.	<b>Program Cycle</b>	<ul style="list-style-type: none"> <li>• The guidelines are not utilized by the staff</li> <li>• DANIDA does not have a consistent performance monitoring system for microfinance to (i) be accountable for results, (ii) learn lessons; and (iii) make appropriate funding decisions</li> </ul>	<ul style="list-style-type: none"> <li>• Develop a list of “dos and don’ts” that spells out basic requirements for formulating a successful microfinance operation</li> <li>• Draft a two-page “what works” operational note to explain the steps to follow for each type of operation</li> <li>• Include the above documents in the aid management guidelines</li> <li>• Develop a performance framework by (i) drafting a simple set of microfinance specific indicators; (ii) incorporating indicators in key documents; (iii) analyzing the indicators; (iv) comparing them with global benchmark; and (vi) using them for management decision</li> </ul>
6.	<b>Future Microfinance Operations</b>	<ul style="list-style-type: none"> <li>• Further budget cuts could affect the quality of the supervision for microfinance operations</li> </ul>	<ul style="list-style-type: none"> <li>• Management should decide the level of future involvement in microfinance (expansion, consolidation, or reduction).</li> <li>• Develop partnerships with market leaders in a few pilot countries</li> </ul>