CGAP

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Helping to Improve Donor Effectiveness in Microfinance

BUILDING CAPACITY FOR RETAIL MICROFINANCE

Retail financial institutions remain the backbone of financial systems that serve low-income clients. They need complex skills to offer poor people quality financial services on a permanent basis. In most countries, inadequate retail capacity is the main bottleneck to scaling up microfinance. This brief addresses how funding agencies—public donors, international NGOs, private foundations, and investors—can help meet the challenge of developing retail capacity.

Elements of capacity building

Building the capacity of financial institutions starts with defining the skills needed, then designing the best package of services. Selecting the right technical service providers (TSPs) and delivery mechanisms are crucial (see examples below). These choices should take into account the institutions' background (e.g., social or banking), maturity, legal status, size, products, and staff qualifications.

TSPs *(local, regional, international)*		**Delivery Mechanisms**		**Enhanced Capacity in:**
Independent consultants Private consulting firms Networks Associations Training institutes International NGOs Funding-agency projects/staff	→	Advice and coaching Training courses Degree programs Staff exchanges Study tours Manuals and guides	→	Financial management Social performance Product design and delivery Human resource management Marketing and client satisfaction Internal controls and audit Efficiency and productivity Information systems

What approaches can funding agencies use to support capacity building?

Provide services directly. Some international NGOs, public donors, and specialized investors provide advice directly. This approach is only appropriate for agencies with strong technical staff. GTZ dedicated one of its financial systems development specialists to work for two years with BAAC, a public agricultural bank in Thailand, to attract small savers.

Contract technical service providers. This is the most common approach, which may be most suitable for new institutions that are not yet able to define their own needs. For ProCredit Bank Bulgaria's start-up and growth phase, its funders (KfW, EBRD, ProCredit, and IFC) hired IPC, a specialized firm that had created and managed similar banks in other countries.

Let the financial institution decide. Unrestricted funding allows an institution to make its own choices about the nature and source of technical services, and makes it more likely that the technical support will be used effectively. Funding can go directly to specific institutions or to a fund accessible to all that meet pre-established criteria. This approach works well with institutions mature enough to understand their own weaknesses and to identify high-quality TSPs.

Build a technical service market. In developed microfinance markets, funding agencies may help develop local TSPs by supporting them directly to improve their own technical capacity or providing funds that local financial institutions can use to buy their services. CAPAF, a multi-donor hub in francophone Africa, has developed 14 local providers of training and consulting services (www.capaf.org).

What are successful practices for building retail capacity?

Capacity building is more art than science. Getting it right is difficult. Measuring results is even harder. Funding agencies best suited to support capacity building tend to have grant instruments, specialist staff, the ability to work with specialized implementing partners, and the flexibility to do smaller projects. Here are nine factors that have been associated with success:

1. Focus on the institution's own goals. Selection and sequencing of technical services should be driven by the institution's own goals, not the funder's agenda. Although the managers of Compartamos in Mexico value recommendations from microfinance technical staff, they advise donors not to drive institutions in directions the institutions would not choose on their own or require the use of specific consultants.

2. Make a long-term commitment. Building retail capacity requires reliable access to technical services over several years. Consultants who drop in once or twice a year are usually not effective in helping new institutions build core operating systems. UNDP and ILO in Cambodia provided in-depth support to ACLEDA in its eight-year evolution from a project to a bank. ACLEDA Bank now attracts commercial investors and mobilizes savings. Funding agencies also need to honor their contractual responsibilities (e.g., timely disbursements and services).

3. Focus on the TSP's track record. Funding agencies should select TSPs that have proven their ability to produce sustainable microfinance. A recent evaluation found that almost all of UNDP's successes in microfinance involved this kind of TSP.

4. Open up the choice of consultants/TSPs. Using only TSPs of the same nationality as the funding agency, or focusing too narrowly on cost, can limit options and lead to poor results. Some agencies select the same TSPs repeatedly, which may promote a single model not suitable for all institutions. For larger investments, agencies should ask for competitive bids so they can choose from a wide array of proposals. Taking advantage of the movement toward untying aid, AFD, DFID, and others have branched out beyond their own countries to seek the best TSPs for the job.

5. Consider using local TSPs. Local technical service providers can offer the following advantages: knowledge of the country context, proximity, and cost-effectiveness. The Ford Foundation identified a group of scholars at the Rural Development Institute of the Chinese Academy of Social Sciences to investigate workable microfinance models for China. On the other hand, funding agencies should not hesitate to use international TSPs where domestic capacity is inadequate. They could also consider partnering strong TSPs from outside the country with local TSPs to help transfer knowledge.

6. Design performance-based contracts with TSPs. As much as possible, contracts should be tied to actual operational improvements in institutions, not just the TSPs' activities (e.g., number of training events). Agencies should link funding increments/renewals to performance and sanction poor performance. Renewal of World Bank contracts with TSPs in Bosnia and Herzegovina was conditioned on whether recipient institutions were satisfied with results in specific technical areas that had been measured in baseline surveys before work started.

7. Withdraw support when results are poor. In conjunction with the TSP, funding agencies must decide when an institution is simply not able or willing to improve. In some cases, the return on investment is so slim that funds are best diverted to other institutions. In Haiti, USAID redirected its focus from supporting one non-performing microfinance institution to designing technical assistance accessible to a range of promising institutions.

8. Use cost-sharing mechanisms. Asking institutions to share the costs helps confirm true demand, increases uptake of new skills, and creates performance incentives. Institutions then learn to budget for technical services—a recurring expense even for mature institutions. Shorecap Exchange has found that design, delivery, and results of technical services are better when its partners have to pay 25 percent of the cost in the first year, increasing to 50 percent in the third year.

9. Talk to others supporting the same institution. When several funding agencies are building capacity in the same institution or the same local market without consultation, inefficiency or conflicting advice can result. The various funders of *MicroSave,* a capacity building program promoting market-led microfinance, formed a program management committee to coordinate their financial support and strategic input.

Author: Ruth Goodwin-Groen, with input from CGAP staff and Anne Ritchie. **For more information:** *Building Inclusive Financial Systems: Donor Guidelines on Good Practice in Microfinance* (Washington, DC: CGAP, 2004); Ruth Goodwin-Groen, ed., *The 7 Cs for Improving Technical Service Delivery to Microfinance Institutions*, SEEP Technical Assistance Working Group (Washington, DC: SEEP Network, 2003); ShoreCap Exchange, "Technical Assistance Delivery to Small Business Banks and Microfinance Institutions: What Works?" Exchanging Views Series No. 1(Chicago: ShoreCap Exchange, forthcoming 2005). CGAP, *Pilot Capacity-building initiative in Africa: What have we learned?* CGAP Focus Note, no. 14 (Washington, DC: CGAP, 1999); David Cracknell, et al, "Lessons from MicroSave's Action Research Programme" (Nairobi, Kenya: *MicroSave*, 2002), www.microsave.org; FACET, "Evaluation of Southern African Micro Finance Capacity Building Facility" (AD Zeist, the Netherlands: FACET BV, 2002). Details on the examples cited are provided in CGAP's "Case Studies in Donor Good Practice," www.cgap.org/direct/ resources/case_studies.html..